FOUNDATIONS OF INTERNATIONAL INCOME TAXATION

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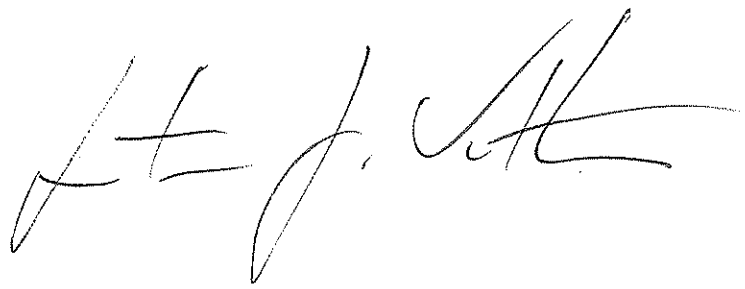

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Through the detailed investigation of this major example of an international regulatory clash (cross-border tax arbitrage), the fundamental question of all global regulatory systems can be clarified and distilled: What vision of international regulatory relations should animate government policy? In making regulatory decisions in the absence of full information, countries must determine the nature of the relationship between and among nationally based regulatory regimes. A nationalist-driven perspective emphasizes competition; a more global perspective encourages cooperation. In reality, neither approach likely serves national or international interests because neither nationalism nor globalism constitutes a defensible, definable goal. The real question is whose interests are to be taken into account in making a policy decision and what outcomes will serve those interests. In tax matters, nations are the dominant actors and can be expected (at least loosely) to promote national interests. The paths most likely to advance these interests will vary by time and context, and may include a range of more or less cooperative behaviors. It is through the detailed investigation of cross-border tax arbitrage that we can gain more insight into this universal regulatory question.

NOTE

A Balancing Act. Diane Ring weighs the criteria of efficiency, equity, political accountability, and revenue impact in her assessment of responses to different forms of tax arbitrage. She acknowledges that the results of her balancing test are not static and will change with the policy goals of the United States government. Specifically in regard to the United States legislation addressing DRCs, Ring uses her balancing test to suggest that:

> The U.S. course of action raises the question of why Congress felt compelled to act in a case in which the balancing test suggests it may not have been advisable to do so unilaterally. Based on the legislative history and commentary surrounding the arbitrage, the most likely answer is a combination of strong pressure from U.S. corporations and a powerful sense of outrage at what seemed an insultingly blatant thwarting of the single-tax principle. In addition, unilateral action was available to Congress whereas multilateral action would typically require the administration's involvement.

Professor Ring concludes with her opinion that a combination of harmonization and competition/independence is the most desirable outcome in cross-border tax regulation. She states, however, that there are multiple ways in which these goals can be achieved and that they need to be considered within the context of the complicated relationships between the relevant countries. For further discussion of tax competition and harmonization, see Chapter 11.

Chapter 4

The Foreign Tax Credit

4.1 Introduction

The U.S. allows income taxes imposed by nations where U.S. citizens or residents earn foreign-source income to be credited against the income taxes that would otherwise be imposed by the United States. Technically, U.S. citizens and residents are subject to U.S. taxation of their worldwide income regardless of its source and therefore need tax relief in order to reduce or eliminate "double taxation." A foreign tax credit ("FTC") is a means of relieving international taxpayers from the burden of paying taxes twice on the same income: once to the country of source, where the income is earned, and again to the country where the taxpayer resides. This system of crediting foreign income taxes first entered the U.S. income tax law in 1918. In 1921 Congress limited the foreign tax credit to the amount of U.S. tax that would have been imposed on the foreign source income. The foreign tax credit has served as the cornerstone of U.S. international tax policy ever since.

There are traditionally three ways by which the country of residence may afford relief: (1) by allowing a deduction of source-country taxes; (2) by exempting source-country income from residence-country taxation; and (3) by crediting source-country taxes against residence-country taxes. The deduction system is the least generous, since the relief is limited to the foreign tax times the taxpayer's domestic marginal tax rate. Exemption is the most generous, subjecting the foreign-source income only to foreign taxation, no matter how low the foreign rate. A credit may offer dollar-for-dollar relief against residence-country taxation. The following table illustrates these three different methods. Assume the U.S. taxpayer's foreign operations generate $100 of taxable income, subject to a foreign tax rate of 30%, and its domestic operations generate $100 of taxable income, subject to the U.S. tax rate of 35%.

Method	Foreign tax	Total U.S. tax (on both domestic and foreign income)	U.S. tax on foreign income	Total tax on foreign income (U.S. tax + foreign tax)
Deduct foreign taxes	$30	$59.50 ($200 − $30) = $170 × .35	$24.50 ($59.50 − $35) [Total U.S. tax	$54.50

		[Total income minus foreign tax multiplied by U.S. tax rate of 35%]	minus U.S. tax on U.S. source income]	
Exempt foreign income	$30	$35 ($100× .35) [No U.S. tax on foreign income]	$0	$30
Credit foreign income taxes	$30 [U.S. tax on worldwide income ($70) minus foreign tax ($30)]	$40 ($70 – $30) [$70 (U.S. tax on worldwide income) minus $30 (the foreign tax credited)]	$5 ($40 – $35)	$35

For the first five years after the Sixteenth Amendment took effect in 1913, the Treasury allowed only a deduction for foreign taxes paid. In 1918 the United States unilaterally instituted a foreign tax credit at the suggestion of T.S. Adams, an economist who was the key Treasury tax advisor during the period when the policy regarding international taxation was being formulated.

When a foreign tax credit is adopted, various issues arise that inevitably complicate the computation of tax. First is the limitation on the credit. If the residence country were to credit fully foreign taxes imposed on foreign-source income at a higher tax rate than the residence country's rate, the residence country would reduce the tax otherwise collected on income earned in its own jurisdiction, in effect benefiting the foreign treasury at the expense of its own fisc. A limitation on the foreign tax credit is essential if the U.S. is to collect its income tax on U.S. source income.

For example, in the preceding example, if the foreign tax rate were 50%, and the United States allowed a full foreign tax credit without limitation, the United States would collect a *total* U.S. tax of only $20 ($70 – $50 FTC). In that case, the foreign tax credit would effectively reduce U.S. tax on *U.S. income* by $15. A limitation is thus necessary to protect the integrity of the residence country's own revenue system. In 1921 Congress enacted a limitation on the foreign tax credit to prevent crediting higher-rate foreign taxes against U.S. taxes on U.S.–source income. The foreign tax credit limitation rules provide, in essence, that the foreign tax credit cannot exceed the tax at the U.S. rate on the foreign income—in the example above, $35.

The policy rationale for the limitation has remained unchanged, but the method of determining the limitation has changed over time. First, Congress has vacillated about whether to group all foreign income and taxes together, regardless of foreign tax rates, in computing the limitation, or whether to calculate the credit and limitation separately for each foreign jurisdiction. These methods are called the "overall limitation"

and the "per-country limitation," respectively. Originally, in 1921 Congress enacted an overall limitation. In 1932 Congress required taxpayers to use the lesser of an overall or per-country limitation. The overall limitation was repealed in 1954 in favor of a per-country limitation. In 1960 Congress restored the overall limitation and allowed taxpayers to choose the more advantageous of the per-country or overall limitation. In 1976 Congress repealed the per-country limitation, and taxpayers were back to the overall limitation first adopted in 1921.

An overall limitation gives corporate taxpayers earning income in more than one foreign jurisdiction the ability to average foreign tax rates. In principle, taxes paid to countries with rates higher than the United States's are not fully creditable because of the Treasury's concern that foreign taxes not diminish taxes due on U.S.–source income. Under an overall limitation, however, taxes paid to jurisdictions with higher rates are averaged with those paid to jurisdictions with lower rates, in effect cross-crediting the higher and lower taxes. The averaging of foreign tax rates under an overall limitation maintains the integrity of the U.S. tax on U.S. source income but is often sufficiently advantageous that it may affect corporate taxpayers' decisions about where to locate their investments.[1] The following simple example illustrates how overall and per-country limitations might work:

Source country	Qatar	Ireland	U.S.
Income	$100	$100	$100
Income tax rate	90%	10%	50%
Foreign taxes paid	$90	$10	?

The U.S. taxpayer has worldwide income of $300, on which it owes (.50 × $300 =) $150 in U.S. income taxes before the allowance of the foreign tax credit. Under an overall limitation, the taxes paid to Qatar and Ireland could be added together to determine the foreign tax credit limitation. Thus, when the limitation fraction of 2/3 ($200 foreign income/$300 worldwide income) is multiplied by the U.S. pre-credit tax of $150, the creditable amount would be $100, and the entire amount paid to both foreign jurisdictions would be creditable. Under a per-country limitation, on the other hand, the limitation fraction would be 1/3 for each of the two foreign countries ($100 per country income/$300 worldwide income), and thus only $50 would be creditable of each of the discrete amounts of income tax paid to Qatar and Ireland. This more than covers the Irish taxes, which are fully creditable, but disallows credits for $40 of the Qatar taxes, which may be carried over to subsequent years. The foreign tax credit would thus be limited to a total

1. The per-country limitation was more favorable in circumstances where the taxpayer had losses in one country and income in another. The foreign taxes on the income were creditable without any reduction for the losses, whereas under an overall limitation foreign losses may offset foreign income and reduce the total creditable foreign taxes.

of $60 ($50 of Qatar taxes and all $10 of Ireland's taxes). When a per-country limitation was in force, taxpayers found ways through tax planning to achieve averaging in many circumstances. For example, patent rights might be transferred to a corporation located in a low-tax country, which would in turn license its use to a related corporation in a high-tax country, producing deductions in the high-tax country and income in the low-tax country. A simple example makes a per-country limitation look as if it works well, but in practice it did not.

The second significant structural development in the foreign tax credit limitation has been to distinguish among various categories of income in an effort to ensure that taxes paid on highly mobile forms of income cannot be averaged with taxes paid on income earned in the active conduct of a business. Separate foreign tax credit income "baskets" were first created in 1962 and greatly expanded in 1986. They are intended to prevent companies from transferring mobile investments to a foreign country principally to earn foreign tax credits. Currently there are ten baskets: (1) passive income; (2) high withholding tax interest; (3) financial services income; (4) shipping income; (5) dividends from noncontrolled section 902 corporations; (6) dividends from a domestic international sales corporation (DISC) or former DISC, to the extent dividends are treated as from foreign sources; (7) taxable income attributable to foreign trade income; (8) certain distributions from a foreign sales corporation (FSC) or former FSC; (9) foreign oil and gas extraction income; and (10) the largest single basket, the residual category called "other income."[2] The residual basket contains active foreign business income earned directly by the taxpayer or from U.S.–controlled foreign subsidiaries, no matter where located, and, thus, permits considerable averaging between high- and low-tax countries. (The baskets are described in more detail in Section 4.3 of this chapter, where they are also summarized in a table.) Excess credits from any given year may be carried back two years and forward five, beginning with the earliest year.

How the limitation should work remains a major source of controversy, because it determines the extent to which corporations may take advantage of averaging high and low foreign taxes, or cross-crediting. When the residence country has the highest tax rate, cross-crediting is much less important because corporations should always owe some residual tax on foreign-source income.

Another important feature of the foreign tax credit system is the so-called "indirect foreign tax credit" of section 902. The indirect foreign

2. Until 2003 income from each noncontrolled section 902 corporation—a corporation in which U.S. persons own at least 10 percent but not a majority of the voting stock—had to be put in a separate basket, making the number of baskets proliferate, but after 2003 separate baskets are not required for each noncontrolled corporation. The taxation of dividends paid from pre–2003 earnings and profits is, however, treated differently than dividends from post–2003 earnings and profits. See Section 4.3 for a more detailed explanation.

tax credit was instituted in 1918 to produce greater parity between U.S. corporations operating through branches in foreign jurisdictions and those operating through foreign subsidiaries. The income earned by foreign branches of U.S. corporations is subject to immediate U.S. taxation offset by the foreign tax credit, but the income of foreign subsidiaries is taxed only when earnings are repatriated in the form of dividends to the U.S. parent corporations. (See Chapter 5.) Subsidiaries typically, however, also pay income taxes to foreign jurisdictions, an expense that will reduce the amount of dividends that can be repatriated to the U.S. parent corporation. In the absence of an indirect foreign tax credit, the share of the foreign taxes paid by the subsidiary would not be creditable by the parent and would thus be subject to double taxation. Thus, section 902 of the Code allows an indirect foreign tax credit—a credit for foreign income taxes attributable to the dividend received from the foreign subsidiary. The foreign tax is "deemed paid" by the domestic parent, which is why this provision is sometimes referred to as the "deemed paid" foreign tax credit. It is allowable only to a domestic corporation which owns 10 percent or more of the voting stock of the foreign corporation. The trick when calculating the indirect foreign tax credit is that the repatriated dividend is grossed up by the amount of the foreign taxes paid.[3] Otherwise, the U.S. parent corporation would receive a deduction as well as a credit. Thus, if a foreign subsidiary earns $100, pays foreign income taxes of $25 and pays a $75 dividend to its parent, the parent will include $100 in income and receive an indirect foreign tax credit of $25. See § 78 of the Code.

In discussions of how to design a foreign tax credit—or even whether to have one at all—a group of familiar normative arguments continually appear. These theories can be divided roughly into two overlapping types: economic theories and theories of equity. H. David Rosenbloom describes the theories as follows:

H. David Rosenbloom, *From the Bottom Up: Taxing the Income of Foreign Controlled Corporations*, 26 Brook. J. Int'l L. 1525, 1526–27 (2001).

> Since most countries impose taxes upon some form of economic activity, and since a rational nation has an interest in supporting economic activity of persons subject to its taxing jurisdiction, the nation generally will wish to impose its tax with as much care as possible to preserve maximum room for that activity, given the necessity of the tax. This may be difficult in particular situations, but the general directive is clear: As between two taxes having the same effect, the one that inter-

3. I.R.C. § 78 allows a domestic corporation, choosing the FTC, to treat amounts paid under § 902(a) (relating to credit for corporate stockholder in foreign corporation) or under § 960(a)(1) (relating to taxes paid by a foreign corporation) as dividends received from the foreign corporation.

feres less with economic freedom is to be preferred. More broadly, it could be argued that general freedom of decision-making is a "good" meriting government protection, and taxes therefore should be imposed with as much leeway as possible for such freedom. Such considerations are commonly referred to as "efficiency." Professor Gergen invokes instead, and probably more fittingly, "the natural law of the parasite: Do the least damage to the host in extracting sustenance from it."

A second desirable feature in a tax system, no less important than efficiency, is what some refer to as "equity." This condition obtains when persons who stand in the same place insofar as the relevant target of tax is concerned are treated similarly by the tax regime. The point is important because tax systems in countries that are not totalitarian ultimately depend, to a large extent, upon the (sometimes grudging) consent of the taxed. If the system does not operate in an equitable way, that consent is difficult to acquire and more difficult to retain, with the result that those subject to the system will devote greater energy to frustrating, avoiding, or evading it. Such actions, in turn, render the system more difficult to administer and enforce in an equitable way which, in turn, only will add to the frustration of persons subject to the regime. For this reason, equity is needed in a tax system for the most pragmatic of reasons, to permit the system to function.

NOTE

Efficiency and Equity. The two theoretical goals, efficiency and equity, sometimes overlap with each other. For example, the Treasury sometimes claims it is both efficient and equitable for a U.S. taxpayer doing business abroad to be taxed at the same rate as its competitors in the U.S. Companies sometimes counter that equity and efficiency demand that they pay the same tax as their competitors in the foreign country where they operate. On the other hand, equity and efficiency are often thought to conflict. The classic example is the claim that equity demands the taxation of income from capital, while efficiency suggests it should go untaxed.

4.2 Origins of the Foreign Tax Credit and the Foreign Tax Credit Limitation

The History of the Foreign Tax Credit

Michael J. Graetz & Michael M. O'Hear, *The "Original Intent" of U.S. International Taxation*, 46 Duke L.J. 1021, 1043–56 (1997).

Just as the enactment of a deduction for foreign taxes occurred in 1913 without any talk of "national neutrality," the move away from this deduction to a foreign tax credit in the 1918 Act took place without any political decision to shift U.S. tax policy to favor "worldwide efficiency" or "capital export neutrality." The Sixteenth Amendment permitting a federal income tax had recently been sold to the American people on fairness grounds, and, in 1918, arguments grounded in tax equity remained far more persuasive politically than notions of promoting more economically efficient investments. T.S. Adams was then just beginning to create the institutional capacity within the Treasury and Internal Revenue Service to analyze the social and economic consequences of fiscal and monetary policies. A politically persuasive case for free trade policies loomed only in a distant future. Throughout the early part of this century, America's trade policy viewed imports unfavorably, and Congress was soon to raise its already substantial protective tariffs.

Then, as now, international tax policy was "something of a stepchild" in the tax legislative process. The big issue before the Congress was finding the means to finance [World War I], in particular the question whether to impose a war profits or excess profits tax. Indeed, Adams initially joined the Treasury Department to assist with the massive tax increases that would be necessary to fund the United States war effort.

This tax-raising occasion was an odd time for Adams to succeed in making the foreign tax credit (FTC) his first enduring contribution to international tax policy. But, because the United States insisted on taxing the worldwide income of its citizens, the pre–1918 arrangement permitted a form of double taxation, with foreign-source income being fully subject to taxation both at home and abroad. In 1913, when the American income tax was first implemented, tax rates were low and this double taxation may have been a comparatively minor nuisance. In 1918, however, with the world at war and tax rates inflating rapidly around the globe, international double taxation was becoming a far more serious burden on Americans doing business or investing abroad. The top marginal rates on individuals in the United States reached 77 percent, and although the basic corporate rate was only 10 percent, an excess profits tax at rates from 8 to 60 percent also applied to many large companies. In such circumstances, additional layers of taxation from other nations were potentially confiscatory. Relief became a matter of some urgency.

In this context, Adams presented an extraordinary proposal: the foreign tax credit, which he described as "one of the most striking departures" in the 1918 Act. Under the FTC, Americans could claim a credit against their American taxes for taxes

paid to other countries; taxes paid abroad would reduce American tax revenue dollar for dollar. The FTC represented what was an extraordinarily generous measure for its time: the United States was assuming sole responsibility for the costs of reducing the double taxation of its residents and citizens. * * * In so doing, the U.S. unilaterally renounced a potentially important bargaining chip in convincing other nations to forego taxing their residents on U.S. source income. * * *

Such generosity was virtually unprecedented. Great Britain, for example, limited its relief from double taxation, also a foreign tax credit, to taxation within the British Empire and, in legislation in 1920, the British further limited its FTC to a maximum of one-half of the British taxes on the foreign income. Yet Adams pursued his scheme because he felt that "it touched the equitable chord or sense, and because double taxation under the heavy war rates might not only cause injustice but the actual bankruptcy of the taxpayer."

To Adams' surprise, the FTC provoked little opposition (or indeed notice) and became law in 1919. Adams attributed the success of his proposal to the fact that legislators are particularly sensitive to the charge of double taxation. Adams later observed, "In my experience with legislative bodies I have found that you can accomplish more for equity and justice in taxation in the name of eliminating or preventing double taxation, than with any other slogan or appeal." * * *

Adams framed the problem of double taxation not as an issue of economic efficiency, but as a matter of invidious discrimination.

Adams identified the ultimate culprit causing this discrimination as the nation of residence: "More double taxation of the unjust variety is inflicted upon the taxpayer by his own government than by foreign governments." He elaborated:

> Every state insists upon taxing the non-resident alien who derives income from sources within that country, and rightly so, at least inevitably so. Now, then, in due course of time, citizens of the home state inevitably invest abroad and derive income from foreign sources. The average state refuses to acknowledge in this situation the right of its own citizen to a proper exemption on income derived from foreign sources. It * * * refuses to recognize when one of its own citizens or nationals gets income from a foreign source that he inevitably will be taxed abroad.

Given the predictability and the justness of taxation abroad, in Adams' view, the nation of residence wronged its taxpayers by levying an additional tax upon foreign-source income, thereby

discriminating unfairly against residents who happened to earn their income abroad.

Though Adams felt, as a matter of principle, that nations should work to alleviate the double taxation of their residents, and, during the limited discussion of the measure, members of Congress focused on the great burden of double taxation and the urgency of relieving it given wartime tax rates, other factors also played a role. In particular, there was a growing recognition of a need to encourage private investments by Americans in Europe. Adams also believed that the United States would reap practical benefits from providing relief to its own taxpayers; he was convinced that a discriminatory tax system that imposed unconscionably high rates on some taxpayers would ultimately prove to be unenforceable.

Moreover, Adams generally shared the sentiments about business of the Administrations for which he worked; he believed American prosperity depended in large measure on the competitiveness of American business abroad. Certain members of Congress also depicted the FTC "as a method to encourage foreign trade and to prevent revenue loss through incorporation of foreign subsidiaries or expatriation." Trade abroad was considered crucial to the nation's economic well-being and was thought to require appropriate support from the government. Relief from double taxation constituted just such appropriate support. And there is some evidence that Adams had this policy in mind in his international tax efforts. * * *

By the end of 1918, the United States had another reason to favor relief for Americans investing abroad: A variety of American economic and diplomatic interests required that a substantial quantity of American capital be channeled to rebuild post-war Europe. The United States was owed eleven billion dollars by allied governments for wartime loans; somehow Europe would need access to American dollars to pay off this debt. Europe would also need American dollars to purchase American exports—a central goal of American economic policy. Given the U.S. antipathy to imports and its high tariffs, it was difficult for Europeans to sell goods to the United States. Moreover, the wartime devastation of Europe's human, physical, and financial capital made serious competition in American markets unlikely. If dollars could not be raised through sales, another possibility was loan forgiveness or other public financing of European recovery by the American government. However, domestic politics in the United States were very different after World War I than after World War II. Americans wanted smaller government, lower taxes, and fewer international entanglements. Americans would not tolerate loan forgiveness, much less a

Marshall Plan, to aid Europe at a time when the United States government was itself sagging beneath what it considered an enormous wartime debt. In sum, if Europe was going to get the dollars necessary for the repayment of its debts, the purchase of American exports, and the economic stability necessary for peace, the source would have to be private investment. * * *

B. The 1921 Act—Limiting the FTC and Enacting Specific Source Rules

With the FTC, Congress put into place the centerpiece of an American international tax scheme that persists to this day: the United States taxes non-residents on U.S.–source income, and residents and citizens on world-wide income, but allows the latter to offset their U.S. tax liability with a credit for income taxes paid abroad to alleviate double taxation. Though the Revenue Act of 1921 retained this basic structure, Adams returned to Capitol Hill once again as spokesman for the Treasury Department to urge a number of significant refinements to the mechanism.

The most important of these reforms was a limitation on the FTC. As originally devised, the FTC could be used to offset up to the full amount of any U.S. "income, war profits and excess-profits taxes" owed by an American taxpayer. Thus, an American with substantial investments abroad, particularly if made in a high-tax nation (or nations), might eliminate his entire tax bill to the United States. Such an unlimited feature of a foreign tax credit in fact furthers the principle of capital export neutrality because, under such a regime, decisions about where to make investments turn only on comparing pre-tax rates of return even when the foreign tax rate is higher than the domestic tax rate. But neither Adams nor Congress was thinking about achieving such neutrality during this period, and both regarded the limitless FTC in 1921 as creating the potential for "abuse." With the high U.S. tax rates obtaining in 1918 and 1919, the ability of the FTC to erase U.S. tax liability was not readily apparent. By 1921, however, U.S. rates had fallen considerably and were in the process of being reduced further. Meanwhile, European nations maintained their higher rates. For instance, in 1921 the "normal tax" (i.e., the base rate applied to the lowest income categories) was 10 percent in the United States, but 30 percent in Great Britain. Under such circumstances, an American investing in Great Britain might easily wipe out his entire U.S. tax liability even though the lion's share of his income was from U.S. sources. * * *

Specifically, Adams requested and Congress enacted what we now call an "overall limitation": the amount of FTC available to any given taxpayer was limited to a proportion of the taxpayer's overall U.S. tax liability equal to the proportion of the taxpayer's global income derived from foreign sources. For instance, an American obtaining 10 percent of his income from foreign sources could use the FTC to offset a maximum of 10% of his total U.S. tax liability on his worldwide income; the taxpayer would thus have to bear an increased tax burden for investing in foreign countries with higher average taxes than the United States. To the Senate Finance Committee, the case for such a limitation was so strong that there was no need even to discuss the proposal. The repeal of the U.S. excess profits tax in 1921 made such a limit even more compelling. Contemporary critics derided the limitless FTC as an instance of unjustified "prodigality" on the part of the American government.

The fundamental purpose of the 1921 foreign tax credit limitation was to protect the ability of the U.S. to collect tax on U.S. source income, but the limitation on the foreign tax credit also has had a number of effects on the investment decisions of U.S. residents. Generally, under such a limitation, if a foreign country's tax rate is higher than the U.S. rate, a U.S. investor will prefer a domestic investment to a foreign investment with an identical pre-tax rate of return. For an investor who has already made some foreign investments, however, the limitation's averaging of foreign taxes of high-tax and low-tax countries might create advantages for investments in low-tax countries (to average against the high-tax foreign country's taxes as a way of offsetting U.S. tax) or indifference about investments in high tax countries (because, due to investments in low tax countries, the limitation may not be reached). The limitation enacted in 1921 clearly eliminated the pure neutrality as between foreign and domestic investments with the same pre-tax rates of returns that had existed under the unlimited earlier version of the FTC.

NOTES

1) *Adams's Outlook.* In the article excerpted above, Michael Graetz and Michael O'Hear look closely at T.S. Adams's papers and determine that the principal theories influencing the discussion of international tax policy since that time—theories of worldwide and national economic efficiency—were not the ones that motivated Adams when he proposed the foreign tax credit. Much of the discussion in Adams's time (and since) has been about the primacy of source-country as opposed to residence-country jurisdiction over business income. The "benefit" theory supporting source-based taxation is expressed in Adams's statement that business "ought to be taxed because it costs money to maintain a market and those costs should in some way be distributed over all the

beneficiaries of that market."[4] As a practical matter, he also argued, "[i]n the long run the business unit or source will yield more revenue to the public treasury than the individual; and the place where the income is earned will derive larger revenues than the jurisdiction of the person."[5] Although Adams believed in the primacy of source-based taxation, he also regarded residence-based taxation as a necessary backstop in international taxation.

2) *Practice and Theory*. T.S. Adams had seen in his earlier work with Wisconsin's income tax how inequities in taxation could result from a tax system that was not enforceable. Such inequities might undercut the very legitimacy of the government's power to tax income. Thus, he brought to his work for the U.S. Treasury as great a concern for practice as for theory. There are special concerns for legitimacy when taxation is a cooperative effort between otherwise competing sovereign states. As Graetz and O'Hear write:

> Adams had an additional reason for stressing enforceability in source rules: rules based on administrative practicability stood the best chance of gaining widespread international acceptance. Adams believed that nations would surrender tax jurisdiction only so long as they could do so without incurring significant financial harm. * * * Adams was sure that nations would most easily be swayed to surrender jurisdiction over income that they could not tax effectively anyway.[6]

3) *The Bumpy Road Ahead*. Graetz and O'Hear write:

> The United States retains a classical corporate tax, under which business income earned by a corporation is taxed twice: first when it is earned by the corporation, and again when it is distributed to shareholders as dividends. Many of our trading partners, however, have moved in recent years to eliminate or substantially reduce this double taxation. The international tax regime, however, is predicated on the existence of a double corporate tax. It generally allocates the corporate level tax to the country where the businesses' income is earned and the personal tax on dividends to the country where the recipients reside. A country's unilateral decision to eliminate either the corporate or individual level of tax upsets this equilibrium and demands fundamental reconsideration of the international consensus about how this income should be taxed.[7]

4. Michael J. Graetz & Michael M. O'Hear, The "Original Intent" of U.S. International Taxation, 46 Duke L.J. 1021, 1036 (1997).

5. Id. at 1038.

6. Id. at 1102.

7. Id. at 1025.

The Foreign Tax Credit Limitation

Elisabeth A. Owens's classic study of the foreign tax credit is more than four decades old, having been written before many legislative changes were adopted. In particular, her characterization of the United States as a country with a high-tax rate is now dated; the U.S. corporate tax rate is higher than that of some OECD nations, but lower than others. Nevertheless, her structural discussion of the FTC limitation remains current, as does her analysis of various forms of the limitation on fairness, incentives for foreign investments by U.S. persons, and revenue.

Elisabeth A. Owens, The Foreign Tax Credit 295–311 (1961).

> [I]f a country which taxes its nationals on income from all geographical sources decides to take unilateral action to relieve double taxation, it can do so only by allowing the country of source of the income the prior claim on that income. A complete shift to the principle of taxation only at source is unnecessary since the "burden" of double taxation under a tax credit system is deemed to be only the excess taxation occurring when the taxpayer is subjected, because it pays taxes to more than one country, to an aggregate tax rate which exceeds the generally applicable rate of the crediting country. Consequently, the tax credit system is based on two principles: first, that the place of source has the first claim on the taxpayer's income and second, that the crediting country, as the country of nationality, may properly impose an additional tax to the extent income has not already been taxed at its source at a rate as high as that of the crediting country.
>
> Within this broad framework, there are several types of limitation which may be used. At one extreme, the crediting country, the United States, can use the limitation only to protect its right to tax as a country of source of income. Since a credit system is based on recognition of the claim of the country of source to tax income, the United States will at least retain its right to tax the domestic source income of its nationals. Some form of limitation is, therefore, inherent in the credit system. Application of an over-all limitation which allows foreign taxes to be credited up to the point at which any additional amount of credit in a given year would reduce the United States tax on United States source income protects the United States' right to tax as a country of source. If an over-all limitation is used, however, the United States either recognizes the right of a foreign country to assert jurisdiction over income from sources in all other countries except the United States, or allows a

foreign country, because it has a tax rate higher than the United States tax rate, a claim prior to that of the United States on the income from all other countries except the United States. * * *

At the other extreme, the crediting country can, with equal logic, use the limitation for the purpose of allowing a credit for only that portion of the tax paid to any one foreign country which is imposed on income from sources within that country, since the superior claim of the foreign country is based only on its right to tax as a country of source. The per-country limitation appears to be based on this concept. If stringently applied, no carry-over of credit would be allowed. * * *

It is clear that the logic of a tax credit system itself does not indicate what is the proper form of limitation. Whether a crediting country, such as the United States which has a relatively high tax rate in comparison to that of many other countries, wishes to allow more credit by using an over-all limitation, or less credit by using a per-country limitation, depends upon other considerations. All the forms of limitation discussed here represent alternatives which have a practical consequence because the United States has a relatively high tax rate. If a crediting country has a very low tax rate relative to other countries, the operative effects are substantially the same whether it uses an over-all or a per-country limitation.

The function of the limitation as a part of the tax credit device for relieving international double taxation raises a problem basically because there are two types of equity involved; equity as between taxpayers of the crediting country and equity as between the countries involved. With respect to the first type, the right of the crediting country to impose a tax in addition to that imposed at the source of the income which will result in an aggregate tax rate equal to that in effect in the crediting country may be accepted as equitable treatment by taxpayers. By the same token, however, it will not appear to be equitable to use a form of limitation which will inevitably tend to result in a higher aggregate tax rate than that in effect in the crediting country. Only the most liberal form of limitation is satisfactory from this point of view, since that form will tend to approximate neutral taxation, i.e., taxation at the same rate whether foreign or domestic income is earned, for the greatest number of taxpayers in the greatest number of cases. A limitation operating on an annual or country-by-country basis will inevitably subject taxpayers to a rate higher than the United States rate if the taxpayer pays taxes in any year or to any foreign country at a rate higher than the United States rate. Insofar as the credit system is a means of producing tax neutrality as between those

taxpayers who engage in foreign activities and those who do not, to the extent it is within the power of the United States to provide such neutrality unilaterally, it is natural that the more restrictive forms of limitation will be subject to criticism on the ground that they do not produce neutrality. It is true that any form of limitation is an obstacle to achieving neutrality, as is the fact that the United States does not compensate taxpayers by a refund for foreign tax paid at a rate which is higher than the United States rate. Generally, however, neither entire elimination of the limitation nor refunds have been advocated as practicably acceptable alternatives. The policy of tax neutrality is probably the taxpayer's strongest argument in favor of liberalizing the form of limitation. * * *

From the standpoint of equity as between countries, however, the crediting country is not solely responsible for providing relief from excessive taxation resulting from international contacts. One justification for a more restrictive form of limitation lies in the view that the responsibility is not solely that of the United States but is to some extent shared by other countries which also secure some of the benefits of freeing international trade and investment from a repressive burden of taxation. In other words, the credit system can be viewed in the light of desirable tax relations between the countries involved—equity as between countries—rather than solely from the standpoint of relieving the burden of taxation on United States nationals—equity as between United States taxpayers. There is no doubt that the solution to the problem of double taxation is the responsibility of all countries involved and that the necessary sacrifice of tax revenues should be shared in some reasonable manner. It can also readily be seen why a restrictive form of limitation may seem reasonable to the government of a crediting country. The crediting country starts from the premise that its tax jurisdiction over its nationals is unlimited and is at least equally as well-founded as the asserted jurisdiction of other countries. In using a tax credit system, even with the most restrictive form of limitation theoretically compatible with the system, the crediting country may feel that it has assumed the greatest share of responsibility for excessive tax rates on international transactions and has relinquished the maximum amount of revenue which could reasonably be expected of it.

* * *

Concepts of Double Taxation

The form of limitation used may be subject to criticism because it is alleged to cause double taxation. There are two aspects to this problem. First, the type of limitation applied may

be criticized because of the concept of double taxation embodied in the limitation. Each form of limitation involves a different concept and the concept itself may seem to be more or less valid. Second, a type of limitation may be analyzed in terms of the extent to which the type of double taxation relief inherently involved in that type of limitation is achieved.

The narrowest concept of double taxation is involved in the per-country limitation (without provision for carry-over of excess credit); that limitation will be discussed first.

Per-country Limitation

The concept of double taxation embodied in the per-country limitation is taxation both by the United States and a foreign country of a taxpayer's annual income derived from sources in a foreign country as that income is calculated under United States law. This concept is narrower than that involved in the over-all limitation because the "income" deemed to be subject to double taxation under the per-country limitation is income from one foreign country rather than income from all foreign sources; it is also narrower than that involved in any provision for carry-over of credit because the "income" is the income of one year rather than several years. It is by no means, however, the narrowest concept that could reasonably be used. * * *

When the per-country limitation does not reduce the amount of creditable tax, double taxation as defined above is eliminated because, although a tax is paid to both the United States and the foreign country, the tax rate is the United States tax rate. The tax is the same as if only the United States imposed a tax. When the limitation is operative to reduce the amount of creditable tax, double taxation as defined above may or may not be eliminated, depending on the reason for the loss of credit. If the reason is that the foreign statutory tax rate is higher than the United States rate, double taxation is eliminated. Both countries tax the same income, but the credit cancels out the United States tax and a tax is paid only to the foreign country. Similarly, if the reason is that the foreign country has a broader tax base than the United States as where it allows fewer deductions or taxes additional kinds of receipts, double taxation in any year as between the United States and the foreign country is eliminated because the excess amount of income taxed in the foreign country is not taxed at all by the United States.

If, however, the excess tax for which credit is not given is a tax on income which is also taxed by the United States, and the excess tax does not arise out of a higher foreign statutory rate, then double taxation does occur when the limitation is operative. This may happen * * * in several kinds of situations: (1) when the foreign country taxes the world-wide income of United States nationals, (2) when the source rules of the foreign country are different from the source rules of the United States, (3) when a divergence between the characterization of income in a foreign country and in the United States results in the application of different source rules to the same receipts, and (4) when the foreign tax is credited against a United States tax on a different year's income. * * *

Although there are thus several circumstances in which double taxation of the kind implied in the per-country limitation may arise, its actual incidence is probably not very great since it depends both upon the per-country limitation becoming operative and upon relatively uncommon conditions. Generally, for example, the source rules and concepts of taxable income in a foreign country are not very different from those of the United States, and generally the foreign tax is applied against the United States tax on the same year's income. Moreover, except in the relatively rare situation in which a taxpayer has no taxable income from a foreign country in a given year under United States source rules and concepts of taxable income, the existence of these theoretical limits to the effective operation of the credit system will not often result in a loss of credit. This is because the United States tax rate is relatively high as compared to the rates of many foreign countries and the entire foreign tax will be creditable despite discrepancies in source rules, etc. Double taxation which does occur under the per-country limitation can be eliminated or mitigated by allowing excess tax over and above the amount of limitation to be credited through use of a carry-over limitation or an over-all limitation. Such relief goes beyond the need, however, in the sense that it allows excess tax to be credited regardless of the circumstances which cause the per-country limitation to become operative; or to state it another way, it involves shifting to a broader concept of double taxation. Double taxation can also be relieved in many instances on an ad hoc basis, as for example, by obtaining a change in source principles in a foreign country through income tax treaties or by the formulation of United States rules which will consistently result in the application of a foreign tax against the United States tax on the same year's income.

Over-all Limitation

The concept of double taxation embodied in the over-all limitation on the credit is the taxation by the United States, on the one hand, and all foreign countries, on the other, of annual income derived from all foreign sources, as that income is

calculated under United States law. The income conceived to be subject to double taxation is aggregate foreign source income as compared to income derived from a particular country under the per-country limitation. * * *

Double taxation of foreign source income in the aggregate can occur under an over-all limitation just as double taxation of the income from one country can occur under the per-country limitation. But as the concept of double taxation embodied in the law is broadened the incidence of double taxation naturally tends to decrease. In a conceptual sense, this is because double taxation will not occur merely because a foreign country taxes income derived from sources in other foreign countries. This decrease is also due to the fact that the limitation must be operative and thus reduce the amount of creditable tax in order for double taxation to arise and the averaging effect of the over-all limitation will lessen the number of instances in which the limitation becomes operative.

Carry-over Limitation

A carry-over of excess credit from one year to other years in a carry-over period can be applied in conjunction with either a per-country or an over-all limitation. It broadens the concept of double taxation by enlarging the "income" deemed to be subject to double taxation from income measured on an annual basis to income measured over a period of years. * * *

Evaluation of Concepts of Double Taxation Inherent in Forms of Limitation

It is clear that the concept of what constitutes double taxation, even as that term is understood in connection with a tax credit system, is flexible. Clarification of the various concepts involved is useful in assessing criticisms based on whether a particular form of limitation does or does not tend to eliminate double taxation. Analysis in these terms, however, cannot determine any one proper form of limitation. Legislative history indicates that other considerations—the problem of providing fair treatment to differently situated taxpayers, the prevailing attitude towards providing more or less encouragement to foreign trade and investment, and current revenue needs—have been the determinants of the form of limitation. The concept of double taxation involved has been more the result than the cause of the form of limitation adopted. * * *

Incentive Effect

The changes which have been made in the character of the limitation probably reflect more than anything else changes in policy with respect to the encouragement of foreign trade and investment. * * * [I]t can be assumed that the greater the amount of credit allowed and the lower the aggregate tax rate on foreign source income, the greater the encouragement to foreign trade and investment. This kind of approach to the selection of the form of limitation suffers from the defect that it is impossible to ascertain pragmatically the quantitative effect on the amount of foreign trade and investment resulting from a more or less restrictive form of limitation. While it can be taken for granted that there will be more foreign trade and investment if a tax credit is available than if it is not, it cannot be so readily assumed that the relatively minor differences in the effects of various forms of limitation will appreciably encourage or discourage international business operations. The revenue effects must also, of course, be taken into account. Since it is difficult to estimate either the short-run costs of a liberalization, before it has stimulated increased investment, or the long-run costs, after the expected increase has occurred, both the cost and the benefit are problematical. This difficulty, however, is intrinsic in considering any tax provision in terms of its incentive effect, and its probable effects on foreign trade and investment are, nevertheless, perhaps the most crucial consideration in deciding upon the form of the limitation on the credit.

The alternative forms of limitation used in the past and the forms which have been proposed can be listed, with a fair presumption of accuracy, in order of the degree to which they will result in the payment of less United States tax and, therefore, a greater amount of encouragement to foreign trade and investment. In ascending order of encouragement, they are as follows:

1. Application of lesser of per-country or over-all limitation.
2. Per-country limitation.
3. Per-country limitation with carry-over of excess credit.
4. Over-all limitation.
5. Application of greater of per-country or over-all limitation, i.e., annual election by taxpayer.
6. Over-all limitation with carry-over of excess credit.
7. Application of greater of per-country or over-all limitation, i.e., election by taxpayer, plus carry-over of excess credit.

NOTES

1) *Efficiency*. For an economic analysis of the efficiency of separate limitations based on type or source of income versus an overall limitation

aggregating the limitation across all foreign income, see Andrew B. Lyon & Matthew Haag, Optimality of the Foreign Tax Credit System: Separate vs. Overall Limitations (2000), available at http://www.bsos.umd.edu/econ/lyon. This paper is also summarized in 1 NATIONAL FOREIGN TRADE COUNCIL, INC., THE NFTC FOREIGN INCOME PROJECT: INTERNATIONAL TAX POLICY FOR THE 21ST CENTURY 293–97 (2001). Lyon and Haag contend that the economic efficiency of a per-country versus overall limitation turns on the relationship of the residence country's tax rate to rates elsewhere in the world. They argue that at current U.S. rates as compared with generally lower foreign tax rates, an overall limitation best serves efficiency goals.

2) *A Corporate Practitioner's Outlook*. Charles I. Kingson, in *The Foreign Tax Credit and Its Critics*, provides a practitioner's look at the inconsistencies that legislative compromises have wrought in the development of the foreign tax credit. He concludes that the "credit's technical flaws are minor. Its major ones are political—the result of interlocking choices (here and abroad) that reject equity for advantage. The present credit embodies skill and principle in the face of significant pressure; and it breathes just a whisper that when President Carter called the Code a disgrace to the human race, he got it backwards."[8]

The Indirect Foreign Tax Credit

The excerpt below discusses the history of the indirect foreign tax credit, § 902, enacted to protect U.S. companies with foreign subsidiaries from double taxation. Critics of the indirect foreign tax credit charge that it places domestic companies with foreign branch operations at a tax disadvantage compared to those with foreign subsidiaries.

Jonathan Davis, *The Foreign Tax Credit: History and Evolution* 11–18, 42–44 (MARCH 8, 1995) (UNPUBLISHED MANUSCRIPT, ON FILE WITH THE AUTHOR).

The Indirect Foreign Tax Credit

> The direct foreign tax credit did not fully address the issue of double taxation. In addition, the 1918 act created the indirect foreign tax credit, which allowed American companies to get credit for taxes paid by their wholly owned foreign subsidiaries. * * *
>
> Many American companies operate abroad through subsidiaries incorporated in foreign countries. This can create a tax advantage, because the United States respects the form of the entity and treats the subsidiary as a foreign entity that is not subject to United States taxation. Prior to 1918, however, ownership of foreign subsidiaries could also create a tax penalty because of double taxation. The double taxation occurred when the money was repatriated to the American parent in the form of a dividend. For example, assume company A, an American company, has a subsidiary, little A, which is incorporated and operates in country Y. If little A makes $1000, $500 will be paid in taxes to country Y, which has a 50% tax rate. Assume that the rest is repatriated to company A in the form of a $500 dividend. Prior to 1921, this $500 dividend was taxed at the United States ordinary corporate rate with no credit. As a result, assuming a 25% United States tax rate, company A would pay an additional $125 tax and would be left with $375. In this example, the effective tax rate based on the combination of taxes paid to country Y and the United States would be 62.5%. If company A had invested directly in country Y, it would have received * * * a credit after 1918 for its foreign taxes paid. [This] would have the effect of eliminating the United States tax leaving company A with the full $500 dividend.
>
> Congress did not perceive any reason to tax a company operating through a subsidiary differently than a company operating through a branch. The indirect credit was meant to simulate the direct credit that the company operating through a branch would receive. * * *
>
> In addition to equalizing treatment between subsidiaries and branches, Congress also wanted to equalize treatment for receipt of dividends from domestic and foreign corporations. Corporations are subject to a two-tiered tax system. The corporation pays tax on its income, and the shareholder pays tax on the dividends issued. If a corporation were a shareholder, this would create a three-tiered tax system as the same income would be taxed when earned, when issued to the shareholder corporation as a dividend, and when issued to the ultimate individual shareholder. Section 234 of the Revenue Act of 1918 created the dividends received deduction. This allowed a corporation a deduction for any dividends received from another domestic corporation. The indirect credit exempted dividends from foreign corporations which were at least 50% owned by American corporations.
>
> It appears that two purposes were solved by separating the indirect tax credit from the dividends received deduction. First, the credit was more restrictive. Corporations received the dividends received deduction even if they only own one share of the domestic corporation issuing the dividend, while the indirect credit was only available if the parent owned at least 50% of the stock of the foreign corporation issuing the dividend. [Now 10%-ed.] Secondly, the indirect credit protects the direct tax credit. If

8. Charles I. Kingson, The Foreign Tax Credit and Its Critics, 9 AM. J. TAX POL'Y 1 at 57 (1991).

a dividends received deduction were allowed from foreign corporations, then a corporation could avoid being taxed on its foreign income. The corporation would set up a foreign subsidiary and have all profits remitted to the parent through a dividend. The parent would get a full dividends received deduction and pay no tax on the money earned. If the money was originally earned in a jurisdiction with no corporate tax, then the corporate tax could be avoided completely.

As stated above, in addition to creating parity with the dividends received deduction, the indirect tax credit was created so that income from foreign subsidiaries would have the same tax treatment as income from foreign branch operations. This goal was not achieved. Instead, the credit actually created tax incentives for a company to operate through a foreign subsidiary instead of a foreign branch. The subsidiary has two main advantages: first the indirect credit was technically flawed [as originally enacted] in that it gave a tax subsidy to subsidiaries incorporated in low tax countries; and secondly, subsidiaries always could avoid or at least delay the payment of United States taxes by not issuing dividends, so that the money would not be subject to American tax jurisdiction.

* * *

The second criticism of the indirect tax credit involves the issue of deferral. It is a basic tax concept that it is better to pay taxes later rather than sooner. By operating through a foreign subsidiary, company A can defer paying taxes on its earnings by deferring the payment of a dividend. * * *

President Kennedy was the first Democratic president to address the foreign tax credit since the Wilson administration first enacted the foreign tax credit in 1918. In 1962, Kennedy was able to get some changes through Congress aimed at eliminating some of the perceived unfair aspects of both the direct and the indirect credit. * * *

Congress * * * attacked [an] aspect of the indirect credit that [gave] incentives to operate through a foreign subsidiary instead of a foreign branch. Congress added gross-up rules in computing the indirect tax credit. * * *

The gross-up rules corrected the technical problem with the indirect credit * * * . Under the old system, a parent operating through a subsidiary could get as much as a 7% lower effective tax rate than a company operating through a branch even before considering deferral. The gross-up rules eliminated this loophole. For illustration, assume that company A has incorporated little A in country X, which has a 10% tax rate. Assume that the U.S. has a 25% tax rate. Further assume that little A makes $1000 of country X source income, pays $100 in tax and repatriates the other $900 to company A in the form of a dividend. Under the old rule, company X has tax liability of $225 and deemed paid credit of $90, so it pays tax of $135 to the United States for total tax liability of $235. The gross-up rules state that company A is deemed to have received the full dividend of $1000 and receives credit for the full $100. Thus, company A's United States tax liability is $150 and its total liability is $250 or 25 percent. If little A paid only a $600 dividend and reinvested the other $300, then company A would be deemed to have received a dividend of $667 and would receive a credit for $67 in taxes paid to country X. The other $33 in tax would be available as a credit when the remaining $300 of little A's earnings and profits were remitted to company A.

NOTE

More about the Indirect Credit. For more extensive analysis of the indirect foreign tax credit, see ELISABETH A. OWENS & GERALD T. BALL, THE INDIRECT CREDIT at pages 3–30 (1979) (on the function and rules of the indirect foreign tax credit) and at pages 329–33 (discussing the relevant policy issues).

4.3 MECHANICS AND STRUCTURAL PROBLEMS

The Basket System

As discussed above, since 1921 the Treasury has limited the foreign tax credit to restrict the crediting of taxes paid on foreign-source income earned in countries with higher tax rates than the U.S. This prevents offsetting foreign taxes against U.S. taxes on U.S.-source income. With an overall limitation, however, it is still possible to cross-credit taxes on income sourced to foreign countries with higher-than-U.S. tax rates against taxes on income sourced to foreign countries with lower-than-U.S. tax rates. In 1976 Congress repealed the per-country limitation and reverted to the overall limitation. To restrict cross-crediting, or "averaging," under the overall limitation, Congress in 1986 enacted a complex "basket" system. Separate basket limitations, related to the total amount of foreign-source taxable income included in each of the baskets, apply to the total of direct foreign tax credits under sections 901 and 903 and to indirect foreign tax credits under sections 902 and 960.

Under the basket system, the foreign tax credit limitation of section 904(a) must be applied separately to nine categories of foreign-source income. The categories are listed in section 904(d)(1)(A) through (I). (Under section 907, foreign oil and gas income are subjected to a

separate but similar limitation process.) The limitation for the separate categories is calculated with the following formula:

$$\frac{\text{Foreign-source taxable income in relevant basket}}{\text{Worldwide taxable income}} \times \text{U.S. tax on worldwide income} = \text{Limitation applicable to income in that basket}$$

Because the ratio is multiplied by the U.S. tax rate on worldwide income, the limitation for foreign taxes on income in any basket cannot exceed the U.S. tax rate on that income.

To figure out the amount of foreign-source taxable income in each basket, a taxpayer must first determine the amount of gross income in the basket; then allocate deductions to obtain taxable income in the basket; finally, the taxpayer must ascertain all direct and indirect foreign tax credits attributable to the taxable income in the basket. Section 904(d)(3) provides look-through rules for interest, rents, royalties, and dividends from controlled foreign corporations (CFCs). This means that a U.S. taxpayer owning at least 10 percent of the voting stock of a CFC must "look through" any dividend to the distributing corporation's underlying income in order to determine the character of the income and its appropriate basket. (This is where the anti-deferral regime of Subpart F, discussed in Chapter 5, flows into the foreign tax credit limitation regime.) Finally, a taxpayer may have to apply the section 904(c) rules for carrying excess foreign tax credits back two years and forward five.

The nine baskets under Section 904 are:

1: 904(d)(1)(A): Passive Income

This basket includes income that would be foreign personal holding company income under section 954(c) if it were received by a controlled foreign corporation (one way in which the foreign tax credit limitation and Subpart F run on parallel tracks). Such income generally includes dividends, interest, royalties, and rents (with exceptions noted below). It also includes gains from the sale or exchange of property (other than inventory) that produce foreign personal holding company income or that produce no income (e.g., diamonds). The guiding idea here is to isolate easily relocated types of investment income, often subject to low rates of tax abroad, so that they cannot be used for averaging against foreign business income more likely to be subject to higher foreign tax rates.

There are some important exceptions. Passive income here does not usually include royalties or rents from unrelated persons earned in the active conduct of a trade or business. For export promotion reasons, the FTC limitation on passive income does not include export financing interest. Neither does it include high-taxed income. This last category of income is subject to the "high-tax kickout" that applies to passive income taxed at a rate higher than the highest rate of U.S. individual or

corporate tax. This distinction is intended to prevent cross-crediting *within* the passive income basket. High-tax passive income is kicked out to the residual (or general limitation) basket.

2: 904(d)(1)(B): High Withholding Tax Interest

This basket includes interest payments on which a foreign withholding tax of at least five percent has been imposed on a gross basis. This income goes into a separate basket because a five percent tax on gross interest income might well represent a much higher rate on a net basis (considering the high percentage of expenses in the income of financial intermediaries) and would therefore enable cross-crediting against low-taxed income if it were placed in the passive income basket. For export promotion reasons, export financing interest is excluded from the high withholding tax interest basket and put in the general limitation basket.

3: 904(d)(1)(C): Financial Services Income

This basket includes income of a "financial services entity," i.e., an entity "predominantly engaged in the active conduct of a banking, insurance, financing or similar business" (as defined in section 904(d)(2)(C)(i); Reg. § 1.904–4(e)(3)(i) tells us that "predominantly" means that at least 80 percent of the entity's gross income must come from "active financing income"). The point here is to prevent U.S. corporations from setting up banking and financing subsidiaries in tax havens in order to cross-credit low-taxed financial services income against other high-taxed active business income. This income includes: (1) income from an active banking or financing business; (2) income from the investment by an insurance company of its unearned premiums or reserves; (3) passive income, even if it would be excluded from the passive income basket for another reason; and (4) export financing interest that would be high withholding tax interest.

High withholding tax interest and export financing interest that does not come under the definition of high withholding tax interest are excepted. This basket takes priority over the passive income and shipping income baskets.

4: 904(d)(1)(D): Shipping Income

Foreign jurisdictions often tax shipping income at low rates, if at all. Such income would thus be valuable for averaging against active business income by corporations in excess foreign tax credit positions if it were not put into a separate basket.

5: 904(d)(1)(E): Dividends from Each Noncontrolled Section 902 Corporation

Unlike the case with CFCs, Congress does not try to equalize the treatment of *non*controlled foreign corporations and foreign branches. This basket applies only to corporate taxpayers receiving a dividend from a foreign corporation in which it owns at least 10 percent, but not a majority, of the voting stock (a so-called "10/50" foreign corporation). In

this more stringent regime, prior to 2003, the dividends from each noncontrolled section 902 corporation were put into a separate basket, allowing no cross-crediting against income of any other type or of any other noncontrolled corporation. In addition, prior to January 2003, the look-through rules did not apply to noncontrolled foreign corporations as they do to CFCs. These rules have changed as of January 2003. Dividends paid out of pre–2003 earnings and profits go into one basket. Dividends paid out of subsequent earnings and profits will generally be treated as income in a separate basket based on the amount of the underlying earnings and profits being dispersed, i.e., on a look-through basis (see § 904(d)(2)(E)(4)). The IRS issued Notice 2003–5 to explain how the credit limitation under section 904 applies to dividends distributed by a 10/50 foreign corporation in post–2002 tax years. This change is intended to simplify the system by not requiring the taxpayer to compute a separate FTC limitation for dividends received from each 10/50 corporation and is generally favorable to taxpayers. For a more in-depth discussion of the new rules, see Carol D. Klein & Lisa A. Felix, Putting All Your Eggs in a Single 10/50 Basket: Here's How, 98 TAX NOTES 2015 (2003).

6: 904(d)(1)(F): Dividends from a DISC or Former DISC (as Defined in Section 992(a)) (to the Extent Such Dividends Are Treated as Income from Sources Without the U.S.)

Foreign-source dividends from DISCs, or domestic international sales corporations, are often untaxed by foreign jurisdictions and so are put in their own basket to prevent cross-crediting against high-taxed income. (In 1976, a GATT (General Agreement on Trade and Tariffs) panel determined that the DISC rules constituted a prohibited export subsidy; the DISC was then replaced with the FSC (foreign sales corporation).)

7: 904(d)(1)(G): Foreign Trade Income

Foreign trade income refers to gross income attributable to foreign trading receipts of a foreign sales corporation (FSC). See below.

8: 904(d)(1)(H): Distributions from a FSC (or Former FSC) out of Earnings and Profits Attributable to Foreign Trade Income, Etc.

In 1999, a World Trade Organization (WTO) panel agreed with a complaint from the European Union that the FSC regime (which had replaced the DISC regime) constituted a prohibited export subsidy under the relevant WTO agreements. In early 2000 a WTO Appellate Body upheld that finding. In an effort to avoid the impact of these rulings, Congress in late 2000 repealed the FSC regime and enacted the "ETI" (Extraterritorial Income) regime.[9] The ETI system met the same fate in the WTO in 2002. Congress now seems to have given up on sustaining any similar export subsidy regime. The FSC provisions referred to in

9. I.R.C. § 114.

Section 904(d)(1)(G) and (H) were repealed, but this basket still applies to income distributed by corporations that qualified as FSC income when that provision was in force.

9: 904(d)(1)(I): General Limitation Basket

This basket is the residual category under section 904(d), and thus it includes all income not caught in one of the previous eight baskets. This basket includes most foreign-source income earned in the active conduct of a business, the obvious exceptions being financial services income and shipping income. Although structurally this is the "residual" basket, in practice it is the basket into which most foreign-source income earned by U.S. corporations falls. Thus, many opportunities for averaging of high- and low-taxed income still exist. The critical policy question is whether the compliance costs of corporations and enforcement expenses of the Treasury due to the staggering complexity of the basket system are worth the supposed benefits it achieves. A number of proposals to simplify the regime are now before Congress.

The following table summarizes the rules:

Basket	**Income Source(s)**
Passive Income § 904(d)(1)(A)	1. Dividends and interest. 2. Rents and royalties (unless derived in the active conduct of a trade or business and received from an unrelated person). 3. Excess of gains over losses from stock, bond, and property sales and exchanges that produce rent, royalty, or no income. *Exceptions:* 1. Income included within any of the other baskets. 2. Export financing interest. 3. High-taxed income (high-tax kickout).
High Withholding Tax Interest § 904(d)(1)(B)	Interest payments on which a foreign withholding tax of at least 5% is imposed on a gross basis. *Exception:* Export financing interest.
Financial Services Income § 904(d)(1)(C)	1. Active banking or financing income (if it makes up at least 80% of the entity's gross income). 2. Income from the investment by an insurance company of its unearned premiums or reserves. 3. Passive income (even if it would be excluded from passive income basket). 4. Export financing interest that would be high withholding tax interest.

Basket	Income Source(s)
	Exceptions: High withholding tax interest and export financing interest that do not come under the definition of high withholding tax interest.
Shipping Income § 904(d)(1)(D)	1. Income from the use of a vessel or aircraft in foreign commerce. 2. Income from leasing or hiring a vessel or aircraft for such use. 3. Income from the performance of service in connection with such use. *Exception:* Financial services income of a financial service entity (see immediately above).
Dividends from Each Noncontrolled Section 902 Corporation § 904(d)(1)(E)	Pre–2003 dividends from a foreign corporation in which the taxpayers owns at least 10%, but not a majority, of the voting stock will be treated as income in the single 10/50 basket. Post–2002, dividends paid out of earnings are generally treated on a look-through basis.
Dividends from a DISC or Former DISC § 904(d)(1)(F)	Foreign-source dividends from DISCs.
Foreign Trade Income § 904(d)(1)(G)	Distributions from earning and profits of a FSC attributable to foreign trade income.
Distributions from a FSC or Former FSC § 904(d)(1)(H)	Gross income attributable to a FSC.
Oil & Gas § 907	1. Foreign oil and gas extraction income (FOGEI), which is income derived from foreign sources from extraction of minerals from oil or gas wells or the sale or exchange of assets used by the taxpayer in this type trade or business. 2. Foreign oil related income (FORI), which is taxable income derived from foreign sources from the processing of minerals from oil or gas wells into their primary products, transportation or distribution of such minerals or products, disposition of assets used in the trade or business, and the performance of any other related service. *Exception:* Dividend or interest income that is passive income.

Basket	Income Source(s)
General Limitation § 904(d)(1)(I)	All residual income including most foreign-source income earned in the active conduct of business. *Exceptions:* 1. Financial services income. 2. Shipping income.

NOTE

The Effect of a Reduction in Rates. When the basket system was expanded in 1986, the U.S. had also reduced its corporate tax rate to 35%, giving the U.S. the lowest rate among its principal trading partners. This tended to put most U.S. multinational corporations in a position of having more foreign tax credits than they could use given the FTC limitation—a so-called excess credit position. Thus, cross-crediting became more important for those corporations—and more of a concern for the Treasury. Since the enactment of the current basket system in 1986, many other OECD countries have also lowered their corporate tax rates, and they are now generally closer to the U.S. rate and in some cases lower. Thus, the 1986 situation no longer exists, raising the question of whether such an elaborate defense against cross-crediting remains worthwhile, given its complexity and costs.

Unintended Consequences

Foreign Tax Credit Manipulation. Taxpayers have sometimes traded shares around the record date for dividends in an effort to shelter U.S. source income from U.S. taxation. For instance in *Compaq Computer Corp. v. Commissioner*, Compaq received a large capital gain in 1992 and sought to offset the U.S. tax on that gain with capital losses while it shielded dividend income with foreign tax credits.[10] To do so it purchased shares cum-dividend in Royal Dutch Petroleum, which had announced but not yet paid a dividend that was going to be subject to Netherlands withholding tax and thus carry substantial foreign tax credits. Compaq then resold all the shares within an hour at the lower ex-dividend price.[11] By that time the price had fallen by the amount of the dividend minus the Netherlands withholding tax. As a result, Compaq suffered a capital loss that was almost precisely offset by the dividend after withholding, but it also received large foreign tax credits. In effect Compaq purchased foreign tax credits for the price of relatively minor transaction costs. The validity of such transactions trading around the record date was challenged by the IRS in the courts. The Tax Court denied the foreign tax credits in *Compaq* on the grounds that the transaction lacked economic substance and any business purpose, but the Fifth Circuit reversed.[12] The following excerpt criticizes the appellate court's decision.

10. Compaq Computer Corp. v. Commissioner, 113 T.C. 214, 215 (1999), rev'd 277 F.3d 778 (2001).

11. 113 T.C. at 217–18.

12. Compaq Computer Corp. v. Commissioner, 277 F.3d 778, 787 (5th Cir.2001).

Daniel N. Shaviro & David A. Weisbach, *The Fifth Circuit Gets It Wrong in Compaq v. Commissioner*, 94 TAX NOTES 511, 513–14 (Jan. 28, 2002).

> Historically, most tax shelters have involved the use of tax arbitrage to create losses that can be used to shelter other income from tax. However, shelters can work just as well * * * by arbitraging credits, such as the foreign tax credit, against phantom taxable income, with the aim of sheltering other foreign-source income from U.S. tax.
>
> To illustrate a basic tax planning opportunity associated with foreign tax credits, suppose a U.S. multinational [is excess limit, i.e., the foreign tax rate on its existing foreign source income is lower than the U.S. tax rate so it could receive more foreign tax credits if it "paid" more foreign taxes without hitting the foreign tax credit limitation. It] makes a new investment abroad, earning $100 that does not qualify for deferral and paying $35 of foreign tax. This is a wash from a U.S. tax standpoint, since the credit equals the U.S. tax liability on the pre-foreign-tax income. Suppose, however, that the multinational could arrange instead to earn an extra $1,000 from a foreign business partner or counterparty, with the entire $1,000 then being taxed away by the foreign government. (The business partner or counterparty that paid it the extra $1,000 might, for example, be informally controlled or secretly compensated by the government that got the money back in tax revenues.)
>
> All of a sudden, the American company would be clearing the same $65 in pre-tax cash as previously. However, it would also be reducing its U.S. tax bill by $650 (the $1,000 of foreign tax credits minus the $350 U.S. tax on the extra phantom income created by not deducting the foreign taxes). Any sophisticated observer would realize that this was a tax arbitrage, * * * even though it arbitraged tax credits against phantom income rather than current deductions against deferred gain. * * * [H]owever, the Fifth Circuit in Compaq would completely misunderstand this. Look at the big enhancement to the pre-tax profit (it would evidently say)—obviously this is a business deal, not a tax deal! [Compaq made a profit on the transaction if one measured profit before the Netherlands withholding tax *and* the U.S. tax because the post-dividend decline in the price of the Royal Dutch Petroleum stock accounted for the withholding tax. If one measured profit after the withholding tax but before the U.S. tax, however, the transaction was unprofitable. When the Fifth Circuit examined the transaction, it adopted the former analysis.]

NOTE

Congress Acts. Ultimately Congress responded to this particular scheme by enacting § 901(k), which disallows credits for withholding taxes on dividends when the dividend-paying stock is held for less than 15 days during the 30–day period beginning on the date which is 15 days before the date on which such share becomes ex-dividend. This rule renders transactions like Compaq's invalid. However, the Fifth Circuit's decision illustrates that the courts are not always quick to disallow such manipulations.

Allocation of Deductions

The foreign tax credit limitation requires that taxpayers compute both U.S. and foreign source income. In doing so, some judgment must be made whether deductions offset foreign or domestic income. In answering this question, it is not enough simply to ask in what country was the money giving rise to the deduction spent. The regulations require an allocation of deductions between domestic and foreign source income. As the following two excerpts illustrate, interest and research and development expenses have proved the most troublesome issues. See § 864 (e) and (f).

Martin A. Sullivan, *Interest Allocation Reform: Time To Talk or Time To Act?* 84 TAX NOTES 1223, 1223–25 (1999).

> Under the U.S. system of international taxation, the worldwide income of U.S. corporations is subject to U.S. tax. To prevent double taxation, a credit is allowed against U.S. income taxes for foreign income taxes. But there is a limit on how much foreign tax credit any corporation can claim. The limit is equal to the amount of U.S. tax allocable to foreign-source income. If U.S. corporations pay relatively low foreign income taxes, the limit is not binding. These corporations—called "excess limit" corporations—do not worry too much about how their foreign-source income is calculated for U.S. tax purposes.
>
> But for firms with foreign income taxes in excess of the foreign tax credit limitation—so-called "excess credit" corporations—maximizing foreign-source income is the name of the game. Therefore, the tax directors of firms with excess credits would like to be able to shift as much interest expenses as possible from foreign-source income to domestic-source income so that those expenses don't reduce foreign-source income.
>
> Before passage of the Tax Reform Act of 1986, U.S. corporations could minimize interest expense allocated to foreign-source income by allocating expenses on a separate company basis, and interest expense incurred in the United States would

be allocated entirely to U.S.-source income. It was possible for U.S. corporations to borrow in the United States, use the funds to invest in foreign operations, but not have any interest expenses allocated to foreign-source income. In the words of the Joint Committee on Taxation, this type of behavior resulted in "an unwarranted amount of foreign tax credits" to U.S. multinationals operating abroad.

The 1986 Act put an end to the most lucrative planning techniques. But it did not stop there. In the need for additional revenue, the Act installed rules that routinely result in an over-allocation of interest to foreign-source income.

The general theory behind the change was that money is fungible. According to the fungibility concept, interest expense—no matter where or for what purpose it is incurred—supports worldwide operations. But the 1986 act did not remain true to the fungibility concept. Interest incurred by foreign subsidiaries of U.S. multinationals simply was excluded from the allocation of interest expense between foreign and domestic income. So, if an affiliated group consists of two identical corporations—one domestic and one foreign—and each corporation incurs equal interest expense, three-quarters of the interest expense of the entire group is allocated to foreign-source income. [All of the foreign corporation's interest expense plus one-half of the U.S. corporation's interest expense.—ed.] This has become known as "water's edge fungibility."

The alternative to water's edge fungibility—and the starting point for efforts to reform current law—is "worldwide fungibility." Under this principle, the interest expenses of foreign members of an affiliated group are not automatically allocated to foreign-source income. Instead, they are put on equal footing with domestic interest and allocated worldwide on the basis of the ratio of domestic to foreign assets. By reducing interest allocated to foreign-source income, this rule increases foreign tax credits for excess credit taxpayers. The interest allocation rules included in the Senate version of the Tax Reform Act of 1986 adopted the principle of worldwide fungibility, but to save revenue it was dropped in conference from the final bill.

ECONOMIC DISTORTIONS

Under current law, borrowing by a U.S. parent and its U.S. subsidiaries reduces the foreign tax credit limitation. Borrowing by foreign entities, however, has no direct impact on the foreign tax credit limitation. This over-allocation of interest expense is more than just "unfair" to U.S. multinationals, it gives rise to a variety of economic distortions.

As is the case for any restrictions on the foreign tax credit limitation, current interest allocation rules increase the taxation on outbound investment by U.S. multinational corporations. In the simplest case, an excess credit corporation has excess credits because its foreign operations are subject to higher rates of tax abroad than in the United States. If the foreign tax credit limitation worked correctly, it would give the U.S. corporation foreign tax credits equal to the U.S. tax rate times its foreign-source income. In that case no U.S. tax—just the high rate of foreign tax—would be paid on the foreign income. But because interest allocation rules can artificially reduce foreign-source income, U.S. multinationals in effect must pay U.S. tax on foreign-source income in addition to the high rate of tax paid to the host government.

Of course, this makes it harder for U.S. corporations to compete abroad. And, as can be expected, U.S. corporations have unendingly criticized the current interest allocation rules. But interest allocation rules do more than violate the principles of competitiveness. They clearly penalize foreign investment and thereby violate the principle of economic neutrality—the principle that Treasury has often cited as a guiding principle of its tax policy.

The interest allocation rules also operate in a manner that discourages investment in the United States. If a U.S. multinational is in an excess credit position, any investment in plant and equipment in the United States financed with debt reduces foreign tax credits. Thus, the interest allocation rules increase the cost of capital on U.S. investment. This in particular has been a problem for highly leveraged U.S. public utilities investing abroad. * * *

Finally, the U.S. interest allocation rules distort financing decisions by U.S. multinational corporations. To mitigate the damaging effects of the current interest allocation rules, U.S. companies avoid borrowing in the United States and instead borrow abroad where they can get a deduction under foreign law without any reduction in their U.S. foreign tax credit limit. * * *

Two economic studies have estimated that the empirical effects of the interest allocation rules have some effect on the investment and financial behavior of U.S. multinationals. * * *

Despite all these problems, it is important to put the interest allocation rules in perspective. No doubt there are many situations in which the current rules result in rough justice for U.S. multinational corporations. But other provisions of U.S. tax law—particularly the ability to defer U.S. tax until

income is repatriated as dividends—mitigate the negative impact of the interest allocation rules. In the aggregate, it does not appear as though double taxation of foreign-source income is a widespread problem. Data from the IRS Statistics of Income Division show that in 1994 * * * $26.5 billion in foreign taxes were paid by U.S. corporations and were offset by $25.4 billion in U.S. foreign tax credits.

Karen B. Brown, *Neutral International Tax Rules Allocating Costs: Successful Formula for U.S. Research and Development*, 1 FLA. TAX REV. 333, 334–53 (1993).

One example of important tax rules for U.S. businesses is the rules governing the allocation and apportionment of research and development expenses to domestic or foreign source income. Research cost allocation is a crucial determinant of the allowable foreign tax credit for multinational businesses. * * * Because the credit against U.S. tax liability is limited to a tax computed at U.S. rates on foreign source taxable income, the Internal Revenue Code rewards the allocation of research expenses to domestic source income, which results in a corresponding increase in foreign source taxable income as a proportionate part of worldwide taxable income. In the past, Congress has employed international tax policy to stimulate U.S.-based research by enacting rules that favor U.S.-based research. Those rules were promulgated in response to complaints by the U.S. business community that the 1977 regulations resulted in an inappropriate allocation of research expenses to foreign source income, which resulted in an inability to obtain full credit against U.S. tax liability for taxes paid abroad. President Clinton * * * [proposed] allocation of all U.S.-based research costs to domestic source income. This article contends that tax rules should not provide an incentive for U.S.-based research. Accordingly, this article supports neutral tax rules that apportion research costs on the basis of income expected to be derived from those activities.

II. ORIGIN OF CURRENT RESEARCH AND DEVELOPMENT ALLOCATION RULES

Section 174(a) of the Code permits a deduction for research or experimental expenditures made in connection with a trade or business. Research or experimental expenditures are those "incurred in connection with a trade or business which represent research and development costs in the experimental or laboratory sense." U.S. multinational businesses must determine the proper method for allocating and apportioning those

expenses to domestic or foreign source income in order to compute foreign tax credit. Because of the foreign tax credit limitation, U.S. taxpayers prefer to allocate most research costs to domestic source income. Allocation of expenses to domestic source income will result in higher foreign source taxable income and increase the credit for foreign income taxes paid.

The current research allocation and apportionment rules derive from regulations promulgated by the Treasury Department in 1977. [Discussion of the details of the 1977 Regulations and Congressional moratoriums on their implementation in 1981, 1983, and 1985 and changes in 1986 have been omitted–ed.]

In 1988, Congress enacted new research expense allocation rules. The new rules retained the former government requirements rule of the regulations, which in general required allocation of research expenses to the geographical location of the political entity imposing legal requirements that necessitate the conduct of research. For all other research expenses, the rules allocated sixty-four percent of expenditures for research conducted in the United States to U.S. source income and sixty-four percent of expenditures for research conducted outside the United States to foreign source income. The remainder was apportioned at the taxpayer's election on the basis of either gross sales or gross income. Special provisions governed expenditures attributable to activities conducted in space and activities of affiliated groups. The rules were a stop-gap measure that applied for only four months of the taxable year beginning after August 1, 1987. The 1977 regulations applied to the balance of the year.

In 1989, Congress enacted Code section 864(f) to deal with the allocation question and to eliminate the necessity for periodic modifications of the 1977 regulations. The provisions contained in the new Code section were identical to those enacted in 1988. The rules adopted were not permanent, however, as they were effective only for taxable years beginning after August 1, 1989 and before August 2, 1990. * * *

Congress extended section 864(f) in 1990 and again in 1991, but failed to extend the provision in 1992. Consequently, those rules expired on June 30, 1992 for calendar year taxpayers. Commentators concluded that on expiration of section 864(f) the 1977 regulations regained control over the allocation of research deductions by U.S. businesses. In July 1992, however, the Service issued *Revenue Procedure 92–56*, which permitted U.S. taxpayers to elect to apply rules substantially similar to those contained in section 864(f) rules for eighteen months.

Eventually these rules will be replaced by permanent rules promulgated by the Treasury Department or enacted by Congress.

A recent proposal by the Clinton administration * * * offers two permanent proposals that affect research cost allocation rules. First, all expenses for U.S.-based research would be directly allocated to domestic source income, and all expenses for foreign-based research would be allocated on the basis of gross sales. Second, the tax credit for increases in qualified research expenditures for U.S.-based activities would be extended. * * *

III. U.S. TAX RULES SHOULD NOT FAVOR U.S.-BASED RESEARCH

* * *

In general, one must distinguish between the rules set forth in the regulations that applied before the effective date of section 864(f), the pre-moratorium regulations, and the rules set forth in new Code section 864(f), the post-moratorium rules. The pre-moratorium regulations provided a complex allocation and apportionment formula to be used by domestic and foreign multinational businesses. A fixed portion (thirty percent) of research and development costs was apportioned to income derived from the location of research activities. Under the post-moratorium rules of section 864(f), sixty-four percent of research costs was allocated to income derived from the location of research activities. * * *

Research and development is a valuable business activity. Government action to encourage that activity—by direct subsidy of research ventures—is appropriate and increasingly necessary in the competitive international business arena. Favorable tax rules allocating research costs also may influence research strategies for multinational businesses. The enactment of such rules, however, is not a valid means of stimulating research and development. The development of sound tax policy is informed by three important goals—maximization of revenue, fairness and efficiency. These goals have been neglected by Congress and the executive branch in the formulation of research and development tax rules. These goals are not and cannot be served by tax rules that encourage U.S.-based research.

This article advocates adoption of neutral research expense allocation rules that address these three goals. The expired rules described above failed because they resulted in an unnecessary loss of U.S. revenue, treated foreign and domestic taxpayers differently, did not respond to the needs of multinational businesses and ignored recent trends in the global marketplace. * * *

A tax policy that encourages the conduct of research activities in the United States represents mere chauvinism. Such a policy is misplaced because it ignores the growing trend of internationalization of industrial research and development. U.S. tax policy should permit U.S. businesses to secure the most efficient research and development opportunities whether they are in or outside of the United States. It should also support collaboration among U.S. and foreign businesses and academic institutions. * * *

Tax rules that favor U.S.-based research derive, in part, from an inaccurate idea that such activities will produce products that will wipe out the burgeoning U.S. trade deficit. However, despite the enactment since 1981 of a series of tax rules encouraging research in the United States, domestic research has declined and international research ventures have proliferated. Moreover, since 1981, the U.S. trade imbalance has steadily accelerated. The government has demonstrated no connection between exports of U.S. products and the location of research activities (United States versus foreign locations) by U.S. taxpayers. Finally, there is no nexus between the measurement of income appropriately taxed and the expired U.S. tax rules that set up a preference for location of the activities in the United States. Consequently, failure to encourage international collaboration places the United States in the unfortunate position of exalting a weak national interest (pride in U.S. ingenuity) over stronger international (efficiency and collaboration) and national (revenue and rational tax rules) interests. * * *

IV. RESEARCH ALLOCATION RULES SHOULD BE NEUTRAL

Congress failed to extend section 864(f) or to provide permanent allocation rules because it believed that the executive branch should adopt acceptable rules that appropriately balance concerns of both government and business. Some believe that Congress abdicated its responsibility to legislate * * *.

One may speculate whether Congress's failure to provide research expense allocation rules resulted from its concern about the revenue impact or its genuine belief that such rules are more appropriately promulgated by the Treasury Department, which is charged with the responsibility to investigate and propose a solution in this area. Congressional inaction in 1992, provides an opportunity to examine the failure of any branch of the federal government to develop effective tax policy. Examination suggests two needs: promulgation of permanent

research cost allocation and apportionment rules that fairly link research costs to the sources of income generated and elimination of arbitrary location-based allocation provisions.

A fair measurement of income derived by multinational businesses that conduct substantial research and development requires the apportionment of research costs to gross income, gross sales or assets of the enterprise. * * * A rational tax system would allocate and apportion deductions on the basis of fair measurement of income * * *.

[My] proposal is that the rules eliminate allocation and apportionment of research costs based on the location of research activities. The allocation provisions should attempt to measure income of all multinational businesses, whether domestic or foreign, by attributing research expenses to gross income or gross sales of the business. Unlike the 1977 regulations, the proposal would permit allocation on the basis of gross sales or gross income without limitation. An alternative basis for allocation * * * would be the asset method employed under the current rules in which a taxpayer allocates interest expense to the source of income derived from the location of its assets (determined on the basis of asset or book value). That method of allocation is based upon a belief that research expense is fungible—attributable to all activities and property regardless of location.

NOTE

The Business Community's Perspective on Interest and R & D Deduction Allocation. Needless to say, U.S. multinationals agree with Martin Sullivan's recommendation for "worldwide fungibility" in allocating interest expenses, but they are not enamored with Karen Brown's suggestion that research and development expenditures be allocated on a worldwide basis relative to sales or assets. As discussed in the Karen Brown excerpt, President Clinton in 1992 proposed that U.S.-based research costs should be allocated to domestic source income. This would have provided an incentive to companies to perform research in the U.S. The American business community supported the proposal because—at least for companies with excess foreign tax credits—it would have lowered the cost of U.S.-based research. Under the proposal, this benefit would have been available only to domestic taxpayers. The Clinton Administration hoped to encourage U.S.-based research by U.S. companies in order to assist a proposed shift in military research activities to the private sector and to help U.S. companies competing in the burgeoning technology sector. In 1993, Congress rejected Clinton's proposed 100% allocation of U.S.-based research costs to domestic source income instead permitting only a 50% allocation. See § 864 (f).

4.4 Policy Directions

The following excerpt suggests that changes in economic circumstances may imply revisions of the U.S. rules for taxing business income abroad.

Council of Economic Advisers, Economic Report of the President 208–10 (Feb. 2003).

International Tax Considerations

The U.S. economy is increasingly linked to the world economy through trade and investment. Domestically based multinational businesses and their foreign investment help bring the benefits of global markets back to the United States by providing jobs and income. Like all firms, multinationals face a number of business decisions, including how much to invest and where. Because multinationals by definition operate in a number of countries, they also have to decide in which country to locate their headquarters, and their decisions in turn affect which countries reap the majority of benefits from the multinationals' operations.

In the context of tax reform, it is important to consider how changes in the international taxation of income would change the incentives for companies to locate production, intangible assets, and research and development in one country rather than another. Reform can have important effects on these business decisions and on the efficient use of the Nation's economic resources, affecting employment and the competitiveness of workers in the United States.

* * *

The rules surrounding deferral are the source of considerable complexity, involving a bewildering assortment of definitions and rules. Deferral is extended to income from active business operations abroad in order to provide an equal footing with other operating businesses in the same foreign country. Deferral of U.S. tax is not extended to income from portfolio investments and other income viewed as highly mobile. Consequently, certain income from portfolio-type foreign investments (for example, interest, dividends, and royalties) is "deemed distributed" and is subject to current U.S. tax. However, such income also includes various categories that are more active than passive, such as foreign base company sales and services income, income from shipping, and certain income from oil activities. [For more on deferral, see Chapter 5—ed.]

The foreign tax credit requires companies to make complex calculations in order to claim the credit against the U.S. tax on repatriated dividends. The foreign tax credit is calculated by "basket" or type of income (for example, passive, financial services, and general active income) so that excess credits generated on highly taxed active foreign business income cannot be used to reduce the U.S. tax on lower taxed foreign income such as passive interest. Over the past 30 years, U.S. companies have repatriated roughly half of the after-tax income earned by their foreign subsidiaries.

The U.S. system of taxing international income dates back to the 1960s, when the United States was the source of half of all multinational investment worldwide, produced 40 percent of the world's output, and was the world's largest capital exporter. From this perspective it was appealing to construct a tax system that was viewed as neutral with respect to the location of foreign investment by taxing all income and taxing it all at the same rate. However, this system is based on the idea that investment abroad is a substitute for domestic investment and on the assumption of perfectly competitive markets in a world with aggressive pricing and ease of entry, and with no brand-name loyalty, economies of scale, or other sources of extraordinary profits.

The underpinnings of the worldwide system have shifted, however. It is now recognized that most multinational corporations produce differentiated products and compete in industries characterized by economies of scale, thereby undermining the perfect competition model of the past. There is some evidence that returns on foreign investment surpass those on domestic investment and exhibit above-normal returns because of factors such as intangibles (brands, patents, and the like). Moreover, the United States is now the world's largest importer of capital and no longer dominates foreign markets. For example, in 1960, 18 of the world's 20 largest companies (ranked by sales) were located in the United States, but by the mid–1990s that number had fallen to 8. Companies can choose where to locate, and, under the worldwide system of taxation, unless the domestic tax rate is the same in all countries in which a company operates, the decision where to locate the company's headquarters will be affected by the countries' tax systems.

There is some concern that the United States has become a less attractive location for the headquarters of multinational corporations. Although multinationals operate in a number of countries, the Department of Commerce reports that the bulk of the revenue, investment, and employment of domestic multinational companies is located in the United States. In 1999 U.S.

parent companies accounted for about three-fourths of U.S.-based multinationals' sales, capital expenditure, and employment. Therefore, where a firm chooses to place its headquarters will have a large influence on how much that country benefits from its domestic and international operations.

In the following excerpt, a tax practitioner addresses the averaging of foreign tax credits. This article was written just before the expansion of baskets and tax rate reductions of the 1986 Act. Thus the tax rates described are higher than those now in effect.

Alan W. Granwell, *Calculating the Foreign Tax Credit Limitation on a Per Country Basis*, 27 Tax Notes 567, 573–75 (1985).

The Conceptual Soundness of the Overall Limitation

One effect of the overall limitation is to permit averaging of taxes paid in high-tax countries with those in low-tax countries. Although the Administration may regard averaging as a potential abuse, averaging of bona fide foreign taxes imposed on foreign source income is a proper attribute of a foreign tax credit for the following reasons: * * *

1. Averaging is consistent with the conduct of a global business. In 1960, when Congress reintroduced the overall method as an alternative to per country, the Ways and Means Committee specifically recognized the appropriateness of averaging. The Ways and Means Committee then endorsed averaging as being consistent with economic reality:

> In most cases American firms operating abroad think of their foreign business as a single organization and in fact it is understood that many of them set up their organizations on this basis. It appears appropriate in such cases to permit the taxpayer to treat his domestic business as one operation and all of his foreign business as another and to average together the high and low taxes of the various countries in which he may be operating by using the overall limitation.

This same view was espoused in 1977 by the Ways and Means Committee Task Force on Foreign Source Income which recommended retention of the overall method adopted in the Tax Reform Act of 1976:

> In many instances * * * averaging of foreign taxes would appear to be appropriate. Many businesses do not

have separate operations in each foreign country but have an integrated structure that covers an entire region (such as Western Europe). In these instances a good case can be made for allowing the taxes paid to the various countries within the region to be added together for purposes of the tax credit limitation.

There is no inherent justification for regarding a country-by-country assignment of income as a more theoretically correct measure of foreign income-producing activity. As Congress has correctly observed (and the Administration concedes), companies do not organize strictly on a country-by-country basis. For example, a German manufacturing subsidiary of a U.S. company may well develop technology that it licenses to a Dutch or Japanese enterprise and may sell its products throughout Europe, Africa and perhaps elsewhere through branches or subsidiaries. The averaging effect of the overall method is consistent with the approach normally taken by U.S. businesses in making investments abroad—to serve broad geographic markets which may involve production, transportation and marketing facilities in several different countries.

Moreover, the rationale for the per country proposal does not necessarily reflect the international norm for those countries that utilize a credit system to avoid international double taxation. In addition, the complex tracing required in the per country computations has no parallel in any other jurisdiction's per country method. Thus, it represents a completely untested mechanism.

2. Averaging permitted under per country limit. Averaging, in effect, has been permitted under the per country limitations previously enacted by Congress. In fact, this was one of the reasons Congress adopted the overall method as an alternative to per country in 1960. In that regard, the Ways and Means Committee noted,

> In addition, making the overall limitation generally available for foreign operations only provides treatment which is already available in the case of the so-called foreign base corporation, or foreign subsidiary serving as a holding company for its subsidiaries carrying on active business enterprises. In the case of a foreign base corporation the Treasury regulations provide that the taxes paid by its subsidiaries are to be treated as if they were paid to the foreign country where the foreign base company is incorporated, and thus aggregated for purposes of applying the limitation.

3. Averaging mitigates the disparity among different tax systems; the per country limitation increases the effective tax rate on foreign source income. The per country proposal will lead to an increase in the overall effective tax rate on foreign source income both because it will accentuate the mismatching of income, deductions and taxes and because of the difference in U.S. versus foreign tax rates.

Averaging mixes income from countries with statutory rates both higher and lower than the U.S. rate. U.S. tax rules have evolved by statute and regulation to accept averaging while denying credits for artificially high foreign levies or for certain types of income subject to manipulation for credit purposes.

Rather than just averaging differences in rates, however, the overall limitation additionally performs an inherently sensible role in adjusting the system under which a U.S. taxpayer operates to the infinite diversity of other tax systems. The averaging permitted under the overall method ameliorates differences that exist between the U.S. concept of foreign taxable income, upon which the credit limitation is computed, and the computation of the income tax base used by foreign countries. These differences often result in a mismatching of foreign tax credits with U.S. tax liability.

For example, if a foreign country grants a 100 percent cost recovery deduction for a certain class of capital property, the income base would be different for foreign and U.S. purposes and, assuming the foreign country's tax rates are equivalent to the U.S. rates, the taxpayer would initially have a lower effective foreign tax rate than for U.S. tax purposes. So too, a second foreign country may have cost recovery rules that create an initially higher foreign effective tax rate than the United States in the early years. Because of the differences in these rules, the timing of the imposition of foreign and U.S. tax will differ, thus creating the mismatching of income and resultant credits. Similarly, a transaction that is tax free in one foreign jurisdiction may be taxable in another jurisdiction. In these cases (and others) averaging minimizes the mismatching of income and taxes for the U.S. company on its aggregate foreign business.

The overall foreign tax credit limitation, through its averaging mechanism, permits the U.S. taxpayer to pay an overall rate of tax equivalent to 46 percent [now 35 percent—ed]. A per country limitation, however, may cause excess foreign tax credits. This could arise because of the way the United States determines its foreign tax credit limitation, i.e., by computing the limitation with reference to net foreign source income (gross income less deductions). For example, the United States has

negotiated tax treaties permitting foreign withholding taxes on gross income (income without reduction by expenses). Indeed, in some important instances, * * * the Treasury Department has failed to obtain a concession reducing the excessively high foreign corporate and withholding taxes in a country in which there is a substantial amount of U.S. foreign investment. This discrepancy can cause inequities even under the overall limitation, but the overall limitation mitigates the harm because foreign tax credits generated in one country may be taken against income generated in another country (one in which, perhaps, little if any foreign tax is paid). Under the per country method, the foreign withholding tax (based on gross income) may well exceed 100 percent of the net income determined after applying Reg. section 1.861–8, and thereby create excess foreign tax credits. * * *

4. Averaging does not reduce U.S. tax on U.S. income. The overall limitation does not cause foreign income tax to offset U.S. tax on U.S. source income. Mathematically, that simply is not the case.

Example. Assume that a U.S. corporation has $100 of U.S. income and $100 in income from each of Countries X and Y. The applicable tax rates are 46 percent in the United States, 60 percent in Country X and 40 percent in Country Y. Worldwide income is $300 and U.S. tax before credit is $138 ($300 × .46). Foreign taxes would be $100 ($60 plus $40). Under the overall method the tax credit would be limited to $92, calculated as follows:

$$\$138 \times \frac{\$200 \text{ (foreign source taxable income)}}{\$300 \text{ (worldwide taxable income)}} = \$92$$

The U.S. tax liability is $46 ($138 − $92), which is precisely the U.S. tax due on the U.S. source income. The U.S. taxpayer has excess foreign tax credits of $8.

The present overall limitation thus prevents the credit from reducing U.S. tax on domestic source income and need not be changed. So, too, the per country limitation prevents foreign income tax from offsetting U.S. tax on U.S. source income. Thus, both limitations, in this regard, work as Congress intended.

NOTE

Schizophrenic Attitude Toward Averaging. As this chapter has noted, U.S. tax policy toward averaging of foreign taxes from different countries has swung from the overall to the per-country limitation and back again. The basket system, put in effect to limit averaging of income taxed at high foreign rates against income earned at lower rates is a major cause of complexity in the foreign tax credit limitation. In 1985, when Alan Granwell wrote this article, the Administration had proposed to curtail averaging by returning to the per-country limitation. In his introduction, not included here, Granwell states, "The basic premise of the [Administration's] proposal is faulty—namely, that the averaging effect of the overall limitation leads to distorted investment decisions. On the contrary, the overall limitation is the correct approach because businesses operate on a global rather than on a country-by-country basis."[13] This is, of course, an empirical claim, which doesn't directly address, or rule out, the possibility that corporate decisions about the location of business activities might be distorted by differences in tax rates from country to country, an issue discussed in the following excerpt.

Robert J. Peroni, J. Clifton Fleming, Jr. & Stephen E. Shay, Reform and Simplification of the Foreign Tax Credit Rules (July 6, 2003) (forthcoming).

In seeking to simplify and reform the foreign tax credit rules, it is helpful to identify the major sources of complexity. We believe that there are five fundamental reasons for the complexity of the current foreign tax credit rules.

First, the design of the foreign tax credit rules is not always tied to the fundamental purpose of the foreign tax credit. As stated by one of the authors in an earlier article:

> * * * The purpose of the foreign tax credit is to mitigate international double taxation and prevent such double taxation from discouraging efficiency enhancing cross-border transactions from taking place. Its function is not, and should not be: to provide a subsidy for foreign investment by U.S. persons, to favor foreign investment over domestic investment or vice versa, or to favor any particular type of foreign investment over any other type of foreign investment.
>
> Arguments by some multinational corporations and their tax advisers that the foreign tax credit provisions should be designed to promote the "competitiveness" of U.S. multinationals in the global economy are essentially claims that the U.S. tax system should subsidize foreign-source income by taxing it more lightly than it does domestic-source income. Those arguments have little to do with the fundamental purpose of the foreign tax credit provisions, which is to

13. Alan W. Granwell, Calculating the Foreign Tax Credit Limitation on a Per Country Basis, 27 Tax Notes 567, 568 (1985).

provide unilateral double taxation relief by the residence country. Moreover, these arguments in favor of skewing the foreign tax credit provisions in favor of "competitiveness" are often made with rather unconvincing empirical support for the claim that the foreign tax credit provisions of current law in fact are causing any competitive harm to U.S. multinationals. * * *

Second, we lack general agreement on which economic model (capital export neutrality, capital import neutrality/competitiveness, national neutrality, or some other approach) should drive the formation of the U.S. international tax rules. Therefore, in designing a particular international tax rule (including the foreign tax credit rules), we often make a compromise between, for example, a rule that effectuates capital export neutrality and a rule that effectuates capital import neutrality. Such compromises often result in the adoption of rules that are more complex, less coherent, and less effective than rules exclusively reflecting one economic model or the other. Unsurprisingly, the current rules reflect a schizophrenia in the tax system caused by the fact that the U.S. tax system reflects all three economic models and, therefore, contains examples of rules that in fact effectuate each of the three divergent economic models. * * *

Third, to a certain extent, complexity in the rules for taxing the foreign-source income of U.S. persons is a result of attempts to make the tax system fairer, more precise, and more economically efficient. In other words, in this as in other areas of taxation, additional complexity is the price we have to pay for greater certainty and equity and more economically efficient tax rules. For example, we could markedly reduce the complexity of the foreign tax credit limit by eliminating the current basket limit system and the current law rules for allocating and apportioning deductions for foreign tax credit limit purposes and by substituting in their place a foreign tax credit limit based on a specified percentage (e.g., 10 percent) of the taxpayer's foreign-source gross income. Such an approach, however, would rank low in an evaluation based on equity and efficiency criteria. As another example, the goal of simplification implies a reduction in the number of separate foreign tax credit limit categories but economic efficiency concerns push the system in the direction of tightening the foreign tax credit limit to prevent cross-crediting, thereby removing an incentive for taxpayers with high-taxed foreign-source income to divert other income to a low tax foreign country. Thus, reducing complexity cannot be the sole objective of any sensible tax reform legislation, but to achieve any significant degree of simplification we have to reduce the

emphasis we place on other tax policy criteria such as fairness and efficiency.

Fourth, cross-border transactions themselves are very complicated and, because they transcend the borders of any particular country, such transactions implicate the tax systems of two or more countries. In addition, sophisticated practitioners in the international tax arena will design these cross-border transactions to take advantage of inconsistencies in the tax treatment of a particular transaction among countries, resulting in cross-border tax arbitrage. * * * The tax rules formulated to deal with such complicated transactions, * * * are not likely to be simple.

Finally, complexity results from the inconsistent conceptual foundations that underlie the U.S. tax rules relating to outbound cross-border investment. As one important example, the Code has two inconsistent approaches for how it views a U.S. corporation that owns stock in a foreign corporation. Thus, in some instances, under the deferral privilege, a U.S. shareholder is allowed to avoid U.S. tax on the profits of a foreign corporation until they are repatriated, thus treating the U.S. shareholder as the owner of stock in the foreign corporation and the foreign corporation as an entity distinct from its U.S. shareholder. By contrast, other Code rules, such as the indirect foreign tax credit allowed by Sections 902 and 960 and the look-through rules in Sections 904(d)(3) and (d)(4), treat a U.S. corporate shareholder that owns at least 10 percent of the voting stock as equivalent to operating a foreign branch operation and, thus, as, in effect, the owner of the foreign corporation's underlying assets and income. These inconsistencies lead to an incoherent tax system that is tremendously complex. The tax system would be much less complex if one consistent conceptual approach were used.

Radical Alternatives to the Current Foreign Tax Credit System and Its Overall Limit With Baskets

One way to think about simplifying the foreign tax credit provisions is to consider alternatives to our current approach for mitigating double taxation of foreign-source income. The current law contains an overall limit with separate baskets that reduce, but certainly do not eliminate, the ability of taxpayers to average high foreign taxes on one item of foreign-source income with low foreign taxes on another item of foreign-source income.

One alternative would be to eliminate the elective foreign tax credit of current law and replace it with only a deduction for foreign taxes paid or accrued. As mentioned above, allowing only a deduction for foreign taxes would move the tax system

markedly in the direction of the highly distortive national neutrality economic model. U.S. taxpayers who engaged in foreign activities would end up bearing more total tax (U.S. and foreign) on their foreign-source income than on their U.S.-source income, except for income earned in foreign countries that did not impose any source tax on the income by statute or treaty exemption. Such an approach would, nevertheless, rank high on the simplicity scale. The degree of possible simplification can be quickly appreciated by comparing the Code provisions and regulations dealing with the foreign tax credit to the much more limited Code provisions and regulations relating to the Section 164 deduction for state, local, and foreign taxes. To be specific, replacing the foreign tax credit with a deduction for foreign taxes would:

(1) eliminate the need to determine whether foreign taxes imposed were income taxes in the U.S. sense or "in lieu of" taxes;

(2) eliminate the need for any indirect credit since only a foreign corporation's income net of foreign taxes would be taxable as a dividend to a U.S. corporation holding stock in the foreign corporation (i.e., the foreign taxes paid by the foreign corporation would reduce the amount available to be paid as a dividend to the U.S. corporation);

(3) allow the elimination of the foreign tax credit limit in any form and, hence, the elimination of the need to separate a U.S. taxpayer's gross income, deductions, and foreign taxes into various categories or baskets;

(4) vastly reduce the importance of the source rules for income items and the allocation and apportionment rules for deduction items, thus eliminating a major source of complexity in our current system; and

(5) reduce the pressure on the transfer pricing rules (at least from the perspective of U.S. taxation of outbound activity), thus simplifying compliance for taxpayers and administration for the IRS.

In addition, one could argue that a deduction for foreign taxes has more theoretical consistency with a * * * pure income tax system than does a foreign tax credit; although some other commentators vigorously argue that fairness concerns strongly support using a foreign tax credit as the means for remedying international double taxation. So if simplification were our only criterion for designing the U.S. international tax system, allowing a deduction for foreign taxes would be the way to go.

However, changing from a credit system to a deduction system would have serious negative consequences that more than offset any simplification gains from such a drastic change. Such a move would be viewed by foreign countries, properly so in our opinion, as the tax equivalent of trade protectionism because it would almost certainly (at least at the margin) discourage U.S. persons from engaging in foreign investment and business activities. Furthermore, such a move would not comport with internationally accepted norms for avoiding international double taxation and would require a revision or termination of our current tax treaties. Accordingly, those who argue that simplification concerns should trump all other tax policy criteria and dictate the shape of the international tax rules for double taxation relief cannot mean what they say.

Another alternative would be to eliminate the foreign tax credit and replace it with a system of exempting foreign-source income from U.S. tax. Such an approach would move the tax system toward the model of capital import neutrality and, at least on paper, would be simpler than the current system. Opponents of such an approach, however, would argue that such a system creates a tax bias in favor of foreign investment and the transfer of business activities and investment abroad to lower-tax foreign jurisdictions. * * * [T]o reduce the incentive to transfer easily movable capital abroad, separate treatment of passive income would be necessary (i.e., taxing foreign passive income, but allowing a foreign tax credit for foreign taxes paid on passive income). Any distinct treatment of passive income would reduce simplicity gains from moving to an exemption system. * * *

Yet another alternative would be to follow pure export neutrality and allow an unlimited foreign tax credit. Such an approach would be simple because all that would be required would be to determine the amount of the taxpayer's creditable foreign taxes. The source of the taxpayer's income and deductions would be irrelevant since an unlimited credit would be allowed without regard to whether the foreign tax exceeded the U.S. rate on the taxpayer's foreign-source income. Of course, such an approach would result in the United States ceding its taxing authority over even U.S.-source income to high-tax foreign countries (to the extent of the excess of the foreign tax credit over the taxpayer's U.S. tax on foreign-source income) and, thus, could lead to a substantial erosion of the U.S. tax base. The United States would, in effect, be subsidizing the public sectors of high-tax foreign countries, which could impose tax rates in excess of the U.S. tax rate without suffering any loss of U.S. investment * * * . [S]uch an unlimited foreign tax

credit would be fully refundable and result in a substantial diversion of funds from the U.S. Treasury to the treasuries of foreign countries. No country to our knowledge has adopted an unlimited foreign tax credit and no country (including the United States) is likely to do so. * * *

Finally, another alternative to our current system would be a system that attempts to prevent any cross-crediting or averaging to any extent in order to minimize the effect of the foreign tax credit system on economic behavior. In theory, if this approach were strictly adhered to, a foreign tax credit should be allowed only to the extent that allowance of the credit does not induce a change in the behavior of U.S. persons to move business or investment activities abroad. Such a theoretically pure approach would require that we treat net income from each transaction (or narrow groupings of transactions) separately for foreign tax credit purposes and allow a foreign tax credit only for the foreign taxes paid or accrued on such income up to the amount of U.S. tax on such income. Any departure from this strict item-by-item approach allows a taxpayer leeway for averaging high foreign taxes on the income from some transactions with low foreign taxes on the income from other transactions and, thus, creates some incentive for U.S. persons to move business or investment activities abroad to low-tax countries.

Nevertheless, an item-by-item approach is probably not administratively feasible at any acceptable cost. Accordingly, some averaging of high and low foreign taxes will be tolerated; the issue is how and where to draw the limits on such averaging. * * * We recommend below that a per-country limitation be enacted, which will substantially reduce cross-crediting opportunities. * * *

Per-Country Limit

Under a per-country limit, a taxpayer separately computes the creditable foreign taxes paid or deemed paid with respect to each foreign country and computes the limit based on its taxable income in each country. Under a pure per-country limit, with no basket limitations within each country, no attempt is made to segregate the various types of income received within the same country and the cross-crediting of high and low foreign taxes on different types of income within the same country is allowed.

Because this limit prevents a taxpayer from cross-crediting the high rates of foreign tax in one foreign country against the low rates or no taxes in other foreign countries, it comes closer to achieving the objective of the theoretically ideal item-by-item limit than does the overall limit. Moreover, at a time when

nominal U.S. income tax rates are lower than the nominal rates in many foreign countries, the per-country limit promotes economic efficiency by significantly reducing the incentive for taxpayers with high-taxed foreign income to move capital to low-tax foreign jurisdictions.

One disadvantage of the per-country limit is that it engenders significant complexity by requiring a taxpayer with operations in many foreign countries to make a large number of separate limitation computations. This limit may require a taxpayer to allocate income and deductions from integrated business activities, parts of which arise in several foreign countries, among the various countries. Thus, opponents of the per-country limit argue that it exacerbates the artificial distinctions made in any system of dividing income and deductions from a single business activity among several jurisdictions.

Furthermore to prevent a U.S. person from routing U.S.-source income through a foreign corporation to change the source of the income, a rule similar to Section 904(g) would be needed to look through dividends, interest, and royalties as to geographical source. Obviously, such a rule would be complicated in application, although probably not measurably more complicated than current law.

Under a per-country limit, a serious technical problem arises when a taxpayer's foreign-source income is taxed by more than one foreign country. The per-country limit may prevent the taxpayer from crediting foreign taxes imposed by a foreign country other than the source country. One solution to this problem is to apply a special source rule under which income having its source in one country but taxed in another country retains its geographical source, but any foreign tax imposed by it is considered a tax imposed by the source country. Needless to say, however, application of such a rule would be complex.

* * *

Another technical defect in the per-country limit is that it allows a taxpayer with losses in one foreign country to use those losses to reduce U.S.-source income while at the same time crediting foreign taxes on foreign-source income in other foreign countries against the taxpayer's U.S. tax liability. This problem was one of the major reasons that Congress repealed the elective per-country limit in 1976. This defect can be cured by adopting a rule similar to Section 904(f)(5) of current law that would allocate the loss from one country proportionately among all of the countries (including the United States) in which the taxpayer has positive amounts of taxable income. Such an allocation

rule, of course, would not be simple in operation. Alternatively, a simpler way of mitigating this problem is to adopt an unlimited foreign loss carryforward with excess losses being usable only against income generated in the country where the losses arose.

The per-country limit does not eliminate the incentive for a taxpayer to shift passive investment capital to a foreign country provided that the investment produces low-taxed income sourced in the same foreign country in which the taxpayer has earned the high-taxed foreign-source income. To ameliorate this problem, we propose that the per-country limit be combined with a separate basket category for passive income from each foreign country. This limit approach comes the closest of all of these alternatives to the theoretical ideal of actual item-by-item approach to limiting the foreign tax credit.

* * *

[P]erhaps the complexity of the per-country limitation could be reduced by treating countries with which the United States has a modern tax treaty and which have substantial income tax systems as a single country for purposes of this limitation. Under this modified per-country limitation approach, a separate limitation would be computed for each other country not qualifying for this aggregation rule.

NOTE

A Response. John Steines, a NYU law professor, has responded to this suggestion of a per-country limitation. He contends that there are ownership structure techniques which corporations could employ to enable cross-country averaging, effectively skirting the intent behind the per-country system proposal. Therefore, Steines believes that such a system would likely add "complexity to the foreign tax credit limitation system and to the transactions it governs without meaningfully curtailing cross-crediting."[14]

In the following excerpt, David Tillinghast rejects a per-country limitation and instead contends that the foreign tax credit limitation could be simplified by streamlining the basket system.

David R. Tillinghast, *International Tax Simplification*, 8 Am. J. Tax Pol'y 187, 215–31 (1990).

Simplifying the Limitation Rules

Certainly the place to start in simplifying the foreign tax credit is at the point of its greatest complexity—the multiple

14. John P. Steines, Jr., Foreign Tax Credit Reform (Feb. 27, 2003) (unpublished manuscript).

limitation baskets that have been applied since the Tax Reform Act of 1986. In appraising how these might be restructured, it is well to remember why they are there in the first place.

Unless the foreign tax credit is applied strictly on an item-by-item basis, a high rate of foreign tax on one item of foreign source income may be averaged against the low rate of foreign tax imposed on another. In effect, the residual U.S. tax which would be imposed on the lightly taxed income is offset by the excess foreign tax imposed on the heavily taxed income. Philosophically, this seems inappropriate to some but not to others. In practical terms, however, the different schools of thought converge on a couple of points. The first is that a strict item-by-item matching of foreign taxes paid against U.S. tax is unadministrable. The second is that, as long as the U.S. rate remains relatively low compared with foreign rates, some sort of limitation on the cross-crediting of foreign taxes seems necessary. The U.S. taxpayer already deriving heavily taxed foreign income will prefer to earn lightly taxed foreign income, rather than U.S. source income, if he can average his foreign tax credits, since that foreign income can be derived tax free (or at a lower effective rate). Thus, the U.S. government sees multiple limitations as serving a need to protect its revenue base from erosion.

There are two readily apparent ways to deal with the government's concern, short of a full item-by-item matching of credits and U.S. tax. The first is to segregate all of the items of income that bear high foreign taxes from those that bear low foreign taxes. The other is to group items of income into categories based on their character, allowing taxes on like-kind items to be cross-credited but not against other kinds of income. The limitation system we now have, employing multiple baskets of income, represents one version of the second method. The discussion here will first turn to the simplification issues arising in this context and then will return to the issue of whether a high-tax/low-tax system would be preferable. * * *

Simplifying the Basket System

Since we now have a system based on limitation baskets and since for present purposes the system is by definition too complex, one obvious goal would be to reduce the number of baskets. The way to go about this, it seems, is simply to identify what features of the regime we consider most essential and which we consider most dispensable, retaining the first and discarding the latter until we reach the point at which other policy objectives argue more strongly than simplification for keeping what is left.

Before detailed consideration of basket simplification issues, it may be well briefly to consider—and reject—a return to the per-country limitation. Under this system, the limitation on the credit for a tax imposed by a particular foreign country was computed by aggregating all taxes paid to that country and all income derived from within its territory. There are several reasons why this system works badly.

To begin with, given the number of countries there are in the world, the per-country system can involve the computation of a very large number of limitations, at least for substantial numbers of taxpayers. To avoid simple manipulative techniques, dividends (and perhaps interest and royalties) received from a foreign corporation would have to be looked through as to geographical source; and it is not easy to make these rules come out right. Under the per-country limitation system, losses in a particular country reduce U.S. source income rather than foreign source income from other countries, thus reducing U.S. tax overall while leaving credits for other countries' taxes unaffected. And finally, grouping income by geographical source alone does not adequately prevent erosion of the U.S. tax base, since it is relatively easy for a taxpayer deriving income in a high-tax country (say, Germany) to create income from sources within the country that bears little or no tax (interest exempt under treaty, for example). Accordingly, even when the Reagan administration proposed a per-country system, it also proposed to segregate the income from each country into baskets according to its character. The potential complexity of this proposal was staggering, and it was abandoned.

Assuming, therefore, that we are talking about worldwide categories of income, let us return to consider, first, some fundamentals of the basket system. As indicated above, two features seem essential. First, there must be a rule like the section 904(g) rule (although not necessarily that particular one) to prevent the routing of income through a foreign corporation from converting U.S. source items into foreign source dividend or interest payments. Furthermore, we must be prepared to apply this rule—as well as any other hereafter adopted—to all foreign corporations at all tiers of ownership. Thus armed, we may start the process of elimination.

(i) Passive Income

Almost everyone's first choice to maintain as a separate limitation basket has to be the passive income basket. Of all of the things that can be done to generate lightly taxed foreign source income, none approaches the ease of diverting passive investments to earn income abroad. Not only is such income

typically subject only to withholding taxes, frequently reduced or eliminated by treaty or unilateral enactment, but it also can relatively easily he derived in jurisdictions that have no income tax at all. A first priority, then, is to cordon passive income off from "business income," as the rest of the income world may be called. Once this is said, however, further consideration needs to be given to simplifying the contours of the passive income basket itself.

* * *

(A) The High–Tax Kick–Out

[T]he most promising simplification would be to eliminate the so-called high tax kick-out. Under this provision, income which is otherwise characterized as passive income is kicked out of the passive income limitation category, into the residual or business income category if the rate of foreign tax imposed on the income equals or exceeds the U.S. rate. The provision creates enormous complexity. * * * Under the high-tax kick-out it is necessary to identity income items (and provide rules for grouping them, if the test is not to be applied on a strictly item-by-item basis, which is an administrative nightmare), allocate and apportion taxes and expenses to them, determine the effective rates of foreign tax that result, and compare this to the applicable U.S. rate. A review of the existing regulation, which consists of several pages of text and examples, will indicate some of the difficulties involved.

That it is necessary to have the high-tax kick-out is far from clear. As discussed above, there is an identifiable rationale for preventing a U.S. taxpayer already paying high foreign taxes from affecting the foreign tax credit computation by the relatively simple gambit of generating low-taxed passive income abroad. But a taxpayer has no comparable incentive to generate passive income taxed at a rate in excess of the U.S. rate; in fact, it would be preferable to derive U.S. source income and bear only the U.S. rate. It therefore does not seem necessary to purge such income from the passive income basket to prevent the creation of revenue eroding incentives.

* * * Passive income is, above all things, highly moveable; the international portfolio investor seeks out situations in which withholding or other source-based taxes will be low or nonexistent. (The United States' own portfolio interest exemption is a testament to this.) Moreover, if the taxpayer in fact earns both high-taxed and low-taxed passive income, the rationale for disallowing cross-crediting within this particular category of income, while allowing it in other categories, is far from clear.

* * *

(B) Export Financing Interest

Under a special exception, export financing interest is carried out of the passive income category (as well as the high withholding tax interest category discussed below). While this rule has the stated purpose of assuring that the 1986 changes did not have "a negative impact on the volume of exports," its importance in achieving this end seems dubious at best. It applies, to begin with, only to interest derived from financing exports produced by the taxpayer itself or a related party. * * * [I]t is at least questionable how seriously exports would be depressed if the exception were eliminated. Alternatively, a broader and simpler exception rule could undoubtedly be designed, if the foreign tax credit treatment of interest on export financing were really considered a critical stimulus to that desired activity.

(C) High Withholding Tax Interest

High withholding tax interest, defined as any interest on which a foreign withholding (or other gross basis) tax is imposed at a rate of five percent or more, is carved out of the passive income category (as well as every other limitation category) and separately treated. This has a special significance for financial institutions, and this is discussed below. For other taxpayers, the effect is like the high-tax kick-out discussed above, except that the income which is kicked out does not go into the residual or business income limitation category but into a separate category of its own.

* * * For portfolio investors, however, that—unlike the financial institutions—presumptively are not relenders of borrowed money, five percent and higher rates of withholding tax do not seem like high rates; and in any event, the reasons for thinking that it might be feasible to eliminate the high-tax kick-out would apply in this case as well.

(ii) Elimination of the "10–50" Baskets

In general, when a U.S. corporation receives a dividend, interest, rents, or royalties from a controlled foreign corporation in which it is a U.S. shareholder (that is, an owner of 10 percent or more of the stock), the income item is not itself assigned to a limitation category. Rather under a lookthrough rule, the income is categorized according to the nature of the underlying income of the payor corporation.

On the other hand, a U.S. corporation which owns 10 percent or more of the voting stock of a foreign corporation that is not a controlled foreign corporation, as defined in section 957, does not (generally) apply the look through rule to such corporation but must segregate any dividends received from that corporation into a separate basket. A U.S. corporation owning noncontrolling interests in many foreign corporations thus must create a very large number of separate baskets. This of course wholly precludes cross-crediting of foreign taxes on such income and contributes very substantially to the complexity problem.

This is of far more than academic concern. The principal impact is on U.S. foreign joint ventures. A lot of effort is consumed in attempting to transform plain vanilla 50–50 joint venture corporations into controlled foreign corporations * * *.

In many cases, however, these techniques do not work. * * *

The policy premises for the "10–50" separate baskets are hard to understand. [Congress in 1997 adopted a provision providing look-through rules and enabling companies to group all 10–50 corporations into one basket, effective January 2003–ed.]

* * *

(iii) Limitations on the Pooling of Business Income

While it is common to refer to a residual limitation basket into which a taxpayer's business income falls, in fact there are three such baskets, and these may be further intersected by a special basket. Depending upon the nature of the business or businesses in which the taxpayer is engaged, residual income may constitute: (a) foreign oil and gas extraction income (FOGEI), which is in effect segregated under separate rules; (b) financial services income, which has its own limitation; or (c) income not described in any of the other limitation categories—the true residual income category, into which falls income from business activities such as the manufacturing and sale of goods, performance of nonfinancial services, active real estate income and the like.

It is at least highly debatable whether the segregation of FOGEI continues to be justified. The regime was originally adopted because of Congressional concern that the sometimes very high rates of income taxes paid by companies engaged in foreign extractive activities might in substance constitute economic rent (royalties) paid to foreign governments that owned the underlying minerals, as well as imposing taxes in their sovereign capacities. It was deemed prudent to remove these taxes from the overall pot, lest the petroleum companies (in particular) be given an irresistible incentive to utilize the massive excess foreign tax credits arising from their extractive

operations by buying up unrelated foreign businesses bearing low rates of foreign tax.

This segregation of high-tax operations from (potential) low-tax operations is of course not the rule for the residual basket generally: a manufacturing company subject to very high rates of tax in, say, India, can still cross-credit Indian taxes with lower taxes paid on its operations elsewhere. The royalty aspects of taxes on extractive activities may have been thought to present unique problems at the time. Subsequently, however, regulations were issued under section 901 to deal with the royalty vs. income lax issue in the context of defining what (and how much) constitutes a creditable tax. With this protection in place, it is at least highly questionable whether the additional complexity of the section 907(c) segregation is necessary.

The idea of segregating financial services income from other types of business income apparently proceeds again from a concern about incentives to average income taxed at high rates with income taxed at low rates. Whereas the FOGEI rules focus on excessively taxed income, the financial services rule focuses on the fact that at least a great deal of financial services income is moveable, in the sense that a taxpayer has wide latitude in deciding the jurisdiction in which it will be earned, and therefore is often taxed abroad at very low rates. The volume of bank lending which has been routed in the past through Bermuda, the Bahamas, and the Cayman Islands, as well as the formerly explosive growth of tax haven insurance (and even more important, reinsurance) operations, can be traced to this circumstance. The Congress felt that permitting cross-crediting of taxes on income from these kinds of activities with taxes from manufacturing and other, more site-specific, business activities might give undesirable incentives for the combination of financial services businesses with other types of business operations.

The author is in no position to argue the economic merits of this decision. Obviously, the foreign tax credit would be simpler if the separate financial services income category were dropped from the limitation scheme. On the other hand, in the vast majority of cases, the financial services limitation will apply to all of the residual income, *i.e.,* income not subject to specific limitation categories, of an affected entity; in other words, most entities will not have income in the financial services income limitation and also in the general business income limitation category, although of course entities within the same controlled group will often fall on different sides of the blanket.

If the financial services income category is retained, however, serious consideration should be given to repealing the rule

under which high withholding tax interest is kicked out of this category into a separate one. * * *

(iv) Pooling Low–Taxed Income Categories

The existing statute creates separate limitation categories not only for passive income, as described above, but also for: (a) shipping income; (b) income representing distributions from a Domestic International Sales Corporation (DISC) or from a former DISC; (c) foreign trade income derived by a Foreign Sales Corporation (FSC); and (d) distributions made by an FSC or former FSC out of foreign trade income. Although the legislative history is not illuminating, it seems clear that each of these categories was cordoned off from income in the residual category because it was thought likely to bear little or no foreign tax. What is not so clear is why it was felt necessary to separate each of these categories from each other. For the reasons discussed above; it seems highly unlikely that a taxpayer would go out of his way to create highly taxed income in these categories—voluntarily to subject an FSC, for example, to substantial foreign taxes (which would completely destroy the purpose of the special purpose corporation). Accordingly, there is no apparent reason why income in all of these categories could not simply be combined in a single limitation basket.

The only possible reservation relates to shipping income. In the author's experience, this is characteristically low-taxed income. But in principle investors might go into high-taxed shipping operations for autonomous business-related reasons; moreover, income that falls in the shipping category sometimes can be structured to produce early year losses, as in the case of aircraft leases. There may, therefore, be reasons not to permit such income to be pooled with the other categories of low-taxed income referred to above.

(v) Summary

If all of the changes discussed in this part were adopted, the limitation baskets would include only:

(1) Passive Income (including DISC and FSC related income), regardless of the rate of foreign taxes borne;

(2) possibly, shipping income;

(3) financial services income;

(4) all other income.

The passthrough rules would continue to apply, as would section 904(g). Income received by a corporation from a noncontrolled section 902 foreign corporation would generally be subject to the pass-through rules, but could be kicked out into the

passive basket (with a cap on the related credit) if the taxpayer could not supply the Service with information sufficient to verify the passthrough computations.

This would not be a model of simplicity, but it would certainly be far less complex than the existing law.

NOTE

NFTC Proposals. The National Foreign Trade Council (NFTC) has also put forth foreign tax credit legislative recommendations. One example is the adoption of an approach in which U.S. interest expense would be applied against foreign-source income only when the debt-to-asset ratio is higher for U.S. investments. Another recommendation addressing the asymmetry caused by the recapture of foreign losses but not domestic losses allows domestic losses to be recaptured for multinationals unable to credit foreign taxes paid. Primarily, the NFTC calls for simplification. For example, like David Tillinghast, the NFTC recommends repealing the high-tax kick-out from the separate limitation for passive income, combining low-tax baskets such as passive, DISC, FSC and shipping baskets, and repealing the separate limitation for high withholding tax interest. See II THE NFTC FOREIGN INCOME PROJECT: INTERNATIONAL TAX POLICY FOR THE 21ST CENTURY 49–60 (2001) for a complete discussion of these legislative proposals. For another take on the foreign tax credit, see Chapter 5, which discusses an exemption alternative.

Chapter 5

Deferral and Controlled Foreign Corporations

5.1 INTRODUCTION

Taxation of profits earned by U.S. individuals and corporations from their ownership interests in foreign corporations is generally deferred until the earnings are repatriated to the U.S. shareholders in the form of a dividend or realized by U.S. shareholders as gain from the sale of shares. This postponement of taxation, commonly referred to as deferral, is a natural corollary of two long-standing principles in U.S. international taxation: the decision to honor the distinct legal identity of foreign subsidiaries and the principle of not taxing the foreign earnings of foreign persons. Any corporation formed with a valid business purpose is treated as a separate entity for tax purposes. The U.S. income tax consequently regards all foreign-chartered corporations as foreign persons even if they are beneficially owned and controlled by U.S. persons. Since foreign persons are not taxed currently on their foreign-source income, profits attributable to U.S. shareholders escape U.S. tax for as long as they are reinvested outside of the United States. Deferral along these lines has always been a part of U.S. international income tax law and is a common practice throughout the world.

This so-called deferral privilege is very valuable to U.S. multinational corporations. By establishing a subsidiary in a low-tax foreign jurisdiction, a U.S. corporation can essentially remove income-generating assets from the immediate reach of U.S. taxation. Although income accumulated in a foreign subsidiary will eventually be subject to U.S. tax upon repatriation to the domestic parent, the effective rate of this tax is diminished due to the time value of money. Over a long enough period of time, the present value of this future tax approaches zero and the U.S. corporation obtains the benefit of any difference between the U.S. tax rate and that of the jurisdiction of the foreign subsidiary.

Because of the ease with which U.S. corporations can establish foreign subsidiaries and choose their country of residence, opportunities for deferral must be limited in order to preserve the U.S. tax base. Without constraints, the deferral privilege would be easy to abuse through artificial manipulations of income, for example, by moving

highly mobile forms of income to foreign entities in order to postpone taxation or by having related foreign subsidiaries report income that should properly be attributed to the domestic parent. From as early as 1937, Congress recognized the need to limit deferral and moved to adopt anti-abuse measures. The earliest of these was a limitation on foreign personal holding companies, companies formed essentially to earn mobile passive income. The most important and complex anti-deferral regime is subpart F of the Code's foreign income subchapter—enacted in 1962. Subpart F taxes currently certain income earned by a foreign corporation that has been deemed a "controlled foreign corporation" (CFC). Generally speaking, a CFC is a foreign corporation that is majority owned by U.S. individuals or corporations, counting only those U.S. shareholders who hold 10% or more of the stock. Subpart F specifies several categories of CFC income that are subject to current U.S. income tax; these types of income have typically been singled out due to the relative ease with which they can be shifted to low-tax jurisdictions.

The Code's anti-deferral regimes are also designed to discourage U.S. corporations from shifting income to foreign "base" companies located in tax haven countries such as Bermuda, Switzerland, and the Bahamas. A typical transaction of this sort is the use of a foreign base company as a conduit for the overseas sales of U.S.-manufactured goods. A U.S. parent corporation intending to market and sell its goods in Germany might sell them first to its wholly owned subsidiary in Switzerland at a below-market price, thus minimizing any profit realized in the United States. The Swiss subsidiary might then sell the goods to the German subsidiary of the same U.S. parent at a price that is inflated so that little German income would be earned upon ultimate sale of the goods at retail. This transaction results in the deflection of income that is in substance associated with economic activity in the United States and Germany to a base company in a low-tax jurisdiction such as Switzerland.

In the absence of current taxation by Subpart F (or reallocation of the income to the proper country through transfer pricing mechanisms discussed in Chapter 9), this income could be reinvested indefinitely in other overseas ventures with the proceeds escaping current U.S. taxation. Moreover, foreign base companies might be utilized in numerous other types of transactions that, in the absence of measures limiting deferral, would have the same effect of diverting income from high-tax jurisdictions to a low-tax jurisdiction. These include ownership of passive investment assets, provision of services to the parent and other related entities within the U.S.-controlled business group, making loans within the controlled group, and holding intellectual property for licensing to related entities. The common strategy employed in all these transactions is the nominal transfer of a multinational corporation's assets, capital and know-how into a base company situated in a low-tax country. These resources are then licensed, loaned, or resold to affiliated corporations

located in high-tax jurisdictions, thus accumulating profits in the foreign base company—profits that are shielded by the deferral privilege from current U.S. taxation. As with the example above involving the cross-border sale of manufactured goods, these foreign base company transactions effectively divert income into jurisdictions with only an artificial connection to the actual taxable economic activity.

Because of the ease with which certain highly mobile assets can be transferred abroad, the U.S. tax base would be significantly eroded without constraints on the default policy of deferral. This chapter traces the development of Subpart F and other anti-deferral regimes in the Code, examines the policy debates about the appropriate scope of the deferral privilege, and discusses a variety of proposals before Congress in this area of international tax policy.

5.2 History and Overview of Subpart F

Deferral has long been controversial as a policy matter; it affects the revenue to the treasury, the competitiveness of U.S. versus foreign corporations, the use of tax havens to shelter tax, and the rewards from shifting the source of various kinds of income. The following excerpt chronicles the policy struggles that have produced the complex and varied anti-deferral regimes we have today.

Keith Engel, *Tax Neutrality to the Left, International Competitiveness to the Right, Stuck in the Middle With Subpart F*, 79 Tex. L. Rev. 1525, 1526–1551 (2001).

From 1913 through the 1950s, U.S. multinational corporations operated free from current U.S. income tax to the extent that they conducted operations through foreign subsidiaries. U.S. income tax applied to foreign subsidiaries only when they repatriated income to the United States. As a result, a growing chorus of U.S. multinationals began to shift their operations offshore. In response to the growing erosion of the U.S. tax base, the Kennedy Administration introduced groundbreaking international taxation legislation.

Under the initial Kennedy Administration Proposal, foreign subsidiary activity was generally to trigger current U.S. income tax for the subsidiaries' U.S. multinational shareholders. The aim of this Proposal was simple—global tax neutrality. Thus, foreign activities of U.S. multinationals were to be taxed at the same rates imposed on wholly domestic U.S. enterprises, ensuring that wholly domestic enterprises would remain competitive with their U.S. multinational rivals.

The Kennedy Administration Proposal faced serious congressional opposition, primarily on the grounds of international competitiveness. The opposition believed that the Proposal

would have subjected U.S.-owned foreign subsidiaries to higher overall taxes than the taxes imposed on their locally owned foreign competitors. Thus, they believed that foreign local neutrality was necessary to ensure that U.S.-owned foreign subsidiaries would remain competitive abroad.

Both sides soon came to a compromise. Under this compromise (known as "Subpart F"), U.S. multinationals are generally subject to current U.S. income tax to the extent their foreign subsidiaries receive disfavored forms of income. These disfavored forms of income include income from passive investments, such as portfolio stocks and bonds. Disfavored forms of business income are of a more limited nature, mainly involving structures that shift income outside a foreign subsidiary's place of incorporation without significant economic cost.

* * *

Historic Development of the Subpart F Compromise

From the earliest days of the Internal Revenue Code, U.S. taxpayers investing abroad faced the same basic choice that they face today. U.S. taxpayers could either invest through a foreign branch or through a foreign subsidiary. Both choices have never been tax neutral.

In the beginning, foreign subsidiaries existed fully outside U.S. taxing jurisdiction without any anti-deferral regimes. The U.S. tax system initially accounted for foreign subsidiary income only upon repatriation to U.S. owners. Repatriation created fully taxable income with foreign tax credit offsets.

Early Measures to Prevent Offshore Movements of Liquid Passive Assets

The initial 1913 failure to impose immediate U.S. tax on foreign subsidiary income soon gave rise to tax avoidance. In the 1930s, Congress responded to these offshore shifts by adopting anti-avoidance measures.

The primary avoidance technique involved the use of foreign subsidiaries as incorporated pocketbooks. Under this technique, U.S. persons would form foreign subsidiaries in tax havens that would simply hold liquid passive assets (such as stocks and securities), producing income outside U.S. taxing jurisdiction. The income produced by these passive assets was subject to little or no tax by the tax-haven country and was not taxed by the United States until repatriated.

Congress viewed this technique as problematic. Holding liquid passive assets in tax-haven subsidiaries as opposed to direct U.S. holdings was of no significant economic consequence

for U.S. taxpayers, and yet this noneconomic distinction yielded substantial global tax savings. Congress responded by enacting the Foreign Personal Holding Company regime. The net effect of this regime was to pierce the corporate veil of foreign subsidiaries qualifying as foreign personal holding companies. U.S. owners are now subject to tax on certain forms of passive foreign subsidiary income during the same year the income accrues in the hands of the foreign subsidiary as if the U.S. owners earned the income directly.

The Foreign Personal Holding Company regime targets only a limited class of closely held foreign subsidiaries. In order to qualify as a foreign personal holding company, the foreign subsidiary has to satisfy stock-ownership and income-producing requirements: (i) the foreign subsidiary has to be owned, directly or indirectly, by five or fewer U.S. individuals; and (ii) at least sixty percent of the foreign subsidiary's gross income initially has to come from certain passive categories. Thus, this regime does not reach foreign subsidiaries owned by publicly held U.S. multinationals, nor does it reach foreign subsidiaries with a preponderance of active income.

In the end, the initial deferral landscape for foreign subsidiaries was left largely intact. No further restrictive action was taken in the foreign area until the early 1960s.

* * *

The Initial 1961 Kennedy Proposal

While the political climate largely favored liberalization until the late 1950s, conditions had changed by the early 1960s. The United States was running a large deficit for the first time in many years, and U.S. multinational investment in foreign subsidiaries was suddenly viewed by some as contributing to this deficit. Still worse, U.S. economic growth in terms of the gross national product had fallen to approximately two percent from a long-standing three percent average. Meanwhile, other industrialized countries had recovered from the ravages of World War II, generating double-and triple-digit growth; even the Soviet Union was reportedly growing at seven percent.

In order to combat this relative economic decline, the Kennedy Administration adopted a two-prong Proposal as part of its 1961 recommended budget. The first proposal was for Congress to adopt a new investment tax credit to stimulate purchases of plant, machinery, and equipment for domestic industries. The Kennedy Administration, with the guidance of Stanley Surrey as the Assistant Secretary of Tax Policy, also proposed that deferral for U.S.-owned foreign subsidiaries be

largely eliminated so that domestic investment would receive full tax parity with foreign investment.

Even more problematic to the Kennedy Administration was the growing use of tax havens to divert business income. The base company mechanism * * * was no longer viewed as a favorable mechanism of promoting foreign investment, but instead as a malignant mechanism to avoid worldwide tax.

The first and most notable structures of concern to the Kennedy Administration involved the diversion of income from high-tax foreign countries to tax havens. The primary example of this structure cited by the Administration involved a U.S.-owned subsidiary in Germany, which had a fifty percent rate that diverted income to a related company in Switzerland, which had an eight percent rate. The Administration regarded this diversion to the lower Swiss rate as an implicit tax incentive for business investors to operate abroad.

However, the Administration generally appeared to view transactions diverting income from U.S. shores to tax havens as a secondary concern to the larger question of global tax neutrality. While U.S. tax revenue was lost, these diversions effectively lowered the tax of operating within U.S. shores, thereby removing the incentive for U.S. multinationals to divert their operations elsewhere.

In specific terms, the Kennedy Administration recommended the outright elimination of deferral for foreign subsidiaries operating within economically developed countries. Deferral would have continued only for foreign subsidiaries within developing countries (who were still in need of economic stimulus). Moreover, even foreign subsidiaries within developing countries would lose the benefit of deferral if those subsidiaries received their income through profit shifting and profit extraction, which the Administration generally viewed as lacking any economic nexus to the country of incorporation.

The Legislative Debate

The Kennedy Administration's antideferral Proposal faced stiff resistance in the House. Certain members of the House Ways and Means Committee questioned the constitutionality of the Administration's Proposal as well as its potential adverse impact on international competitiveness of U.S. businesses.

Similarly, witnesses from the U.S. international business community raised the banner of competitiveness in opposition to the Proposals. While conceding that most of their competitors were from high-tax industrialized nations, these witnesses argued that these foreign competitors were similarly using tax-haven devices to reduce their own foreign tax burdens. Therefore, if the Administration ended deferral as proposed, U.S. businesses would be unable to compete with their foreign counterparts who would continue to reduce their global tax burdens through the tax-haven device. * * *

The Structure of the 1962 Subpart F Regime

The Kennedy Administration's concerns regarding tax havens ultimately became the centerpiece of reform in 1962. Repeating President Kennedy's declaration, both the House and the Senate announced their intent to "eliminate the tax haven device anywhere in the world," viewing the tax-haven device as one that "exploits the multiplicity of foreign tax systems and international agreements in order to reduce sharply or eliminate completely their tax liabilities both at home and abroad." However, Congress stopped short of ending deferral for all U.S.-owned foreign subsidiary income. The 1961 hearings convinced Congress that the Administration's more generalized antideferral approach would have placed legitimate U.S.-owned businesses at a competitive disadvantage.

The modified 1962 Proposal targeted only "tax-haven" income earned by CFCs (hereinafter referred to as "Subpart F income"), leaving deferral intact for the remainder. Subpart F income generally includes income from liquid passive investments, income from diversionary transactions (e.g., profit extraction and profit shifting), and income from related parties that is deemed to be a mechanism for extending deferral; each type of income is discussed below.

a. Passive Income

One major category of Subpart F income involves income from liquid passive investments (referred to in the Code as "foreign personal holding company income"). This category includes dividends, interest, rents, and royalties arising from passive assets. This category also includes the sale or exchange of property that generates these forms of income, such as the sale or exchange of stock and securities.

Congress targeted passive income because it believed that no rationale existed for generally delaying the taxation of foreign subsidiary passive income because passive income failed to create competitive business concerns. Congress was also well aware that deferral created an irresistible temptation to shift liquid passive assets offshore because the underlying economic earnings from these assets remained the same regardless of location. Subpart F treatment for these items of passive income effectively levels the playing field for foreign subsidiaries owned by publicly held U.S. multinationals with those owned by closely

held U.S. persons, the latter of which were already denied deferral under the Foreign Personal Holding Company regime. * * *

b. Diversionary Sales Income

A CFC's sale of personal property generally does not create Subpart F income (referred to by statute as "foreign base company sales income") unless the sale both involves a related party and lacks any economic nexus to the CFC's country of incorporation. Restated in technical terms, the sale of personal property by a CFC creates Subpart F income if: (i) the CFC purchases personal property from, or sells personal property to, a related party (the related-party requirement); and (ii) the CFC neither produces the property within its country of incorporation, nor is the property ultimately sold for use, consumption, or disposition within the CFC's country of incorporation (the lack-of-economic-nexus requirement).

The net effect of the Subpart F sales rule is to eliminate the diversionary sales arrangements initially identified by the Kennedy Administration. The related-party requirement targets artificial diversions among members of the same group because income diversions of this kind have no underlying economic meaning. * * *

c. Diversionary Services Income

Subpart F services income (referred to by statute as "foreign base company services income") operates in similar fashion to the Subpart F rules for related-party sales. Similar to Subpart F sales, CFC services do not create Subpart F income unless the services both involve a related party and lack any economic nexus to the country of incorporation. * * *

1963–1993: Gradual Tightening of Antideferral

The Subpart F compromise for U.S.-owned foreign subsidiaries has remained largely in place since its initial 1962 enactment. Subsequent legislative changes have been largely peripheral with most of the changes from 1963 through 1993 representing a gradual tightening of antideferral.

Changes to the Subpart F Income Categories

Congress has generally expanded the Subpart F income categories since its 1962 enactment. In addition to the creation of the foreign base company shipping and foreign base company oil related income categories, Congress has expanded the passive income category.

Congress extended the Subpart F passive income category to include additional identified forms of liquid passive items,

such as income from commodity sales, currency transactions, interest equivalents, and notional principal contracts. Congress believed that these items had the same liquid nature (with the attendant avoidance potential) as the passive income identified in 1962.

* * *

The Mid–1990s: Reversing Course

By the mid–1990s, the political forces favoring international competition successfully pressed their case that antideferral had become too restrictive. This political effort provided CFCs with relief against passive asset accumulations and for active banking income.

NOTES

1) *Compromising Between CEN and CIN.* Because Subpart F originated as a policy compromise between the Kennedy Administration's worldwide efficiency goal and the business community's concerns over international competitiveness, debates over deferral often continue to be dominated by the ideological rift between CEN and CIN. From the standpoint of capital export neutrality, the deferral privilege ought to be eliminated entirely since it distorts investment decisions by creating an incentive to move capital overseas to low-tax countries. Capital import neutrality, on the other hand, favors the preservation of deferral in order to ensure that U.S. businesses receive the same tax treatment as their competitors when operating in foreign markets. Subpart F could thus be viewed as striking a balance between these two positions by eliminating deferral with respect to certain types of income while otherwise keeping the deferral privilege intact. Over time, the anti-deferral rules have been relaxed and tightened, perhaps reflecting Congress's ever-evolving balance between CEN and CIN.

Beyond the idea of striking a balance between these two theoretical poles of international tax policy, it is difficult to find any coherent policy underlying this unstable compromise on deferral. Much of the legislative history of Subpart F suggests that Congress in 1962 was motivated primarily by the pragmatic goal of preserving the U.S. tax base and not by any fundamental desire to implement worldwide efficiency in taxation. For instance, the House Ways and Means Committee's March 1962 report on the proposed Subpart F legislation stated four objectives: "(1) to prevent U.S. taxpayers from taking advantage of foreign tax systems to avoid taxation by the United States 'on what could ordinarily be expected to be U.S. income'; (2) to reach income retained abroad that was not used in the taxpayer's trade or business and not invested in an under-developed nation; (3) to prevent the repatriation of income to the United States in such ways that it would not be subject to U.S. taxation; and (4) to prevent taxpayers from using foreign tax systems to divert

sales profits from goods manufactured by related parties either in the United States or abroad."[1]

2) *Transfer Pricing*. An additional anti-abuse tool that has existed since long before the inception of Subpart F is the transfer pricing regime, which is presently codified in section 482. This provision authorizes the Commissioner to restate the prices charged for goods and services sold between related business entities in order to prevent tax avoidance and more accurately reflect the income of such entities. Under this reallocation mechanism, the government may administratively reverse pricing manipulations used to shift income into tax havens in transactions with foreign base companies. For a more detailed discussion of the U.S. transfer pricing regime and its enforcement, see Chapter 9.

5.3 Subpart F and Other Anti-Deferral Regimes

The ongoing policy compromises on deferral have produced a stifling array of complex rules making up the present version of Subpart F and the several other anti-deferral regimes still in existence. Ostensibly, the function of Subpart F remains distinguishing between the "good" deferral of active business income and the "bad" deferral of passive tax haven income, singling the latter out for current taxation. Rather than establishing a general standard aimed at determining a taxpayer's motive in any given transaction, Subpart F accomplishes this purpose using objective and mechanical rules designed to isolate income typically associated with tax avoidance. This is necessarily an imperfect endeavor, and, as is often the case with bright-line rules in the Code, anti-deferral provisions are constantly subject to tax planning strategies that circumvent the statutory purpose while maintaining literal compliance with the law. Much of the complexity of Subpart F stems from the perpetual legislative process of grafting layers of new rules onto the original statutory scheme in order to foreclose particular tax-reduction opportunities. The following excerpt provides a summary of the Code's anti-deferral regimes as they exist today, leaving out much of the formidable detail of the statutory and regulatory rules. Consider the extent to which these various mechanisms serve a discernible common objective.

Staff of the Joint Committee on Taxation, Technical Explanation of the Tax Simplification Act of 1993, JCS-1-93 (Jan. 8, 1993).

> Since 1937, the Code has set forth one or more regimes providing exceptions to the general rule deferring U.S. tax on income earned indirectly through a foreign corporation. Today the Code sets forth the following anti-deferral regimes: the

1. H.R. Rep. No. 87-1447, at 58 (1962), quoted in 1 National Foreign Trade Council, Inc., The NFTC Foreign Income Project: International Tax Policy for the 21st Century, Report and Analysis 49 (2001).

> controlled foreign corporation rules (secs. 951–964); the foreign personal holding company rules (secs. 551–558); passive foreign investment company (PFIC) rules (secs. 1291–1297); the personal holding company rules (secs. 541–547); the accumulated earnings tax (secs. 531–537); and rules for foreign investment companies (sec. 1246) and electing foreign investment companies (sec. 1247). The operation and application of these regimes are discussed in the following sections.

Controlled Foreign Corporations

General Definitions

A controlled foreign corporation is defined in the Code generally as any foreign corporation if U.S. persons own more than 50 percent of the corporation's stock (measured by vote or value), taking into account only those U.S. persons that own at least 10 percent of the stock (measured by vote only) (sec. 957). Stock ownership includes not only stock owned directly, but also all stock owned indirectly or constructively (sec. 958).

Deferral of U.S. tax on undistributed income of a controlled foreign corporation is not available for certain kinds of income (sometimes referred to as "subpart F income") under the Code's subpart F provisions. When a controlled foreign corporation earns subpart F income, the United States generally taxes the corporation's 10–percent U.S. shareholders currently on their pro rata share of the subpart F income. In effect, the Code treats those U.S. shareholders as having received a current distribution out of the subpart F income. In this case, also, the foreign tax credit may reduce the U.S. tax.

Subpart F income typically is income that is relatively movable from one taxing jurisdiction to another and that is subject to low rates of foreign tax. Subpart F income consists of foreign base company income (defined in sec. 954), insurance income (defined in sec. 953), and certain income relating to international boycotts and other violations of public policy (defined in sec. 952(a)(3)–(5)). Subpart F income does not include the foreign corporation's income that is effectively connected with the conduct of a trade or business within the United States, which income is subject to current tax in the United States (sec. 952(b)).

Foreign Base Company Income

In general.—Foreign base company income includes five categories of income: foreign personal holding company income, foreign base company sales income, foreign base company services income, foreign base company shipping income, and foreign base company oil-related income (sec. 954(a)). In comput-

ing foreign base company income, amounts of income in these five categories are reduced by allowable deductions (including taxes and interest) properly allocable, under regulations, to such amounts of income (sec. 954(b)(5)).

Foreign personal holding company income.—One category of foreign base company income is foreign personal holding company income (sec. 954(c)). For subpart F purposes, foreign personal holding company income generally includes interest, dividends, and annuities; some rents and royalties; related party factoring income; net commodities gains; net foreign currency gains; and net gains from sales or exchanges of certain other property.

This last category of net gains from sales of property generally includes the excess of gains over losses from sales and exchanges of non-income producing property and property that gives rise to interest, dividends, rents, royalties, and annuities. Thus, foreign personal holding company income includes gain on the sale of property that was held for investment purposes, but does not include gain on the sale of land, buildings, or equipment that was used by the seller in an active trade or business of the seller [Reg. sec. 4.954–2(e)(3).] Stock and securities gains generally are treated as foreign personal holding company income. * * *

Income received by a foreign insurance company, including income derived from its investments of funds, generally is subject to taxation under section 953. * * * Treasury regulations specify that taxation of an insurance company's income under section 953 takes precedence over taxation of that income as foreign personal holding company income under section 954 (Proposed Treas. Reg. sec. 1.953–6(g)). When dividends, interest, or securities gains derived by a controlled foreign insurance company are not taxed under section 953, they generally are taxed as foreign personal holding company income under section 954. * * *

Other categories of foreign base company income.—Foreign base company income also includes foreign base company sales and services income, consisting respectively of income attributable to related party purchases and sales routed through the income recipient's country if that country is neither the origin nor the destination of the goods, and income from services performed outside the country of the corporation's incorporation for or on behalf of related persons. Foreign base company income also includes foreign base company shipping income. Finally, foreign base company income generally includes "downstream" oil-related income, that is, foreign oil-related income other than extraction income.

* * *

Certain operating rules

Income inclusion.—When a controlled foreign corporation earns subpart F income, the United States generally taxes the corporation's U.S. shareholders currently on their pro rata share of the subpart F income (sec. 951). In the case of a corporation that is a controlled foreign corporation for its entire taxable year, and a U.S. shareholder that owns the same proportion of stock in the corporation throughout the corporation's taxable year, the U.S. shareholder's pro rata share of subpart F income is the amount that would have been distributed, with respect to the shareholder's stock if on the last day of the corporation's taxable year the controlled foreign corporation had distributed all of its subpart F income pro rata to all of its shareholders. The pro rata share definition provides for adjustments where the corporation is a controlled foreign corporation for less than the entire year or where actual distributions are made with respect to stock the shareholder owns for less than the entire year.

In addition, the United States generally taxes the corporation's U.S. shareholders currently on their pro rata share of the corporation's increase in earnings invested in U.S. property for the taxable year. * * *

Distributions of previously taxed income.—Earnings and profits of a controlled foreign corporation that are (or previously have been) included in the incomes of the U.S. shareholders are not taxed again when such earnings are actually distributed to the U.S. shareholders (sec. 959(a)(1)). * * *

Distributions by a controlled foreign corporation are allocated first to previously taxed income, then to other earnings and profits (sec. 959(c)). Therefore, a controlled foreign corporation may distribute its previously taxed income to its shareholders, resulting in no additional U.S. income taxation, before it makes any taxable dividend distributions of any current or accumulated non-subpart F earnings and profits.

Allowance of foreign tax credit.—U.S. corporate shareholders of a controlled foreign corporation who include subpart F income in their own gross incomes are also treated as having paid the foreign taxes actually paid by the controlled foreign corporation on that income, to the same general extent as if they had received a dividend distribution of that income (sec. 960). Therefore, the U.S. corporate shareholders may claim

foreign tax credits for those taxes to the same general extent as if they had received a dividend. Actual distributions by a controlled foreign corporation are not treated as dividends, and thus generally do not carry further eligibility for deemed-paid foreign tax credits, to the extent that the distributions are of previously taxed income.

* * *

Gain from certain sales or exchanges of stock in certain foreign corporations

If a U.S. person sells or exchanges stock in a foreign corporation, or receives a distribution from a foreign corporation that is treated as an exchange of stock, and, at any time during the five-year period ending on the date of the sale or exchange, the foreign corporation was a controlled foreign corporation and the U.S. person was a 10–percent shareholder (counting stock owned directly, indirectly, and constructively), then the gain recognized on the sale or exchange is included in the shareholder's income as a dividend, to the extent of the earnings and profits of the foreign corporation which were accumulated during the period that the shareholder held stock while the corporation was a controlled foreign corporation (sec. 1248). * * *

Foreign personal holding companies

In general

Congress enacted the foreign personal holding company rules (secs. 551–558) to prevent U.S. taxpayers from accumulating income tax-free in foreign "incorporated pocketbooks." If five or fewer U.S. citizens or residents own, directly or indirectly, more than half of the outstanding stock (in vote or value) of a foreign corporation that has primarily foreign personal holding company income, that corporation will be a foreign personal holding company. In that case, all the foreign corporation's U.S. shareholders are subject to U.S. tax on their pro rata share of the corporation's undistributed foreign personal holding company income.

Operating rules

A foreign corporation is a foreign personal holding company if it satisfies both a stock ownership requirement (sec. 552(a)(2)) and a gross income requirement (sec. 552(a)(1)). The stock ownership requirement is satisfied if, at any time during the taxable year, more than 50 percent of either (1) the total combined voting power of all classes of stock of the corporation that are entitled to vote, or (2) the total value of the stock of the

corporation, is owned (directly, indirectly, or constructively) by or for five or fewer individual citizens or residents of the United States. The gross income requirement is satisfied initially if at least 60 percent of the corporation's gross income is foreign personal holding company income. Once the corporation is a foreign personal holding company, however, the gross income threshold each year will be only 50 percent until the expiration of either one full taxable year during which the stock ownership requirement is not satisfied, or three consecutive taxable years for which the gross income requirement is not satisfied at the 50–percent threshold.

Foreign personal holding company income generally includes passive income such as dividends, interest, royalties (but not including active business royalties), and rents (if rental income does not amount to 50 percent of gross income) (sec. 553(a)). It also includes, among other things, gains (other than gains of dealers) from stock and securities transactions, commodities transactions, and amounts received with respect to certain personal services contracts. * * *

Passive foreign investment companies

The 1986 Act established an anti-deferral regime for passive foreign investment companies (PFICs) and established separate rules for each of two types of PFICs. One set of rules applies to PFICs that are "qualified electing funds," where electing U.S. shareholders include currently in gross income their respective shares of a PFIC's total earnings, with a separate election to defer payment of tax, subject to an interest charge, on income not currently received. The second set of rules applies to PFICs that are not qualified electing funds ("nonqualified funds"), whose U.S. shareholders pay tax on income realized from a PFIC and an interest charge which is attributable to the value of deferral.

NOTES

1) *Coordination of Anti–Deferral Regimes*. Foreign corporations that meet the definition of a CFC under section 957 cannot avoid the Subpart F rules by qualifying as entities covered under another anti-deferral regime. In the case of foreign personal holding companies, items of income that are currently taxable under both this regime and Subpart F are included only under the Subpart F rules. Income that is includible only under one of these regimes but not the other is taxed without regard to the other set of rules. Under 1998 amendments to the Code, a corporation that meets the definitions of both a CFC and a PFIC is in most cases not treated as a PFIC. The overlap between these two regimes has thus been minimized, with the PFIC regime now having

somewhat lesser significance in curtailing deferral. It might be worthwhile to consider, however, the use of the PFIC interest charge method as a broader means for handling anti-deferral under Subpart F. Repatriation is already discretionary for multinationals, and there exist substantial disincentives for it. See Chapter 7 for discussion of the PFIC regime, along with other rules governing the taxation of foreign portfolio investments

2) *Defining CFCs*. Since Subpart F only applies to foreign corporations that meet the greater than 50% ownership requirement, tremendous pressure is placed on this definition of "control." While one can argue whether the requirement for majority control by U.S. shareholders is necessary, it was originally adopted out of concern for fairness. To demand current payments from shareholders before profits are repatriated—and thus before the shareholders are in a position to pay—seemed unfair. Congress thought that only with a majority of shareholders could those who owe tax compel repatriation of the foreign subsidiary's profits by voting a dividend to fund the tax.

In order to avoid Subpart F, many U.S. corporations have sought to structure their ownership of foreign subsidiaries in a manner that excludes them from the CFC definition while still maximizing their control of the subsidiaries' activities. The Treasury regulations under § 957 reflect the government's efforts to challenge certain abusive varieties of "decontrol" transactions fashioned for this purpose. They make clear that formal ownership arrangements will be disregarded if the original parent corporation has actually retained majority control over its foreign subsidiary. The typical technique is an express or implied arrangement under which the new shareholders agree not to exercise their voting power contrary to the parent's wishes.

5.4 The Contemporary Policy Debate Over Deferral

As the previous discussion illustrates, Subpart F reflects a political compromise that has satisfied no one. Moreover, its immense complexity has created costly compliance and enforcement challenges. Notwithstanding the contested policy considerations and empirical claims, the interplay of deferral with the foreign tax credit provisions gives corporations considerable leeway to game the taxation of income earned abroad. The foreign tax credit is allowed either where a corporation earns income itself or when it receives either an actual or statutorily deemed dividend from a subsidiary. Both of these direct and indirect foreign tax credits are filtered through the foreign tax credit's basket system, and interest and other deductions are allocated to the income on which the foreign taxes were paid. Subpart F requires that certain items of income are taxed currently, but as long as repatriation remains voluntary, a corporation can make dividend payments to offset the Subpart F income in the same basket. A corporation, for instance, may repatriate dividends out of high-taxed foreign business income to balance a low or zero-taxed

royalty payment, taxed currently by way of Subpart F and caught in the general limitation basket. By cross-crediting the high-taxed income against the low-taxed income, the corporation may effectively reduce the U.S. tax on its total realized foreign income. This is but one straightforward example illustrating that even extremely elaborate anti-deferral systems do not prevent entirely the kind of behavior they were enacted to curb.

The following excerpt chronicles how perceived abuses of the deferral privilege by U.S. corporations have sparked renewed debate in recent years over the appropriate scope of Subpart F and whether the regime continues to fulfill its intended purposes.

Keith Engel, *Tax Neutrality to the Left, International Competitiveness to the Right, Stuck in the Middle with Subpart F*, 79 Tex. L. Rev. 1525, 1552–1557 (2001).

> The current dispute between tax practitioners and the Service over the proper role of Subpart F came into sharp focus when practitioners began forming hybrid branches after the Treasury issued the "Check-the-Box" regulations in the mid–1990s.[2] Under these regulations, a foreign entity can qualify as a corporation for foreign tax purposes but as a branch (i.e., generally disregarded) for U.S. tax purposes. The purpose of the hybrid branch structure is to utilize an intragroup note to shift income from a high-tax country to a tax haven while simultaneously avoiding Subpart F.
>
> A typical hybrid branch structure involves three U.S.-owned foreign entities: (i) a foreign holding company, (ii) a foreign active company, and (iii) a foreign hybrid entity. The foreign holding company and the active company (as well as the active company's business) are located in the same high-tax country. The foreign holding company forms a hybrid branch in a tax haven with the hybrid qualifying as a corporation for foreign tax purposes but as a branch for U.S. tax purposes. The parties then establish a creditor-debtor relationship with the foreign active company paying interest to the hybrid branch.
>
> If the structure works as designed, the hybrid structure has a twofold effect. First, the interest payments siphon foreign taxable income from the active (high-tax) company to the tax-haven hybrid because the hybrid qualifies as a separate corporation for foreign tax purposes. Second, the transaction arguably avoids Subpart F by virtue of the same-country exception for

2. The Check-the-Box regulations essentially allow taxpayers to freely elect their entity status for U.S. tax purposes. Treas. Reg. § 301.7701–2(a), –3(a) (1996). In the case of single-owner entities, such as the hybrid, the Check-the-Box regulations freely allow taxpayers to elect corporate subsidiary or branch status. § 301.7701–2(a).

related parties. Because the hybrid branch is generally ignored for U.S. tax purposes, the transaction is deemed a direct payment between the foreign holding and active companies located within the same country.

* * *

Service Challenge and Ensuing Debate

In early 1998, the Service issued temporary regulations that essentially reverse the hybrid's nonentity U.S. tax status.[3] These antihybrid regulations treat the hybrid as a corporation for Subpart F purposes. The hybrid's receipt of income thus qualifies as Subpart F income falling outside the same-country exception because the interest is deemed received by the hybrid, an entity located in a different country from that of the related payor.

The new antihybrid regulations soon faced heavy opposition. Practitioners seriously questioned whether the Service had the unilateral regulatory authority to prevent the tax-avoidance impact of the hybrid structure. Practitioners also contended that the Service's interpretation represents poor tax policy vis-à-vis the intended scope of Subpart F. They argued that the hybrid branch structure merely avoids foreign tax, which is not a concern to the U.S. fisc. Practitioners also believed that U.S. multinationals need the hybrid structure to maintain a level playing field with their foreign rivals who were similarly utilizing tax havens to reduce their global tax burdens.

The Service responded by arguing that the antihybrid regulations were needed to protect the integrity of Subpart F because Subpart F represents a balance between global tax neutrality and international competitiveness, which the hybrid structure upsets. Stated differently, the Service believed that Subpart F's mandate includes the prevention of the avoidance of worldwide tax, "otherwise, U.S. businesses striving to be competitive in the United States could have been disadvantaged by tax burdens higher than those imposed on their multinational counterparts that availed themselves of hybrid structures."

* * *

Congressional Response and Service Compromise

Recognizing that the Service was not going to yield, practitioners soon began an intensive congressional lobbying effort to terminate the antihybrid regulations. Congress responded by proposing legislation that would have postponed implementation of the antihybrid regulations for six months for further study. To avoid congressional action, the Service reissued the antihybrid regulations in proposed form with a June 19, 1998 effective date as well as a limited grandfather provision for hybrid structures entered into before June 19, 1998. In face of a potential further congressional moratorium, the Service retreated again, delaying the effective date to no sooner than five years after the regulations are finalized (the latter of which will occur no sooner than July 1, 2000). [As of June 2003, these regulations have still not been finalized.—ed.]

3. Reg. § 1.954–9T.

The heated controversy over the proposed anti-hybrid regulations demonstrates that the policy discourse over deferral is still predominantly couched as a struggle between CEN and CIN. For its part, the Treasury Department reaffirmed its longstanding position that worldwide efficiency in investment incentives is one of the pivotal aims of Subpart F. The anti-hybrid regulations underscored the government's willingness to pursue this norm even where there is no immediate threat to the U.S. tax base. After delaying the implementation of its regulations in 1998, the Treasury Department announced that it would conduct a study of the rules contained in Subpart F. In this report, which follows, the Treasury discusses the challenges to Subpart F and evaluates criteria and options for reforming the system. At the outset, the report lists several goals that should form the basis of any potential reform: (1) meeting revenue needs in an equitable manner, (2) reducing complexity, (3) minimizing distortions in investment decisions, (4) conforming with international norms, and (5) preserving the competitiveness of U.S. businesses. The following excerpt, however, demonstrates that—at least as of the end of the year 2000—the Treasury remained committed to furthering a policy of capital export neutrality above all other objectives. The excerpt describes various factors—including, most notably, changes in the global economy—which hinder the effectiveness of Subpart F and summarizes the government's conclusions regarding possible solutions.

U.S. Treasury Department, The Deferral of Income Earned Through U.S. Controlled Foreign Corporations: A Policy Study 62–99 (Dec. 2000).

CHAPTER 5

AVOIDING THE RULES OF SUBPART F

I. General

* * *

The purpose of this chapter is to examine generally the effectiveness of the specific rules of subpart F in meeting [its

intended] goals. Subpart F attempts to achieve its goals through specific rules that are intended to tax passive income on a current basis and to prevent the deflection of income to low-tax jurisdictions and other special tax regimes. This chapter considers two illustrative categories of transactions that avoid the application of those specific rules.

II. Illustrations of Techniques to Avoid Subpart F

A. Hybrid Entity Techniques

The rules of subpart F are largely premised on the assumption that for non-tax reasons business will be carried on in corporate form (e.g., to limit liability). Even if this assumption still holds true in the foreign context, it is no longer true in the United States. As a result, subpart F can be avoided by planning techniques that exploit both the corporate focus of the subpart F related party rules and the failure of subpart F to address directly inter-branch passive income payments. These tax avoidance techniques generally involve the use of hybrid entities. A hybrid entity is an entity that is classified differently for U.S. tax purposes than it is classified for foreign tax purposes.

* * *

B. Manufacturing Exception to FBCSI

As previously noted, [foreign base company sales income (FBCSI)] is income of a CFC from the sale of personal property that is purchased from, or on behalf of, or sold to, or on behalf of, a related person where the property is both manufactured and sold for use outside the CFC's country of incorporation. * * * One weakness of the FBCSI rules is that they may not apply to some types of transactions through which income from the sale of goods manufactured in a high-tax jurisdiction can be diverted to a low-tax jurisdiction, such as certain transactions in which there are no purchases or sales involving related persons. These transactions are illustrated below.

1. Contract Manufacturing

The first technique relies upon the focus in the FBCSI rules on the owner of the property being sold. Thus, if at all stages in the acquisition, production, and disposition of the property from or to unrelated persons, only one CFC holds title to the property (although others may be involved in manufacturing the property to be sold), then the FBCSI rules will never apply. This is because there will have been no sale to, from, or on behalf of a related person.

Assume CFC2, a contract manufacturer, is related to CFC1, the selling CFC. CFC1 holds title to raw materials that are

being processed by CFC2, and CFC1 pays CFC2 for processing them. CFC2 is incorporated and has its operations in a high-tax jurisdiction, while CFC1 is incorporated and has its operations in a low-tax jurisdiction. The processing takes place outside of CFC1's country of incorporation. CFC1 purchases the raw materials from an unrelated party and sells the finished goods to an unrelated party outside CFC1's country of incorporation. If CFC1 had instead sold raw materials to CFC2 and then repurchased the manufactured goods from CFC2, or if CFC1 had purchased finished goods from CFC2, CFC1's resulting sales income would have been FBCSI.

However, in this case, the taxpayer takes the position that subpart F does not apply to CFC1 because there has been no sale to, from or on behalf of a related person. This is despite the fact that the group of related corporations has managed to reduce income in a high-tax jurisdiction by splitting off the sales profit into CFC1 and reducing the manufacturer's profit in CFC2 (for example, to a small mark-up over costs). Thus, the sales profits have been diverted within the group to an entity (CFC1) in a low-tax jurisdiction, in the manner that the FBCSI rules were intended to prevent. The taxpayer might also take the position that the amounts paid to CFC2 are not foreign base company services income because the goods are manufactured (and hence the manufacturing services are performed) in the country where CFC2 is incorporated.

* * *

III. Is Subpart F Still Effective?

The examples in this chapter show that it may be possible to circumvent crucial provisions of subpart F. In these cases, subpart F may no longer effectively prevent deflection of income. The next chapter examines challenges that subpart F faces now and will face in the future.

CHAPTER 6

CHALLENGES TO SUBPART F: ENTITY CLASSIFICATION, SERVICES AND ELECTRONIC COMMERCE

I. Introduction

The last chapter described how parts of subpart F may now be avoided, particularly by the use of hybrid entities. The creation of these hybrid entities are facilitated by changes in the federal tax entity classification rules. However, changes in the entity classification rules are not the only changes that have challenged the current rules of subpart F. The nature of business is also changing. Subpart F was designed and enacted in

the 1960s when the foreign business paradigm was a manufacturing plant. Since that time, however, services activities have grown significantly as a percentage of the overall U.S. economy, and this growth appears likely to continue. The treatment of services under subpart F is already posing a number of challenges to subpart F. Further, it is possible now to perceive some of the challenges to subpart F that will be posed by electronic commerce.

* * *

III. Subpart F and Services

As noted above, services activities are a significantly greater contributor to the overall U.S. economy today than when subpart F was originally enacted, and this growth in services activities seems likely to continue. Subpart F was designed principally to deal with manufacturing industries operating in high-tax, developed countries, rather than with service industries. The treatment of services is already posing a number of challenges to subpart F. One example of these challenges is provided by the financial services exception to subpart F under section 954.

A. The Financial Services Exception as an Illustration

* * *

Financial services income is by its nature highly mobile, and it is thus often hard to determine precisely where such income is earned. The statute attempts to address this problem, for example in the context of "qualified banking or financing income," by providing that the income must be "treated as earned by such corporation or unit in its home country for purposes of such country's tax laws." This provision was intended to ensure that the income be reported as earned for tax purposes in the country where it was actually earned as an economic matter. One weakness in the provision, however, is that, although it may ensure that the items are included in gross taxable income where they are actually earned, it does not prevent subsequent deflection of this income for foreign purposes by some of the hybrid transactions described above. Thus, the amount may be included in gross taxable income but not in the actual net amount on which tax is imposed.

Additionally, the statute prevents all active financial services income from constituting foreign base company services income. As a result, to the extent that active financial services income can be earned in a low-tax jurisdiction, such income

(unlike other types of services income) is insulated from treatment as foreign base company services income.

B. Conclusion on the Potential Impact on Subpart F of a More Service–Based Economy

Subpart F does not deal with other service industries in anywhere near the level of detail of the financial services rules. Nevertheless, despite their level of detail, the financial services rules do not sufficiently address the mobility of business enterprises or of income, nor do they adequately distinguish active from passive businesses. However, even if changes were made to deal properly with services within the current structure of subpart F, the result would be more complexity. Industry specific lists of factors indicating when a business is active, for example, would need to be produced and then kept updated. Bright line rules would be replaced by subjective facts and circumstances tests. This complexity is disadvantageous for both taxpayers and the government. Complexity may require taxpayers to spend more on compliance (or may discourage them from complying). Government may also be required to devote more resources to administering the system, and the complex nature of the law may hinder uniform government enforcement.

IV. The Challenges to Subpart F Posed by Electronic Commerce

A. General

The previous section noted the difficulties of applying subpart F to the provision of services generally. The ability of taxpayers to provide services (as well as goods) over the Internet and through other electronic media will present further challenges to the current subpart F regime. None of these challenges is entirely new. The increased commercial use of the telephone, radio, television, and facsimile has contributed to a trend in which the physical location of the provider of goods and services is less significant and more difficult to determine.

* * *

Electronic commerce may present challenges to the subpart F rules to the extent that such rules look to where transactions or activities take place. For example, the technologies underlying electronic commerce make possible new sorts of services, such as Internet access, and make easier the remote provision of other services, such as remote database access, video conferencing and remote order processing. With respect to all such services, it is difficult to assign a place of performance, a factor that is relevant with respect to certain subpart F rules. Similarly, it may be difficult to ascertain a place of use, consumption or

disposition (another factor relevant in the application of certain subpart F rules) with respect to the sale of digitizable products, such as images and computer software, delivered electronically.

New technologies increase opportunities for CFCs to be incorporated in low- or no-tax jurisdictions. These technologies increase the ease with which employees of a CFC can be located outside the CFC's jurisdiction of incorporation, and increase the ease with which certain products and services can be provided to a CFC. They also allow CFCs to provide services to customers located outside their jurisdiction of incorporation with relative ease. * * * [T]hese developments together increase opportunities for CFCs to earn income that may not be subpart F income.

* * *

As planning opportunities become more generally known, offshore companies may become the operating vehicles of choice for many newly formed electronic commerce companies. In addition, many U.S. electronic commerce companies are relatively new. Therefore, it may be possible for them to move offshore without incurring a significant tax liability. These developments, taken together, may pose greater challenges to subpart F in the future.

V. Conclusions Relating to Challenges to Subpart F

* * * [S]ubpart F was intended to address a systemic problem in the U.S. tax system that created inequity and caused tax base erosion. Many of the specific rules of subpart F, however, may no longer operate effectively. In addition, weaknesses in these rules are exacerbated by the new entity classification rules, which have facilitated the creation of hybrid entities. The growth in service industries is creating new issues that may be difficult to resolve without adding considerable complexity to the subpart F rules. The challenges that will be posed by electronic commerce and the Internet are only just beginning to emerge. Thus, although the policies underlying subpart F may be as important (or more important) today as they were in 1962 (when subpart F was enacted), new developments are already challenging the effectiveness of subpart F, and these challenges seem likely to increase in the future.

* * *

CHAPTER 8

RESTATEMENT OF CONCLUSIONS

* * *

Competitiveness and the Taxation of Foreign Income

Chapter 4 considered the issue of multinational competitiveness. The chapter first noted that promoting multinational

competitiveness may conflict with the goal of promoting economic welfare. It then attempted to evaluate the effect of subpart F on competitiveness and concluded that the available data do not provide a reliable basis for evaluating whether subpart F has had a significant effect on multinational competitiveness. Although some have attempted to use statistics selectively in an attempt to show a decline in U.S. competitiveness, there is no convincing evidence of such a decline, nor is there convincing evidence regarding what impact, if any, subpart F may have had on these figures. Further, there are many other statistics that appear to show, generally, that the U.S. economy is highly competitive.

* * *

Considering Options for Change

Chapter 7 discussed several options for the reform of subpart F. Although the chapter made no specific recommendations, it noted that any subsequent reform of subpart F should be guided by the fundamental goals of international tax policy as those goals were developed from the conclusions of this study. Thus, Chapter 7 concluded, generally, that to further the goal of equity, an anti-deferral regime should contribute to the even apportionment of the tax burden between income from domestic and foreign investment, it should tax passive income on a current basis, and it should avoid inappropriate distinctions between the conduct of business in corporate form and the conduct of business in non-corporate form. To promote the goal of economic efficiency, an anti-deferral regime generally should reduce the tax disparity between income from U.S. and foreign investment. To promote simplicity and administrability, an anti-deferral regime should provide a clear, simple and coherent distinction between passive and active income, and should use a more comprehensive approach in targeting income subject to the anti-deferral rules. To promote the goal of consistency with international norms, a broad range of anti-deferral regimes are possible, although any such regime should avoid rules that may lead to international double taxation or double non-taxation or that radically increase administrative burdens. Chapter 7 also noted that the impact of an anti-deferral regime on multinational competitiveness is a relevant factor but should not be considered in isolation, as it may conflict with the fundamental policy goals of equity and efficiency.

Summary of Conclusions

Subpart F was intended to address problems arising from incompatible features of U.S. tax law. These features are still incompatible and still in place. The problems they create still exist, and the need to address these problems is perhaps greater than ever. Because of changes in other areas of the law and changes in the nature of business, however, in significant ways subpart F may not effectively address these problems, and it may become less effective in the future.

A careful review of the economic literature reveals that capital export neutrality, which provides that U.S. and foreign income should be taxed at the same rates, is probably the best policy when the goal is to maximize economic welfare (although the foreign-to-foreign related party rules of subpart F may not be maximally efficient in all cases). Therefore, preventing significant tax disparity should remain an important goal.

An anti-deferral regime continues to be needed to prevent significant disparity between the rates of tax on U.S. and foreign income, thereby promoting efficiency, preserving the tax base and promoting equity.

NOTE

Continued Preeminence of CEN. As Chapter 8 of Treasury's Subpart F study makes clear, the Treasury Department dismisses multinational competitiveness as a guiding justification in Subpart F reform, and suggests that it might conflict with other policy goals. Indeed, most of the other stated goals are largely ignored by the study or conflated with the objectives of CEN. Equity, for example, is treated as identical to capital export neutrality, requiring that "the tax burden should be imposed equally on all income, without regard to its source," with Treasury noting that a "more detailed analysis of equity concepts in international taxation is beyond the scope of this study."[4] The report also places little emphasis on the goal of simplification, apart from claiming that an elimination of deferral would be simpler than the present regime.[5] Recognizing a goal of conforming with international norms, however, the Treasury stops short of proposing a complete repeal of the deferral privilege; none of the United States's trading partners has adopted such a strong anti-deferral policy.

As the following excerpt illustrates, some academic commentators have gone further than the Treasury Department in advocating an anti-deferral regime that conforms more closely to the precepts of CEN. They contend that eliminating deferral altogether would be the most effective solution to the problems plaguing Subpart F.

4. U.S. Treasury Department, The Deferral of Income Earned Through U.S. Controlled Foreign Corporations: A Policy Study at 82–83 n.3 (2000).

5. Id. at 90.

Robert J. Peroni, *Back to the Future: A Path to Progressive Reform of the U.S. International Income Tax Rules*, 51 U. Miami L. Rev. 975, 986–989 (1997).

The deferral principle is one of the most significant elements complicating the U.S. international tax system.* * * To combat abuse of that principle, the United States has enacted a series of extremely complex and somewhat overlapping anti-deferral regimes, which have provided much work for tax attorneys, accountants, and treatise authors * * * . Yet, despite this myriad of complex anti-deferral regimes, the basic principle of deferral remains, a principle that substantially undercuts the fairness and efficiency of the U.S. tax system.

The deferral principle undercuts tax fairness by allowing U.S. persons to avoid paying current U.S. tax on their economic income earned through foreign corporations conducting business operations in low-tax foreign countries, while U.S. persons with the same amounts of economic income earned directly through a branch operation abroad or through a business conducted in the United States must pay current U.S. tax on their income. Moreover, the deferral principle encourages U.S. persons to shift investments to low-tax foreign countries in violation of capital export neutrality, thereby reducing worldwide economic welfare.

The complicated web of anti-deferral regimes of current law represents a compromise between ending deferral altogether and allowing deferral of income earned through foreign corporations without limitation. Congress has tinkered with the anti-deferral regimes over the years by tightening up the definition of Subpart F income in the CFC provisions and adding new anti-deferral regimes, as in 1986 with the introduction of the PFIC regime. The tinkering, however, has only made the system more complex without significantly eliminating the problems caused by the deferral principle. As a result, a ridiculously complicated set of rules has evolved that makes deferral elective for the well-advised U.S. taxpayer and creates traps for the unwary. For example, a U.S. corporation is likely to elect branch status for a foreign entity with income earned in a high-tax foreign country where a foreign tax credit will offset any U.S. tax on the income. A U.S. corporation is also likely to elect branch status for a foreign entity with losses so that the losses can offset the U.S. corporation's income.

The elective nature of the deferral principle has been fortified and made more explicit by the Treasury Department's recent adoption of the so-called check-the-box entity classification system. Under this system, U.S. persons operating abroad

through foreign entities other than per se foreign corporations, will more readily be able to elect deferral of U.S. tax on their foreign source income by choosing whether to have the foreign entities treated as corporations or partnerships (or branches in the case of an entity with a single owner) for tax purposes. This essentially elective deferral system is unacceptable from a policy point of view and needs to be changed in order to accomplish any significant reform of the U.S. international tax system.

Less radical proposals have been advanced to simplify the anti-deferral regimes by expanding the definition of Subpart F income in the CFC provisions and combining the other anti-deferral regimes aimed primarily at passive income into one or two unified regimes. These efforts might achieve some marginal improvement over the current law, but I believe that more radical reform of the anti-deferral regimes is necessary. At a minimum, it is time to repeal deferral for U.S. shareholders of CFCs and reformulate the PFIC provisions to constitute the only anti-deferral regime aimed primarily at passive income earned by U.S. persons through non-controlled foreign corporations.

Undoubtedly, U.S. multinationals and commentators who advocate the capital import neutrality standard would oppose any proposal to repeal deferral for CFCs on the ground that repealing deferral would substantially impair the international competitiveness of U.S. persons operating businesses abroad. They would argue that repeal of deferral would impose an extra cost (a current U.S. tax) on U.S. multinationals operating in low-tax foreign countries—a cost not borne by their competitors from countries which allow deferral or use a territorial system for taxing foreign source income—and, would, thus, erode their competitive position in the global economy. However, this argument assumes that firms from different countries have to pay the same tax rate in the host country for international investment to be allocated efficiently—an assumption that is incorrect. As stated by Jane Gravelle:

> [Arguments against further restricting deferral focus] on a vague term—"competitiveness"—when what should really be considered is efficiency. There is no reason that firms from different countries need to pay the same tax rate in a location for investment to be allocated efficiently; the important thing is for a firm to face the same tax rate wherever its location. If firms face the same tax rate in each location and earn the same after-tax return in each location, their pretax return on their marginal investments will be equal. The pretax return measures the true economic productivity of capital.

> We are operating in a second-best world because other countries, like ourselves, do not tax currently the returns of their firms in foreign jurisdictions. All marginal investments by foreign firms in tax haven countries, therefore, tend to have lower pretax returns than investments in higher tax rate countries. Regardless of what these other firms do, it is more efficient for our firms to move some investment back to the United States, when tax rates are lower abroad, if they are earning a lower rate of pretax return tax in the tax haven and thus are less productive than an investment in the United States.

NOTE

U.S. Multinationals Weigh In. In sharp contrast to both the views of the Treasury Department expressed in its Subpart F report and of Professor Peroni, the U.S. multinational business community has lobbied aggressively for a liberalization of the Subpart F rules to broaden the deferral privilege. The argument for this policy direction is rooted in familiar notions of competitiveness and capital import neutrality. Responding to the Treasury's anti-hybrid regulations and Subpart F study, the National Foreign Trade Council (NFTC), an association of U.S. multinational corporations, released its own report on Subpart F reform in 2001. As with the Treasury study, the NFTC report acknowledges the worldwide economic changes that have occurred since the enactment of Subpart F and agrees that the present regime fails to accomplish its original purposes. Yet, as the following excerpt shows, the NFTC draws entirely different conclusions about the correct path for reforming U.S. anti-deferral policy.

1 National Foreign Trade Council, Inc., The NFTC Foreign Income Project: International Tax Policy for the 21st Century, Report and Analysis 67–127 (2001).

Chapter 4

Other Countries' Approaches to Anti–Deferral Policy

> This chapter compares selected portions of the anti-deferral regimes of Canada, France, Germany, Japan, the Netherlands, and the United Kingdom with that of the United States. * * * The comparison illustrates that, in several important areas, the U.S. controlled foreign corporation (CFC) provisions in subpart F are harsher than the rules in the foreign countries' comparable regimes. The comparison is important, not because it implies that the United States should join a "race to the bottom," but because it demonstrates that the rest of the developed world has not joined the United States in a "race to the top."

U.S. government officials, have increasingly criticized suggestions that U.S. taxation of international business be relaxed. Their criticism either directly or implicitly accuses proponents of such relaxation of advocating an unwarranted reaction to "harmful tax competition" by joining a race to the bottom. * * * The inference is unwarranted. The CFC regimes enacted by these countries all were enacted in response to and after several years of scrutiny of the U.S. subpart F regime. They reflect a careful study of the impact of subpart F and, in every case, include some significant refinements of the U.S. rules. Each regime has been in place long enough for each respective government to study its operation and to conclude whether it is either too harsh or too liberal. While each jurisdiction has approached CFC issues somewhat differently, each has adopted a regime that, in at least some important respects, is less harsh than subpart F. The proper inference to draw from this comparison is that the United States has tried to lead and, while many have followed, none has followed quite as far as the United States has gone. A relaxation of subpart F to the *highest* common denominator among other countries' CFC regimes would help redress the competitive imbalance created by subpart F without contributing to a race to the bottom. * * *

Some of these regimes may also, in fact, be stricter than the U.S. subpart F regime in certain respects. This chapter has not exhaustively examined each of the CFC regimes to identify all the differences between them and subpart F. * * * Nevertheless, this chapter reveals * * * that the U.S. regime is almost always the harshest, sometimes by a wide margin. * * *

Table 4–1a. Summary of Examples

Country	Active financial services income from unrelated parties	Active financial services income from related parties	Engaged in active business-dividend from subsidiary in another country	Holding company dividend from active subsidiary in another country
Canada	Deferred	Deferred	Deferred	Deferred
France	Deferred	Deferred	Deferred	Attributed, but gets 100% participation exemption
Germany	Deferred	Taxed currently	Deferred if holdings are commercially related to its own active business	Taxed currently unless it would have been exempt to parent

Country	Active financial services income from unrelated parties	Active financial services income from related parties	Engaged in active business-dividend from subsidiary in another country	Holding company dividend from active subsidiary in another country
Japan	Deferred	Taxed currently	Deferred	Taxed currently
Netherlands	Deferred	Deferred	Deferred	Deferred
United Kingdom	Not taxed currently	Taxed currently	Deferred	Deferred if CFC has a business establishment effectively managed there and 90% of its income is from companies in active business
United States	Taxed currently	Taxed currently	Taxed currently	Taxed currently

Table 4–1b. Summary of Examples

Country	Engaged in active business-interest from active subsidiary in another country	Holding company-interest from active subsidiary in another country	Active business-royalty payments from subsidiary in another country
Canada	Deferred	Deferred	Deferred
France	Deferred	Taxed currently	Deferred
Germany	Deferred if lent on a short-term basis or if funds are borrowed on foreign capital market and lent on a long-term basis	Deferred if funds are borrowed on foreign capital market and lent on a long-term basis	Deferred if used on R & D and no participation of related parties
Japan	Deferred	Taxed currently	Deferred if it meets non-related party or location criteria
Netherlands	Deferred	Deferred	Deferred
United Kingdom	Deferred	Deferred if CFC has a business establishment effectively managed there and 90% of its income is from companies in active business	Deferred
United States	Taxed currently	Taxed currently	Taxed currently

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Chapter 5

The Economy Three Decades after Subpart F

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In the decades since subpart F was enacted in 1962, the global economy has grown more rapidly than the U.S. economy. Concomitantly, U.S. companies have confronted both the rise of powerful foreign competitors and the growth of market opportunities abroad. By almost every measure—income, exports, or cross-border investment—the United States today represents a smaller share of the global market. At the same time, U.S. companies have increasingly focused on foreign markets for continued growth and prosperity. Over the last three decades, sales and income from foreign subsidiaries have increased much more rapidly than sales and income from domestic operations. To compete successfully both at home and abroad, U.S. companies have adopted global sourcing and distribution channels, as have their competitors.

These developments have a number of potential implications for tax policy. U.S. tax rules that are out of step with those of other major industrial countries are more likely to hamper the competitiveness of U.S. multinationals in today's global economy than was the case in the 1960s. The growing economic integration among nations—especially the formation of common markets and free trade areas—raises questions about the appropriateness of U.S. tax rules that treat foreign transactions that cross national borders differently from those that occur within the same country. The eclipsing of foreign direct investment by portfolio investment calls into question the ability of tax policy focused on foreign direct investment to influence the global allocation of capital. The adoption of flexible exchange rates has eliminated currency considerations as a rationale for using tax policy to discourage U.S. investment abroad. Indeed, as the world's largest debtor nation, the use of tax policy by the United States to discourage investment abroad is thoroughly antiquated.

Chapter 6

The Neutrality–Competitiveness Balance Reconsidered

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U.S. international tax policy represents a balancing of two generally inconsistent economic principles—*competitiveness* and *capital export neutrality*. Subpart F, enacted in 1962, did not terminate deferral (as would be required to achieve capital export neutrality), but instead limited deferral in certain cases where opportunities for abuse were perceived to exist. In subsequent amendments to subpart F, the balance has generally shifted in favor of capital export neutrality and away from competitiveness.

As we approach the end of the 20th century, there are important reasons to re-examine the current balance point embodied in the subpart F rules:

- U.S. multinationals face much greater global competition than was the case when subpart F was first enacted.
- No country, including the United States, has adopted international tax rules that are consistent with capital export neutrality. None imposes current tax on all foreign-source income and none has an unlimited foreign tax credit. Indeed, half of the OECD countries *exempt* foreign source business income either by statute or treaty—these countries do not tax foreign-source income even when it is distributed.
- Annual foreign portfolio investment now exceeds foreign direct investment. With the growth in portfolio capital flows, imposition of capital export neutrality tax rules upon foreign direct investment does *not* necessarily improve international capital allocation, but does make it more difficult for U.S. multinationals to compete abroad.
- The theoretical link between current taxation of foreign-source income and efficient investment location depends crucially on a stylized view that treats foreign direct investment as indistinguishable from portfolio investment. Empirical evidence, however, suggests that this stylized view of foreign direct investment is incorrect. When more realistic assumptions are adopted, Professors Devereux and Hubbard find that deferral, rather than current taxation, is most consistent with national welfare maximization (for investments in low-tax foreign countries).

Both changes in the international economic environment and refinements in the theory of international taxation are consistent with a re-balancing of U.S. international tax policy towards competitiveness and away from capital export neutrality. This could be accomplished by narrowing the scope of subpart F to passive income. A secondary benefit from such a shift in policy would be a major simplification of U.S. tax rules, as the subpart F rules are a source of substantial complexity and tax controversy. Such a shift also would tend to harmonize

U.S. tax rules with those of other major industrial countries that target their anti-deferral rules more narrowly on passive-type income.

5.5 Proposed Reforms to Subpart F

Congress in 2003 seemed more inclined to agree with the arguments of the multinational business community for loosening some of the constrictions of Subpart F than with the academics who would tighten them. A number of bills have been introduced in the Congress to liberalize Subpart F. Some of these have been coupled with legislative proposals to inhibit corporate inversions. As discussed in Chapter 3, lawmakers have become increasingly concerned about the number of U.S. corporations seeking to reincorporate abroad. Among the reasons cited by multinational corporations for pursuing such transactions is the desire to escape the broad reach of current taxation under Subpart F. Whether or not the relative severity of Subpart F actually constitutes a significant impetus for U.S. companies to shift their residence overseas, Congress seems receptive to this argument as well as to the general appeals for multinational competitiveness. A description of some recent proposals before Congress for narrowing the scope of Subpart F follows.

Staff of the Joint Committee on Taxation, Background Materials on Business Tax Issues Prepared for the House Committee on Ways and Means Tax Policy Discussion Series, JCX–23–02 (Apr. 4, 2002).

Incremental reform proposals relating to the subpart F anti-deferral rules

Background

Generally, income earned indirectly by a U.S. person through a foreign corporation is subject to U.S. tax only when the income is distributed to the U.S. person. This deferral of U.S. tax is limited by a number of anti-deferral regimes (e.g., "subpart F") that impose current U.S. tax on certain types of income earned by certain corporations. Drawing the line between "good" income (active business income) and "tainted" income (passive or highly mobile income) has proven contentious and has also engendered considerable complexity.

Exclusion of all active income from the scope of subpart F

Present law places the income from many sales, services, shipping, and certain other activities conducted abroad on the "tainted" side of the line (because such activities are thought to be highly mobile and thus prone to tax-motivated manipulation), thus subjecting the income from such activities to current U.S. tax. Many U.S.-based multinationals complain that these rules penalize the use of common, non-tax-motivated business structures (e.g., centralizing sales and services functions for a number of different foreign markets within a single foreign entity), thus placing U.S.-headquartered businesses at a competitive disadvantage in the normal conduct of their active business activities around the world. They argue that the scope of subpart F should be limited to passive income (e.g., dividends and interest) earned abroad, and that other rules (e.g., the arm's length transfer pricing rules of section 482) are sufficient to address any abuses involving the manipulation of active income streams. The proposal would eliminate certain subpart F active-income categories (the foreign base company sales, services, shipping, and oil-related income categories). This proposal arguably could exacerbate problems that may arise in taxing income from electronic-commerce transactions.

Permanent "active financing" exception

Passive income (e.g., interest) generally falls on the "tainted" side of the subpart F line, since such income can easily be shifted into low-tax jurisdictions. In the case of banking, financing, insurance, and similar businesses, however, this taint is arguably inappropriate, since these businesses earn this type of income in the active conduct of their core business activities. Subjecting this income to subpart F would arguably cause U.S.-based financial services companies to be treated more harshly than both U.S.-based manufacturing companies and foreign-based financial services companies. Accordingly, since 1997 a temporary exception from subpart F for "active financing income" has been provided. The exception under present law is set to expire after 2006. U.S.-based financial services companies argue that the temporary nature of the exception makes it difficult for them to engage in long-range business planning. The proposal would make the exception permanent.

Expansion of the "de minimis" exception

To avoid subjecting taxpayers to the complex rules of subpart F when a controlled foreign corporation earns incidental amounts of "tainted" income, subpart F provides a "de minimis" exception. Under this exception, a controlled foreign corporation's income is not treated as tainted as long as the tainted income constitutes less than the lesser of $1 million or 5% of the corporation's gross income. For example, a controlled foreign corporation that conducts an active business but also earns a trivial amount of interest on its working capital generally does not need to contend with subpart F, as long as the amount of the interest falls short of the de minimis threshold. U.S.-based multinational enterprises argue that this threshold is set too

low to provide them any meaningful relief. For example, a controlled foreign corporation that earns only $1 million of interest income on its working capital is ineligible for the exception, even though $1 million may indeed represent an incidental amount in the context of a large foreign subsidiary of a U.S.-based multinational. The proposal would raise the dollar limit (or even eliminate it), and the percentage limit.

NOTE

The Influence of U.S. Multinationals. The influence of the NFTC report and its arguments are readily apparent in these proposals. Indeed, all three of the measures described above were specifically urged in the second volume of the NFTC's publication, which sets forth recommendations for the incremental reform of Subpart F.[6] If this is indicative of a prevailing legislative trend, the multinational business community seems likely to accomplish its agenda of reorienting the policy balance of Subpart F more toward competitiveness.

5.6 An Exemption of Foreign Source Business Income as an Alternative to the Foreign Tax Credit

Another international tax reform proposal that has drawn growing attention from academics and lawmakers is the exemption of foreign source active business income. Several industrialized countries, including France, Germany and the Netherlands, utilize this sort of exemption regime. In practice, our present system of deferral complemented by a foreign tax credit already enables many U.S. corporations essentially to exclude foreign source business income from U.S. taxation by holding profits offshore and selectively repatriating dividends. In 1996, for example, the United States collected only about $1 billion of residual U.S. income tax on the foreign source income earned by U.S. corporations abroad.[7] An exemption of such income offers the potential of simplifying the U.S. international tax system, for example, by eliminating the foreign tax credit basket system. In addition, recent economic research suggests that moving to an exemption system might increase revenue to the U.S. treasury by over $9 billion annually.[8] The following excerpt examines how an exemption system might work in the U.S., concluding that any gains from simplification would depend heavily on the details of the exemption regime.

6. 2 National Foreign Trade Council, Inc., The NFTC Foreign Income Project: International Tax Policy for the 21st Century, Conclusions and Recommendations 37–57 (2001).

7. Harry Grubert, Enacting Dividend Exemption and Tax Revenue, 54 Nat'l Tax J. 811, 816–817 (2001).

8. Id.

Michael J. Graetz & Paul W. Oosterhuis, *Structuring an Exemption System for Foreign Income of U.S. Corporations*, 54 Nat'l Tax J. 771 (2001).

The OECD nations have split virtually evenly over the best structure for taxing foreign source business income earned by multinational corporations. About half the OECD countries provide a tax credit for foreign taxes; the other half exempt from domestic taxation active business income earned abroad. Discussions of international tax policy often treat this choice as grounded in different philosophies or normative judgments about international taxation. Foreign tax credit systems are frequently said to implement "worldwide" taxation or a "universality" principle, while exemption systems are described as "territorial" taxation. Likewise, tax credit systems supposedly implement "capital export neutrality" while exemption systems further "capital import neutrality". However, tax credit and exemption systems are far closer in practice than these dichotomies suggest. The OECD nations have all conceded that the country of source—the nation where income is earned—enjoys the primary right to tax active business income, with the residence country—the nation where the business is incorporated or managed—retaining at most a residual right to tax such income.

Since the enactment of the foreign tax credit in 1918, the United States has never seriously considered replacing it with an exemption system. In 2000, however, the U.S. Congress, in an apparently unsuccessful effort to thwart World Trade Organization disapproval of U.S. tax benefits for "foreign sales corporations," characterized as normal U.S. exemption of foreign business income. Issues under foreign trade agreements may push the United States to consider replacing the foreign tax credit with exemption. Recent analyses by economists suggest that moving to an exemption system for direct investment (with appropriate anti-abuse rules) could increase U.S. revenues without precipitating any substantial reallocation of capital by U.S. firms. Moreover, the existing U.S. foreign tax credit rules are extraordinarily complex, requiring U.S. companies doing business abroad to spend large and disproportionate amounts to comply. One study estimates that nearly 40 percent of the income tax compliance costs of U.S. multinationals is attributable to the taxation of foreign source income, even though foreign operations account for only about 20 percent of these companies' economic activity. Some analysts are now calling for the U.S. to take a serious look at exemption of foreign source business income, often on the grounds that an exemption sys-

tem might be simpler than the existing credit system. To date, however, little work has been done in identifying the issues that must be resolved for exemption to be implemented and discussing the potential structure of an exemption system for the U.S. Such analysis is essential to assess the likelihood of accomplishing simplification goals. We undertake a preliminary foray into those questions here.

Implementing either a foreign tax credit or an exemption system for foreign source business income demands resolution of similar questions. Most of the issues raised by an exemption system parallel those that have been debated over the years under the current credit system. This is not surprising; both systems share the same general goal: avoiding international double taxation without stimulating U.S. taxpayers to shift operations, assets or earnings abroad. Domestic and foreign source income must be measured in both systems. Both systems must answer the question of what income qualifies for exemption or credit. Whether income earned abroad by a foreign corporation should be included currently in U.S. income or included only when repatriated as a dividend has long been debated under our foreign tax credit system. If not all foreign source income is exempt, this question remains important in an exemption system. And it is necessary to decide the appropriate treatment of foreign corporations with different levels of U.S. ownership. Likewise, transfer pricing issues are significant and difficult to resolve under either a credit or exemption system.

Detailed analysis and evaluation of each of these issues is not possible here. We start, therefore, by assuming that the political and economic determinations that have shaped current law will continue to exert great influence over the design of an exemption system. We also assume that if the U.S. were to adopt an exemption system, it would generally resemble exemption systems of other OECD nations that have used exemption rather than foreign tax credits. But, even with these constraints, investigating the potential structure of an exemption system spurs reconsideration of issues long taken for granted under our foreign tax credit regime. Our analysis illustrates that shifting to an exemption system might well afford an opportunity to simplify U.S. international income tax law, but only if simplification is made a priority in enacting such a change. Our discussion here also points to potential simplification of the rules governing international taxation of business, whether or not exemption is enacted. As a political matter, however, such simplification may be more likely when Congress is making a substantial change in the regime for taxing international business income. * * *

INCOME ELIGIBLE FOR EXEMPTION

Alternatives

The first issue in designing an exemption is deciding what foreign source income is exempt. Potentially such an exemption could apply broadly to all foreign source income or narrowly, for example, only to active business income that is subject to tax by a nation with which the U.S. has an income tax treaty or which taxes income at rates comparable to the U.S. rate. Some OECD countries limit their exemption systems to countries with which they have tax treaties or to income taxed at a certain level abroad; others do not. We consider first the potential structure an exemption system applicable generally to active business income without regard to whether the income is generated in a treaty jurisdiction and without regard to the rate at which it is taxed by the foreign country where it is earned.

Following the practice of other nations which exempt foreign source income, such an exemption would apply generally to the branch profits of any U.S. corporation and to dividends received by U.S. corporate taxpayers from foreign corporations. This means that interest income and royalty income, both of which are deductible abroad and therefore not subject to foreign income tax, would be subject to U.S. tax. Under current law, U.S. businesses are often able to shelter interest and royalties earned abroad from U.S. tax through foreign tax credits. Thus, an exemption system would increase the tax on this type of income for many U.S. companies compared to current law.

Definition of Active Business Income

Since active business income but not other types of income earned abroad would generally be exempt, it becomes essential to determine what constitutes eligible active business income. The Internal Revenue Code today does not provide any direct precedent. Nonetheless, the current Code does provide guidance, which probably would be used in defining eligible active business income. Identifying business income eligible for exemption and determining how to treat income not eligible for exemption raise questions parallel to those under current law in determining what income earned through foreign corporations should be taxed currently or eligible for deferral of U.S. tax until repatriated and how the foreign tax credit should apply when that income is subject to U.S. tax. Business income eligible for exemption might be defined first by excluding income that is "passive," drawing on existing Code provisions that identify and tax currently types of passive income earned abroad, particularly Subpart F of the Code. The rationale for excluding passive

income from exemption parallels that for taxing such income currently under Subpart F.

Because such income has no nexus to business activity, it is highly mobile and easily shifted abroad to low or no tax jurisdictions. Thus, exempting such income would create an unacceptable incentive to move assets offshore and potentially would lose large amounts of revenue. Consequently, income that constitutes passive income (technically foreign personal holding income) under Subpart F (mostly interest, dividends, rents and royalties) would not be eligible for exemption. Special rules will be necessary when such amounts are earned by entities in which a U.S. corporate taxpayer has a certain minimum ownership interest. (In the latter case, as we discuss below, "look-through" rules would be applied to characterize some types of passive income.) The distinction between income eligible for exemption and nonexempt passive income would raise definitional issues similar to those long debated under Subpart E. For example, banks, securities dealers, insurance companies and other finance-related businesses earn interest and other types of "passive" income that are considered active business income under current law; we believe that such businesses should probably be eligible for exemption as are other active businesses, at least when their financial-service business is located predominately in the country of incorporation.

Once passive income earned abroad by U.S. corporations is excluded from exemption—as we believe it should and will be—the risk occurs that an exemption system might become about as complex as current law. For example, every active foreign business utilizes working capital, and earns passive income from the temporary investment of such capital. Without a de minimis rule which ignores small amounts of passive income, every corporation will have to take into income some amount of passive income and presumably calculate foreign tax credits allowable with respect to such income. A de minimis rule based on a proportion of total gross income or total assets might promote substantial simplification by allowing the income of foreign corporations engaged in an active business to be completely exempt without leading to an unacceptable level of tax planning.

A separate question is whether other "non-passive" types of Subpart F income should be exempt from U.S. taxation. In some cases, for example, Subpart F currently taxes certain sales and services income. In most cases such sales and services income, which is active business income, is taxed currently under Subpart F because of the ability of taxpayers to locate the activities that generate this income in low-tax jurisdictions

thereby minimizing both U.S. and foreign source-based income taxes. These Subpart F rules were first adopted in 1962 and some business organizations have recently called for revision, urging, for example, that the transfer pricing rules are adequate to address "abuse" cases. The fundamental policy issue to be faced by an exemption system is whether these (and other) types of "mobile" active foreign business income, which can sometimes be moved to low tax jurisdictions, should be eligible for exemption. Transfer pricing enforcement throughout the OECD has become more vigorous and sophisticated. A simpler system would no doubt result if the transfer pricing rules (which in this case would be enforced by the country from which the sales or services income is deflected to a low or no tax jurisdiction), rather than an exclusion from exemption, could be relied on to constrain tax avoidance.

* * *

TREATMENT OF NON–EXEMPT INCOME EARNED BY U.S. TAXPAYERS

Foreign Tax Credits

The discussion above makes clear that not all foreign source income earned by a U.S. corporation will be eligible for exemption. Non-exempt income would surely include foreign source interest, rents and royalties not attributable to an active foreign business, dividends on portfolio stock, income from export sales not attributable to an active foreign business and any other types of active business income (perhaps such as space or shipping income or interest and royalties attributable to an active business) that are specifically determined to be ineligible. However, to the extent that these types of income are potentially subject to foreign tax (including withholding tax) on a basis, the U.S. should make an effort to avoid double taxation. Thus, as under today's rules, such income should probably continue to be allowed a credit for the foreign taxes paid on that income.

If a foreign tax credit is permitted for any income, in principle all the questions that exist today regarding limitations on foreign tax credits would have to be resolved. However, if the nonexempt income were limited to only these classes of income, much simplification would be possible. For example, given this limited application, a single worldwide foreign tax credit limitation could be applied. A worldwide limitation seems reasonable since taxpayers almost always will be subject to tax abroad on these types of income at rates lower than the U.S. corporate tax rate, and therefore they will almost always have foreign tax credit limitations in excess of creditable foreign taxes. A single

worldwide limitation would be far simpler than the baskets of current law, and the fact that taxpayers would virtually always have excess foreign tax credit limitations both permits additional simplifying changes and lowers the stakes in applying some rules that would be retained.

If, however, averaging of credits across types of income is of great concern, separate limitations might be applied based on categories of income (similar to today's limitations) or types of taxes (e.g., withholding taxes versus income taxes normally applied to residents). Finally, a separate limitation could be applied to each item of foreign source income not eligible for exemption (much like the so-called "high-tax kickout" limitation on passive income under the current foreign tax credit). However, we see no justification for this level of complexity. In a system that generally exempts active business income, we do not find any policy justification for multiple separate limitations that outweighs the simplification advantages of a single worldwide foreign tax credit limitation.

Treatment of Non–Exempt Foreign Corporation Earnings

If not all income earned by a foreign corporation is eligible for exemption, the question occurs whether non-exempt income should be subject to current inclusion by U.S. corporate shareholders or, alternatively, should not be taxed in the U.S. until distributed as a dividend. Most passive types of income are today subject to current inclusion under Subpart F when earned by controlled foreign corporations. Investors in non-U.S. controlled foreign corporations, which earn mostly passive income, may be subject to current taxation (or roughly equivalent consequences) under the Passive Foreign Investment Company (PFIC) regime or other "anti-deferral" regimes. We see no reason that shifting from a foreign tax credit to an exemption system should delay the imposition of U.S. tax on passive income (which exceeds a de minimis amount) that is taxed currently under present law. Thus, we assume that the U.S. would continue to subject passive types of foreign source income to current inclusion.

If some types of active business income also are not exempt, a decision must be made whether to subject that income to current taxation. Here we believe that avoiding the complexity of having three categories of income for U.S.-controlled foreign corporations—exempt income, currently included income and deferred income—is sufficiently important to argue for current taxation of all non-exempt income. If non-exempt income is taxed currently and dividends are exempt, the timing of dividends becomes of no consequence under U.S. tax law. On the other hand, if a category of deferred income is retained, look-through treatment of dividends might be necessary.

Assuming that all income of U.S. controlled foreign corporations is either exempt or currently included, rules are necessary to measure the income in two categories. For example, rules allocating expenses between the two categories of income would be necessary. Likewise, loss recapture rules (similar to those in Subpart F today) would be necessary to prevent losses from income-producing activities from permanently reducing nonexempt currently includable amounts.

In addition, an "indirect" (or "deemed-paid") foreign tax credit would be appropriate to allow U.S. corporate taxpayers to claim foreign tax credits for foreign taxes paid by foreign corporations on non-exempt income. Such a foreign tax credit would require rules allocating foreign taxes between exempt and currently includable income. The rules would also require integration with the foreign tax credit limitation rules discussed above with respect to foreign source income earned directly by U.S. taxpayers. Thus, many of the foreign tax credit issues that exist today would remain although they would apply to a much smaller category of income earned by foreign corporations and therefore might be substantially simplified.

DISTINGUISHING AMONG U.S. CORPORATE SHAREHOLDERS

In addition to rules establishing the scope of exemption and the treatment of dividends received from foreign corporations, it becomes necessary to decide whether all U.S. corporate shareholders should be entitled to exemption. In theory, the answer to this question should be yes; otherwise some international double taxation at the corporate level will occur. However, applying an exemption system, as discussed above, requires that U.S. corporate shareholders receive significant amounts of information from those foreign corporations in which they have the requisite level of ownership. The U.S. recipient would, for example, have to know the amount of the foreign corporation's passive earnings and the amount of foreign taxes imposed on those earnings. It thus seems impractical to apply an exemption system on a look-through basis to all U.S. corporate shareholders of foreign corporations.

In determining whether U.S. tax applies currently or is delayed until earnings are repatriated and for foreign tax credit purposes under current law, the U.S. has three different regimes relevant to this issue:

(1) Subpart F limits deferral but allows foreign tax credits to shareholders owning 10 percent or more of the voting

stock in controlled foreign corporations (CFCs). (CFCs are defined as foreign corporations in which U.S. persons each owning 10 percent of the voting stock own a total of more than 50 percent of the stock by vote or value).

(2) To avoid international double taxation, the "indirect" foreign tax credit is allowed to U.S. corporations that own at least 10 percent of voting stock in a foreign corporation which is not a CFC.

(3) No foreign tax credit and no limitation on deferral applies to a U.S. corporation whose ownership in a foreign corporation is less than 10 percent of the voting stock.

In designing an exemption system these categories should be rethought. Today a U.S. corporation, which owns less than 10 percent of the voting stock of a foreign corporation, is treated as a "portfolio" investor. Full double taxation of foreign source income at the corporate level is justified largely on the assumption that such corporate investors cannot get the information necessary to determine their foreign tax credits under U.S. law.

A 10 percent voting stock threshold could also be adopted for distinguishing "portfolio" from "direct" investment for the purpose of applying exemption. The issue remains, however, whether U.S. corporate investors owning less than 10 percent should be fully taxed or fully exempt on dividends (and capital gains). If, as we assume, rules similar to the current Passive Foreign Investment Company regime continue to apply to all investors in foreign corporations that hold predominately passive assets, dividends (and gains) from non-PFIC foreign corporations might be treated as exempt by U.S. corporate shareholders owning less than 10 percent of voting stock in all cases without requiring any significant information and without creating undue potential for tax planning mischief.

* * *

CONCLUSION

We have attempted here to identify the issues that Congress must resolve if it were to replace the existing foreign tax credit system with an exemption for active business income earned abroad. In this discussion we have stuck rather close to present law in addressing how these issues might be resolved under an exemption system. In other words, we have treated a potential change to exemption as an incremental move in U.S. international tax policy rather than viewing such a shift as an occasion to rethink fundamental policy decisions reflected in current law.

Our analysis reveals that virtually all of the questions that must be answered in a foreign tax credit regime must also be addressed in an exemption system. There is little simplification necessarily inherent in moving to an exemption system, but such a move does provide an opportunity to reconsider a variety of issues that might simplify the taxation of international business income. While, in principle, much simplification of current law is possible without abandoning the foreign tax credit, it may be politically unrealistic to think that such simplification will occur absent a substantial revision of the existing regime, such as that entailed in enacting an exemption system.

Our analysis suggests that much of the complexity of an exemption system occurs in the scope and treatment of non-exempt income. If this category generally can be limited to passive non-business income with meaningful de minimis rules applied to the treatment of such income, the impact of these rules can be minimized. Surely the basket system limiting foreign tax credits could be eliminated. Moreover, under an exemption system along the lines we have described here, the timing of the payment of dividends would be of no consequence. Thus, under an exemption regime significant simplification could be achieved for many companies and the costs of complying with U.S. international tax rules might well decrease substantially for U.S. corporations.

A major concern surrounding the adoption of an exemption system, particularly among adherents of capital export neutrality, is the incentive it might create for U.S. companies to invest their resources abroad. However, in the next excerpt economists Roseanne Altshuler and Harry Grubert conclude that no significant locational distortions would occur under an exemption system compared to current law, nor do they find that adopting an exemption system would result in a substantial outflow of capital from the United States.

Rosanne Altshuler & Harry Grubert, *Where Will They Go if We Go Territorial? Dividend Exemption and the Location Decisions of U.S. Multinational Corporations*, 54 Nat'l Tax J. 787 (2001).

We approach the question of how location incentives under the current system are likely to be altered under dividend exemption from three different angles. We start by comparing the U.S. allocation of foreign direct investment (FDI) in manufacturing across low-tax versus high-tax jurisdictions with that of two major dividend exemption countries, Canada and Germa-