Tax Reform: International Tax Issues and Some Proposals

By Robert H. Dilworth*

Robert H. Dilworth is a member of the bar in the District of Columbia, Illinois and California (inactive), and has practiced in various locations within and without the United States since 1966. From September 2005 until February 2007, he served as the Senior Advisor to the Assistant Secretary of the Treasury for Tax Policy.

* The author appreciates the advice and counsel of his colleagues who have reviewed prior drafts of this article, including inter alia and in particular Joseph L. Andrus, Bernard T. Bress, L.G. “Chip” Harter, David G. Noren and Eric Solomon. They did their best to correct the errors of omission and commission, great and small, but the final version is not their fault. The views expressed herein are those of the author and do not represent the views of the Treasury Department, any other Federal agency, or the United States Government, any firms or clients with which he has been associated or any of his colleagues who commented on prior drafts.

I. Tax Reform: Context.................................8
   A. General.............................................8
   B. President Bush’s Mandate to the 
      Advisory Panel on Federal Tax Reform
      (January 2005)......................................9
   C. ABA Task Force on International Tax 
      Reform (2006)....................................10
   D. Treasury Department 2007 Review of 
      “Competitiveness”...............................11
   E. The Rangel Bill (2007)..........................11
   F. Personal Views and Recommendations......12
   G. International Tax Reform Has a 
      Long History.....................................12
      1. Revenue Act of 1962......................12
      2. Tax Reform Act of 1986...................13
      3. Gradison-Rostenkowski (1992).........14
         a. Deferral Provisions......................14
         b. Foreign Tax Credit.......................14
         c. Joint Ventures
            (10-50 Companies).......................14
      4. 1997–2006 Congressional 
         Tax Reforms..................................15
      5. 1996 Fundamental Administrative 
         Change in Core Architecture of 
         Subpart F......................................16
   H. The Role of Discontinuities (“Abuses” 
      or “Tax Arbitrage”) in the Pursuit of 
      Tax Reform........................................19
   I. Worldwide Tax; Corporations As 
      Separate Taxpayers.............................21
   J. President Obama: Possible 2009 
      Proposals.........................................23

©2009 R.H. Dilworth
II. Present Law: Selected Issues ..........................23
   A. General...........................................23
   B. Residence-Based Taxation of “Domestic” Corporations: Which Agglomerations of Capital and Services Should Be Treated As U.S. Residents and Which Should Be Treated As “Foreign”? ..................23
   C. Deferral vs. Current Inclusion of Foreign Affiliate Income.................................26
      1. The Present Value of Deferred Tax...27
         a. Kennedy Administration 1961 Proposals........................................27
         b. 2000 Treasury Subpart F Study ..27
         c. The Search for Comparables and Data Points ..........................28
         d. Collateral Damage Concerns ...28
         e. Formulas to Measure the Time Value of Money ....................29
         f. Examples of Anti-Deferral Measures to Respond to the Problem ..........29
      2. U.S. GAAP Accounting for Undistributed Foreign Affiliate Income and Deferred Tax on the Income, ......36
         a. Consolidation of All Majority-Owned Subsidiaries ......................36
         b. Additions to the Provision for Current and Deferred Tax Liabilities ................37
   D. The “Repatriation” Tax..................................39
      1. The “Problem”: Discouraging Use of CFC Assets to Make Investments in the United States Rather Than Abroad.................................................39
      3. The Role of U.S. GAAP in Deferral and Repatriation ..........................40
      4. Code Sec. 956 and “Effective Repatriation”........................................41
         a. The Normal Rules for Taxing Shareholders on Corporate Income.....41
         c. The Tax Reform Act of 1976 and “Effective Repatriation” ...............42
         d. Administrative Expansion of “Effective Repatriation” ...................43
      5. The Potential Solutions to “the Problem” (If There Really Is a Repatriation Problem) .........................44
   E. Matching of Expenses and Foreign-Related Income to Which the Expenses Relate.................................46
      1. Matching of Expense as Equivalent to a Partial End to Deferral ................46
         a. Dividend Exemption Proposal Is an End-Deferral Proposal.............46
         b. The Rangel Bill Expense Deferral Proposal..............................47
         c. Approximate Equivalence of Deferred Expense and Accelerated Pre-Realization Income Recognition.............47
         d. Undistributed Income in Excess of Ordinary Return on Disallowed Deduction ..........48
      2. Matching Entails Complexity........48
      3. Expense Matching Is Easier Than Taxing Undistributed Income and Tracking Previously Taxed Income ..........48
      4. Denying a Deduction Anywhere ..........48
         a. Generally.......................................48
         b. Asymmetry with Domestic Equity Investment ..........................49
      5. Expense Matching As Half a Loaf ....49
      6. Illustrative Calculation of Tax Effect of Deferring or Disallowing Expenses Matched to Foreign Income, .....50
         a. Foreign Tax ..................................50
         b. Foreign Creditable Taxes........51
         c. Increasing Residual U.S. Tax by Denying Foreign Tax Credits .......51
         d. Low-Tax Same Country Foreign Business Income ..........................51
      7. Other Countries Do Not Do This. So What? ..................................51
      8. What Kinds of Income Should Be Combined for Purposes of Matching?...52
         a. Narrow Income Exemption, Narrow Expense Matching .............52
         b. Broad Income Exemption, Broad Expense Disallowance ..............53
   F. Cross-Crediting ..................................54
      1. Cross-Crediting and Its Origins........55
      2. Per-Country Limitation ......................55
      3. 1986 Act “Basketing” .........................56
      4. Problems Associated with “Cross-Crediting” ................................57
      5. In Defense of Cross-Crediting (Credit-Averaging) .........................57
      6. Illustration of Cross-Crediting and Expense Allocation ......................57
         a. Business Profits in Low-Tax
Jurisdictions ..............................60

7. Cross-Crediting and Insulation Against “Proper” Consequences of Doing Business in High Tax Countries. ..........63

8. Effect of Source Rules on Cross-Crediting. ........................................63
   a. Export Sales ................................ 63
   b. Royalties ...................................65

G. Related-Party Transactions and the Arm’s-Length Principle .........................68
   1. Discussion .....................................68

   1. Foreign Business Entity Competition with Domestic Direct Investment...74
      a. Issues.......................................74
      b. Discussion ...............................75
   2. Corporate Residency and the Assertion of U.S. Worldwide Taxing Jurisdiction. 78
   3. Does It Really Make Any Difference? 79

I. Tax Competition Between Countries and the Race to the Bottom: What Role Should U.S. Tax Play in Backstopping the Tax Systems of Foreign Countries?....80
   1. Issues ..........................................80
   2. Subpart F Not Aimed at Race to the Bottom. ................................80
   3. Other Reasons to Backstop the Collection by Foreign Countries.....83

J. Financial Services and Passive Income. .84

K. The Disregarded Entity Rules and Electivity Under Subpart F. ...............86

L. International Joint Ventures. ..........87

M. Tax-Exempt Investors. ....................90

III. Recommendations .................................91

A. Retain Existing Core Architecture: ...92

B. Eliminate Separate Regimes for Foreign Business Conducted via Foreign Corporations vs. Branches and Other Passthrough Entities. ....92

C. Match Foreign-Related Expenses and Foreign-Related Income. ..........92

D. Repeal Foreign Base Company Sales Income and Foreign Base Company Services Income Provisions Now in Subpart F. .................................93

E. Retain Related-Party Look-Through Rule that Excludes from Subpart F Income Related-Party Interest, Rents and Royalties Paid by Foreign Affiliates to Other Foreign Affiliates......................94

F. Transfer Pricing: Exclude Risk Based Allocations of Income to CFCs Except by Treaty. ..........................94

G. Eliminate Repatriation Tax on Arm’s-Length Transactions Between a CFC and U.S. Affiliates ................94

H. Retain Crediting of Foreign Taxes Against U.S. Tax on Export Sales Income (Foreign-Related Income) ....95

I. Make Intangible Property Royalty Sourcing Symmetrical with Income From Export Sale of Inventory Property, Except to the Extent Otherwise Provided by Treaty .........95

J. Interest from Related Parties Should Continue to be Foreign Source Income Eligible for Cross-Crediting. ..95

K. Dividends, Interest, Rents and Royalties from Portfolio Investment Should Be Ineligible for Cross-Crediting Any Foreign Income Tax Imposed on Foreign Direct Investment Income.....95

L. Contributions of Appreciated Property to Foreign Affiliates ....95

M. Joint Ventures (10/50 Companies). .96
   1. Matching ..................................96
   2. Foreign Tax Credit ........................96
   3. Foreign Personal Holding Company Income ........................97
   4. Foreign Base Company Sales Income. ................................97
   5. Foreign Personal Holding Company Exclusion: Look-Through Rules Should Apply to Interest, Rents and Royalties...97

N. Foreign Direct Investment in the United States Should Continue to Be Taxed on Effectively Connected Income ........................................97

O. Foreign Portfolio Investment in U.S. Business Entities. .....................97

P. Financial Institutions .............................97
   1. Domestic: Present Law Temporary Exclusion from Subpart F Should Be Made Permanent. ........................97
   2. Foreign Parent Financial Institutions: Domestic Branches Should Be Treated As Separate Corporations.................98

Q. Tax-Exempt Investors.........................98
I. Tax Reform: Context

A. General

This article will discuss certain issues and topics central to the debate about whether and, if so, how, to make fundamental changes in federal income taxation of income from cross-border trade and investment. Part I describes the context of the next round of examining options for changing the basic system for U.S. taxation of income from cross-border trade and investment. Part II discusses some, but not all, of the important issues that have to be considered in any debate about significant change in the current system. Part III sets forth the author’s recommendations of changes that should be made (or, in some cases, merely considered). The recommendations cover more topics than the issues discussed in Part II. For example, there are discussions of changes that might be made in the treatment of transfers of assets from a fully taxable U.S. environment to a U.S. tax-exempt or tax-deferred environment. Any changes would be occasioned by a need to maintain symmetry with other recommendations rather than to implement independent tax policy considerations peculiar to Code Sec. 367.

The topic is an old one, almost a perennial. It is likely to be addressed with new vigor in the new Administration and in the presence of a Congressional majority that may be able to escape deadlock. It is worth noting at the outset that the author is a private sector practitioner whose professional experience is more grounded in the tax concerns of Main Street multinationals than in the concerns and experiences of Wall Street financial institutions and their advisors. Those Main Street biases may be apparent in an uneasiness with measuring taxable income on the basis of discounted present value of future cash flows that are often more conjectural than interest accruals or on the basis of marking to market assets whose economic exploitation is not intended to be based on sales into a financial market (such as factories).

Financial institutions (and their advisors) may be comfortable with marking to market because their income-producing assets and liabilities are often traded in markets. This approach to measuring the time, character and source of income may be used in the Wall Street ‘real world’ to determine whether the financial institution is profitable, and whether its key personnel should be compensated based on changes in the present value of estimated amounts of anticipated future cash flows on financial assets and liabilities. Main Street enterprises, in contrast, often do not make investment decisions (or compensation decisions) based on projecting disposition of their factories (marking them to market). Similarly, the author’s disquiet with present value analysis of future tax obligations, to explain why Main Street enterprises make the business investment location decisions they do, may seem to a career public finance economist as wrong-headed or uninformed. Financial accounting principles on which such decisions may depend may have their conceptual shortcomings, but, right or wrong, they matter to the executives who make the business investment location decisions.

This disclaimer is not intended to suggest that such practitioner perceptions are somehow better or more accurate than the other participants’ perceptions. It would be sufficient that the perceptions based on Main Street experiences be taken into account by policy makers to test the confidence one can have in projecting the impact of a proposed tax change on behavior by Main Street multinationals.

The problems to be “fixed” by implementing a quasi-territorial dividend exemption system were described in the Panel Report in very conclusory fashion. The two most important “problems” were “deferral” of tax on foreign subsidiary earnings and “cross crediting.” This article began as an effort to explore with a tax-literate audience (who might not have been deeply immersed in the details of the

Code Sec. 956 is akin to the appendix. It is not clear what useful function it performs, and it occasionally causes undesirable consequences.

The article was begun in November 2005, shortly after the President’s Advisory Panel on Federal Tax Reform delivered its report entitled “Simple, Fair, and Pro-Growth: Proposals to Fix America’s Tax System.” The Panel Report was promptly put on the shelf, for reasons evidently unrelated to the international provisions. The Panel Report re-proposed, with minor changes, the quasi-territorial “dividend-exemption” system that had been proposed in the report of the Staff of the Joint Committee on Taxation entitled “Options to Improve Tax Compliance and Reform Tax Expenditures.”

The problems to be “fixed” by implementing a quasi-territorial dividend exemption system were described in the Panel Report in very conclusory fashion. The two most important “problems” were “deferral” of tax on foreign subsidiary earnings and “cross crediting.” This article began as an effort to explore with a tax-literate audience (who might not have been deeply immersed in the details of the
international provisions of the Code) how subpart F
operated, and how the foreign tax credit has been
applied and limited. The next step was an examina-
tion of the dividend exemption proposals and how
they would change the application of present law to
basic multinational business activities. This article
seeks to examine the underlying assumptions about
the consequences of deferral (primarily the asserted
impact on business investment location decisions)
and “cross-crediting.” The asserted merits of changes
should be tested before leaping to the end game.

Some elements of this article were covered more
briefly in written testimony submitted at a hearing of
the Senate Finance Committee June 26, 2008. That
hearing addressed “The Foundation of International
Tax Reform: Worldwide, Territorial, and Something
In Between.”

The word “reform” seems to be invoked with some
frequency by proponents of particular changes in or-
der to enhance their appeal to an audience that may
not be inclined to examine the proposals in detail. It
may be that, in the end, the greatest “reform” would
be to leave the core architecture unamended for
some protracted period in order to provide stability
and predictability of the tax system so that business
decisions may be made on a longer time horizon
than two sessions of a single Congress or at most
several Congresses.

It also may be that “reform” will turn out to be
nothing more than trying to raise more revenue from
those multinational business enterprises that the
United States has the power to reach. It is also worth
remembering the aftermath of the tax reform process
that culminated in the Tax Reform Act of 1986. That
round of reform introduced relatively complicated
measures designed to prevent “cross-crediting” of
foreign taxes borne by foreign income in one “bask-
et” against U.S. taxes on other “baskets” of foreign
income,

as well as reductions in the limitation even
for taxes on other foreign source income within the
same basket.

While there may be solid policy rea-
sions that can be added to justify various anti-cross
crediting measures, it is also true that an important
stated justification for doing so in 1986, and perhaps
even now, is to increase taxes on business enterprises
doing international business.

Stated differently, increasing the tax burden on
income from international business activities may be
popular simply because it may be politically more
palatable than taxing other constituencies. Senator
Long coined the phrase about tax “reform” consist-
ing of taxing someone other than “you and me.”

Later, Dan Rostenkowski, then the Chairman of
the Ways and Means Committee, refined the thought to
establish a recurring theme in modern tax reform:
“Don’t tax you. Don’t tax me. Tax the companies
across the sea.”

The question that must be asked at each juncture
in the process of evaluating proposals to reform the
system of taxing foreign business income of U.S.
multinational corporations is whether a particular
proposal is structurally desirable on its own for some
articulated tax policy reason or some articulated so-
cial policy reason, or whether, instead, it is merely a
more palatable or expedient way to raise tax revenue
to “pay for” some other tax reduction or expenditure.
Either answer may be justifiable as desired tax policy
but it is important that policy makers understand
which answer justifies a particular proposal.

B. President Bush’s Mandate to the Advisory Panel on
Federal Tax Reform (January 2005)

President George W. Bush created the Advisory
Panel in January 2005. The President instructed the
Advisory Panel to recommend options that would
make the Code simpler, fairer and more conducive
to economic growth. The Advisory Panel delivered its
report, entitled “Simple, Fair, and Pro-Growth: Pro-
posals to Fix America’s Tax System,” to the Secretary
of the Treasury John Snow on November 1, 2005. In
response to the receipt of the Panel Report, the Treas-
ury stated that it intended to examine the proposals
carefully and, in due course, to make recommenda-
tions to the President.

The portions of the Advisory Panel Simplified Income
Tax Panel Report that explicitly address international
tax reform are limited to the taxation of income from
foreign direct investment by U.S. corporations. Other
recommendations in the Panel Report, however, affect
the taxation of income from some international port-
folio investment income. Portfolio capital flows, and
the income there from, significantly exceed foreign
direct investment capital and income flows, both into
and out of the United States. Any “fundamental” tax
change should at least try to avoid unintended effects
on the cross-border movement of portfolio capital and
the income there from.

It is also important to reflect on exactly why funda-
mental international tax reform was being considered.
As noted above, a similar version of the Simplified
Income Tax Panel Report partial territoriality proposal appeared in the January 2005 JCT Options Report. That report was prepared in response to a joint request from the Chairman and from the Ranking Member of the Senate Finance Committee to explore options to improve tax compliance and to reduce the size of the “tax gap.”21 The JCT Options Report was not a response to a Congressional or even a Senate Finance Committee mandate or request to examine options for fundamental tax reform.

The portion of the JCT Options Report dealing with the partial territoriality proposal identifies several particular “Reasons for Change.” Although the reasons given may be individually and collectively worthy of consideration, none of the reasons rises to a level of “fundamentality” comparable to other Panel Report fundamental changes such as limiting the deduction for interest on home mortgage indebtedness or implementing integration of corporation and shareholder taxation. Indeed, the JCT Options Report’s own characterization suggests that the partial territoriality proposal is a proposal with uncertain prospects for achieving even the limited goals the Staff describes for it:

Replacing the worldwide, deferral-based system with a dividend exemption system arguably would mitigate many of these remaining problems, while generally moving the system further in the direction charted by the Congress in 2004.22 (Emphasis added.)

The JCT Options Report proposal for its version of a partial territoriality system was estimated to increase tax revenues by approximately $54.8 billion in the aggregate for the nine years including 2006 through 2014. A threshold question is whether the proposals in both the JCT Options Report and the Panel Report are included primarily in order to raise revenue to help pay for more important reforms if those more popular reforms could reduce tax revenues. Indeed, it may be worth asking whether these proposals were attached to the Panel Report only because the Panel Report was the next train leaving the station on which to load this freight.

The Treasury made no public recommendation to the President with respect to the Panel Report. The proposals in the Panel Report that address international tax issues remain, however, useful points of reference in considering the options that succeeding Administrations will explore. In addition, as noted below, the Treasury did follow up with inquiries into the “competitiveness” of the U.S. business tax system, and those inquiries and the report thereon were informed in various ways by the Panel Report.


The American Bar Association Section of Taxation appointed a task force to think about reform of the international provisions of the Code. The Task Force published its report in October 2006.24 The ABA Report covers a number of important issues and contains a range of recommendations that reflects the diversity of views among members of the Task Force.25

The “end-deferral alternative” in the ABA Report would apply to noncontrolled foreign corporations, in contrast to the present-law approach (imposing residence-based residual taxation on any undistributed income) only if the foreign corporation is controlled in the aggregate by United States shareholders (each holding at least 10 percent of the foreign corporation). The ABA Report recommendation would apply tax on undistributed income even if United States shareholders held in the aggregate only 25 percent of the foreign corporation. The ABA Report contended that a 25-percent interest should be sufficient to have the foreign corporation listen to the Americans explain their U.S. tax problems.26 The minority shareholder’s opportunity to complain is no doubt of some value, but inevitably such a tax regime will discourage participation by U.S. MNCs in cross-border joint ventures. That collateral damage is presumably thought to be acceptable, or maybe even desirable, in order to achieve the other objectives that would be advanced (the ABA Report asserts that deferral is inconsistent with the special fairness criterion posited in the Executive Summary portion of the ABA Report, and that special criterion is evidently more important than the possible adverse effects on the American economy of discouraging U.S. MNC participation in cross-border joint ventures).

The ABA Report prescribes a special “fairness” euphemism as a criterion for testing the merits of taxation of income from cross-border trade and investment. The ABA Report defines fairness in special terms that might not be immediately apparent to a lay reader: it is a euphemism for progressivity of tax on individuals.27 Fairness as so defined is thus not even a relevant concept in comparing the tax burden on similarly situated business enterprises (such as U.S. MNCs versus non–U.S. MNCs). In other contexts,
inter-business corporate behavior might be tested for “fairness” (e.g., unfair business practices). Readers who do not keep in mind the special definition of a common word may confuse the conclusions reached using the special definition with broader “fairness” conclusions that might be based on lay usage of the word.

The ABA Report further asserts that fairness is also limited to only United States citizens and residents. Taxable corporations are assumed to be owned by citizens and residents of the country in which the corporation is incorporated. United States citizens and residents are assumed to own U.S. MNCs and therefore both to bear the corporate tax and to be the more prosperous individuals among us. In a global economy in which portfolio capital (i.e., shareholder investment capital) is raised all over the world, by all MNCs (domestic and foreign) and deployed by all MNCs (domestic and foreign) in direct investment all over the world, it is not entirely clear that the assumption is well founded. U.S. citizens and residents may not be the ultimate payers of the progressive tax imposed on U.S. MNCs. If foreign individuals (and foreign corporate MNCs) are significant investors in U.S. MNCs, they may change their behavior in response to different tax regimes applied on similar or even identical corporate businesses whose tax exposure is materially and adversely different merely because of the place of incorporation of the top-tier publicly traded corporation.

The ABA Report assumes that all U.S. MNCs are overwhelmingly owned by U.S. citizens and residents. The empirical corroboration of that essential assumption is not addressed in the ABA Report. Before taxing U.S. MNCs on undistributed earnings of foreign affiliates, even noncontrolled foreign affiliates, on the assumption that this is essentially just a redistribution of tax burden among American individuals, it is worth checking to see how true this assumption really is. The ABA Report further asserts that the foreign tax credit is not “fully consistent with the ability-to-pay (“fairness”) criterion measured by reference to U.S. citizens and residents.” It suggests that such a credit for foreign taxes paid by a business enterprise may be justified by the benefits to U.S. citizens and residents from international trade.

The ABA Report also identifies the problem that in some cases a foreign tax credit may offset U.S. tax on foreign-related income that arises from U.S. economic activity (export sales income and royalties).

D. Treasury Department 2007 Review of “Competitiveness”

The Treasury undertook an examination of the competitiveness of the federal business tax regime in 2007. On December 20, 2007, the Office of Tax Policy issued a report, “Approaches to Improve the Competitiveness of the U.S. Business Tax System for the 21st Century.” The Treasury Approaches Report contains observations and a description of various options available to tax policy makers, and the revenue consequences thereof. It does not, however, make specific recommendations of the preferred course of action after taking into account the benefits and costs of the several options it discusses. The Treasury Approaches Report observed at the outset in its Executive Summary:

Rather than present a particular recommendation, this report examines the strength and weaknesses of the various approaches [discussed in the Treasury Approaches Report]. ... This report does not advocate any specific recommendations nor does it call for or advance any legislative package or regulatory changes.

The Treasury Approaches Report also noted that a revenue-neutral reform would have an uncertain effect on competitiveness.

E. The Rangel Bill (2007)

Various items of recently proposed legislation are also part of the context in which international tax reform will be addressed during the current Administration. An important Congressional offering is the legislation introduced by Charles Rangel, Chairman of the Committee on Ways and Means, October 25, 2007. The international provisions in the Rangel Bill may have been primarily intended to be revenue raisers, rather than measures intended to achieve particular conceptual tax policy goals such as “fairness” (progressivity of tax burden) or a more efficient allocation of business direct investment capital. The provisions that apply specifically to deferral of foreign business income and the foreign tax credit are in fact significant revenue raisers, and are identified as such in the Rangel Bill, although there was no technical explanation that accompanied the proposal and that confirmed precisely what its purpose may be.

One component of the Rangel Bill international proposals may anticipate a potential approach to
making more targeted adjustments to the present system than simply choosing one or the other perennial “bookends” (1) ending deferral altogether, or (2) providing a broad territorial exemption system). Tools for making proportionate and targeted changes, to deal with agreed^46 problems, might be developed from the expense-deferral concept used in the Rangel Bill.

F. Personal Views and Recommendations
This article presents recommendations on how the continuing international tax reform discussion should proceed. A set of recommendations may serve as a useful “for instance” on the balance that might be struck among competing goals and thus may serve as an aid to analysis by policy makers, even those who might prefer a different balance than the one that appeals to the author.

The article considers exclusively international income tax reform actions the United States might undertake. It concentrates on taxation of income from foreign direct investment and from cross-border trade. It considers cross-border portfolio investment in the context of the effect on portfolio capital movement of the taxation of direct investment income, and vice versa.

One important option to consider in undertaking any evaluation of potential changes in taxation of income from cross-border trade and investment is to forego “fundamental” tax reform and instead make targeted adjustments to the present regime to deal with perceived shortcomings. Even such adjustments will require first reaching agreement that the asserted problems are real and need to be cured. Achieving such an agreement has been elusive over the past 50 years. It is critical, however, that any changes that may be made are made to solve a describable problem the contours of which are agreed upon by a significant constituency. Change should not be made merely in order to claim a political success in achieving a “fundamental” change.

G. International Tax Reform Has a Long History
We are not now engaged in a quest to find the “original intent” of the prior tax policy makers who agreed upon the existing system. In evaluating the various proposals that have been, or can be, made to change what we now do, however, the history of the architecture is sometimes informative as to the conceptual framework and the goals of present-day proponents of competing alternatives. The seemingly simple phrases in the competing proposals, such as “simplification” or “competitiveness” or “fairness” may obscure rather than enlighten the analysis of what the proposed changes are actually intended to achieve.

1. Revenue Act of 1962
Serious international tax reform has been the subject of Congressional review since at least as long ago as 1918, when the United States amended its newly hatched income tax regime to provide a foreign tax credit. The most important comprehensive changes in U.S. MNC taxation relevant to our current examination occurred in 1962^45 and 1986.46

The Revenue Act of 1962 was enacted in the context of competing proposals to reform the federal income tax treatment of income from cross-border trade and investment. The competing proposals of that generation are in many ways similar to the proposals on the table now.

The Kennedy Administration in 1961 first proposed a complete end of deferral for business operations in developed countries. In contrast, the National Foreign Trade Council (NFTC) had several years earlier proposed a complete territorial exemption. The reasons given 50 years ago continue to resonate today, and the resonance is more than a mere coincidence. Then, as now, it was understood that the United States must “fairly” apportion the cost of government and must be careful that its multinational enterprises continue to be able to operate competitively in a global economy. Then, as now, the United States depended on the efficient movement of capital into and out of the United States. Then, as now, there were nontax policy (particularly foreign policy) implications associated with encouraging or discouraging U.S. multinational direct investment outside the United States and with encouraging or discouraging foreign multinational direct investment in the United States. Then, as now, stability and predictability of the tax system were important considerations in preserving a vigorous national economy.

The Kennedy Administration first proposed a regime under which all undistributed income of a controlled foreign corporation would be taxed to its controlling, in the aggregate, U.S. shareholders. Prior to that time, in 1954, there had been a proposal to apply deferral to foreign branches earning active business income and to lower the rate of tax on repatriated
income by 14 percentage points. The provision was not included in the Internal Revenue Code of 1954. Representative Hale Boggs (D-La.) in 1959 proposed a rate reduction for certain foreign business income. The NFTC was reported in tax literature from that time to have advocated a complete territorial exemption system, in order to foster competitiveness of U.S. businesses with foreign corporations.

The Revenue Act of 1962 enacted subpart F. Undistributed “foreign base company sales income” was subjected to current residual federal income tax because such income was determined to be readily “deflected” from normally high-tax manufacturing countries to low-tax “base countries” (tax havens). In addition, similar anti-base erosion provisions were added to tax undistributed foreign personal holding company income resulting from related party payments of interest, rents and royalties, as well as related party dividends. Such income items are now sometimes referred to as items of “mobile income.”

In addition, subpart F as enacted included a curious provision designed to impose tax on investments of previously untaxed “good” earnings (non–base company income) in “United States property.” Code Sec. 956 is akin to the appendix. It is not clear what useful function it performs, and it occasionally causes undesirable consequences. A significant amount of ink has been devoted to the problem that there is a “repatriation tax” that discourages efficient direct investment of foreign subsidiary earnings in the United States. The expedient of simply eliminating or modifying what may be the world’s only anti-domestic-investment tax regime does not seem to have surfaced as an option worth considering.

The expedient of simply eliminating or modifying what may be the world’s only anti-domestic-investment tax regime does not seem to have surfaced as an option worth considering.

The 1986 Act introduced the following significant changes in the international provisions:

- The foreign tax credit was substantially reduced by providing for interest expense allocations against foreign source income that did not take into account leverage in foreign subsidiaries (borrowings by foreign subsidiaries to finance earnings).
- Subpart F income was expanded to include the ordinary business income derived by foreign subsidiaries of banks and financing business.
- Subpart F income was expanded to include income resulting from ordinary risk management activities of nonfinancial enterprises (currency, interest rate and commodity risk management).
- Joint ventures were targeted for adverse treatment, because someone thought they were a form of business unrelated to the worldwide business of multinational enterprises. Foreign tax credits associated with joint ventures were carved out and subjected to separate limitations.

2. Tax Reform Act of 1986

The Tax Reform Act of 1986 is sometimes held up as a model for a good tax reform process: broaden the base and lower the rate. Indeed, books with catchy titles have recounted how success was achieved in spite of Gucci-shod lobbyists. Notwithstanding any merits the 1986 Act might have had in the reform of domestic taxation, it is a sobering reminder that reform paid for at the expense of multinational business can adversely affect ordinary cross-border trade and investment for a generation or more. Further, the durability of tax reform that broadens the base while raising rates is at least questionable: the Panel Report indicated that the Code had been amended more than 15,000 times since the enactment of the 1986 Tax Reform Act. It is possible that some portion of the next round of “reforms” will be paid for by further burdens on income from cross-border trade and investment, as they were in 1986.

The 1986 Act introduced the following significant changes in the international provisions:

- The foreign tax credit was substantially reduced by providing for interest expense allocations against foreign source income that did not take into account leverage in foreign subsidiaries (borrowings by foreign subsidiaries to finance earnings).
- Subpart F income was expanded to include the ordinary business income derived by foreign subsidiaries of banks and financing business.
- Subpart F income was expanded to include income resulting from ordinary risk management activities of nonfinancial enterprises (currency, interest rate and commodity risk management).
- Joint ventures were targeted for adverse treatment, because someone thought they were a form of business unrelated to the worldwide business of multinational enterprises. Foreign tax credits associated with joint ventures were carved out and subjected to separate limitations.
on the theory that such joint ventures were not really part of the global enterprise.\textsuperscript{61}

The punitive provisions were modified, albeit sometimes only temporarily, in the period 1997–2006.


There was a significant uptick in international tax reform debate in 1992. Representatives Gradison\textsuperscript{62} and Rostenkowski\textsuperscript{63} introduced H.R. 5270.\textsuperscript{64} The most important components were measures to repeal deferral of tax on undistributed business income of all controlled foreign corporations (and not merely tainted base erosion or deflectable income), and to restore some of the benefits of the foreign tax credit lost by the interest expense allocation provisions of the 1986 Act.

\textbf{a. Deferral Provisions.}

H.R. 5270 proposed to end deferral for all income of all controlled foreign corporations. In addition, the bill would have provided the controlling parent (more than 50-percent ownership) of the controlled foreign corporation with an election (irrevocable) to treat the controlled foreign corporation as a domestic corporation that would itself be subject to U.S. corporate income tax on its worldwide income.

If the election was not made, the United States shareholder would be taxed currently on undistributed income of the controlled foreign corporation. Losses of the controlled foreign corporation would not flow through to the United States shareholder, and would not have been generally available to offset future income of the controlled foreign corporation.\textsuperscript{65} If the controlled foreign corporation were 80-percent-owned by a common domestic parent, and if the domestic-corporation election were made, the deemed or synthetic domestic corporation could be included in a consolidated group, and the losses of the synthetic domestic corporation could flow through to offset other taxable income (domestic or foreign) of the consolidated group.

The opportunity to include a controlled foreign corporation in a domestic consolidated group occasioned some public comment that the deferred intercompany gain rules would permit deferral of recognition of export sales income and would result in significant tax revenue loss (one “turn” of inventory).\textsuperscript{66} The general opportunity to take foreign business losses as deductions against domestic business taxable income was symmetrical with the option under present law (then and now) to operate in branch form. At the time, it was frequently not possible to do business in corporate form but to treat the foreign corporation as a disregarded entity (i.e., a branch). That opportunity was provided later when the check-the-box regulations were adopted in 1996.\textsuperscript{67}

\textbf{b. Foreign Tax Credit.}

H.R. 5270 proposed to undo the “double counting” interest expense allocation put in place by the 1986 Act. It proposed a version of the worldwide interest expense allocation that would reduce the amount of interest expense allocated against the numerator in the limiting fraction in the foreign tax credit formula. As discussed below,\textsuperscript{68} the foreign tax credit can be increased if expenses are allocated away from the numerator in the limiting fraction, and decreased if expenses are allocated toward the numerator.

The worldwide allocation proposal would decrease the amount of domestic interest expense allocated against the numerator by taking into account interest expense of foreign corporations. The worldwide interest expense allocation approach was eventually enacted in 2004.\textsuperscript{69} This provision would have been applicable to interest expense of controlled foreign corporations that were not synthetic domestic corporations. Synthetic domestic corporations’ interest expense would have been taken into account in the same manner as interest expense of other members of the consolidated group.

\textbf{c. Joint Ventures (10-50 Companies).}

H.R. 5270 would have provided an election to treat a foreign corporation of which United States shareholders owned between 10 percent and 50 percent (i.e., a noncontrolled foreign corporation) as a controlled foreign corporation. The benefit for the electing United States shareholder would be look-through treatment of the underlying income for purposes of the foreign tax credit basketing regime put in place by the 1986 Act, instead of segregating such income into separate baskets for each 10-50 company. Corporate income taxes paid or accrued by the deemed

The Panel Report thus generally does not represent, and should \textit{not} be viewed as, a bipartisan \textit{compromise} or accommodation of the longstanding conflicting points of view even though promulgated in a bipartisan Panel Report.
controlled foreign corporation could then be taken into account as creditable taxes against U.S. tax otherwise due on other foreign source income, including royalties and interest from the 10-50 company. The cost of the election would be current inclusion of the income (but not the losses) of the deemed controlled foreign corporation. Losses would not flow through because a less-than-80-percent affiliate could not be included in a consolidated group.

This aspect of H.R. 5270 is worth keeping in mind: it is necessary to do something to accommodate noncontrolled joint ventures in a U.S. tax system that was based in large part on the ancien régime that prevailed when U.S. corporations controlled the entities that they used in order to participate in the global economy. One approach is to treat the joint venture as undesirable and to discourage participation by treating noncontrolled foreign corporations as if they were controlled by the U.S. MNC. Another approach would be to treat noncontrolled foreign corporations as if they had no nexus with the remainder of the global operations of a U.S. MNC. The two approaches are both present in H.R. 5270, as elective alternatives. The ongoing discussion of international tax reform is likely to involve a similar duality.

4. 1997–2006 Congressional Tax Reforms

Since 1986, significant legislative changes have been made in several of the core pieces introduced by the 1986 changes. The post-1986 significant legislative changes date generally from 1997.79 A number of the post-1986 legislative changes are explicitly temporary. Making them permanent, or permitting them to expire, may be perceived by different constituencies to be important or even fundamental.

The Panel Report does not allude to the relatively recent Congressional changes in U.S. taxation of income from cross-border trade and investment, particularly to the changes made between 1997 and 2006. As a result, readers of the Panel Report (and perhaps even some of the members of the Advisory Panel) may not appreciate the extent to which Panel Report recommendations reflect significantly different policy choices than those that were made by the Congress as recently as the Congress that enacted the AJCA and TIPRA, and the several prior Congresses in session since 1997.

In evaluating any proposal for fundamental or significant change, it will be useful to consider the differences between the reform proposals and recent Congressional policy choices. The differences are, in many respects, the same policy differences (and political differences) that were present at the birth of subpart F in 1962 and that were present in 1986 when the Tax Reform Act of 1986 substantially reduced creditability of foreign income taxes. The 1986 foreign tax credit measures, for example, involved the use of the international part of the Code to raise revenue to pay for other politically desirable tax expenditures in the same or other contemporaneous legislation.72 The 1962 Act, in contrast was only marginally concerned about raising revenue.

The 1997–2006 changes cost the government tax revenues. They were justified as good principles to enhance competitiveness of U.S. MNC business outside the United States. In that sense, the changes were not tied to revenue goals, just as the 1962 enactment of subpart F was asserted to be a good idea for efficient allocation of direct investment of business resources, with only ancillary or coincidental tax revenue goals.

To a significant extent, the dividend-exemption proposal in the Panel Report would reverse decisions reached by Congress in enacting the recent legislation. The Panel Report thus generally does not represent, and should not be viewed as, a bipartisan compromise or accommodation of the longstanding conflicting points of view even though promulgated in a bipartisan Panel Report. The Panel Report generally comes down fairly firmly on the side of the argument that potential adverse impact on international (tax) competitiveness of U.S.-parented multinational corporations is not important enough to outweigh the perceived shortcomings that result from (1) present law’s combining “deferral” and “cross crediting,”73 and (2) “foreign base erosion.”74 The asserted shortcomings of present law, according to the Panel Report, include the tax-based enhancement of foreign direct business investment over domestic direct business investment as well as concerns about the fiscal erosion of the tax base of foreign countries which, with the United States, form some sort of tax policy community of interest.75

In certain other cases, however, the Panel Report is consistent with (or suggests the possibility of working out a position that would be consistent with) the recent Congressional reform initiatives. One example is the proposed treatment of financial services industry taxpayers as eligible for territorial exempt treatment of the business income that would otherwise be currently taxable “Mobile Income.”76 Another example is including in exempt Foreign Business Income...
items of income derived from non-mobile activities in a low-tax jurisdiction, even though such activities may thereby benefit from a tax-based enhancement compared to domestic activities.

Congressional changes in the core architecture since 1997 have been pejoratively dismissed by some persistent critics of the present system of deferral and cross-crediting. Many of the Congressional changes that have been made in that time period were recommended by the National Foreign Trade Council (NFTC) in its lengthy studies published in 1999 and 2001. It would be a profound misunderstanding of the continuing debate to ignore the conceptual underpinnings of the 1997–2006 legislative changes.

The Congressional changes made since 1997 consist largely of undoing provisions adopted in the Tax Reform Act of 1986 that were controversial even in 1986 and have been continuously controversial thereafter. As discussed below, a number of the 1986 provisions were adopted as revenue raisers in the context of broader tax reform. The 1986 Act changes were recognized at the time to entail both complexity and an increased tax burden on income from international business activities and direct investment. The 1986 Act changes were viewed by some as merely first steps toward finishing the job started in 1962, but not then completed, in enacting subpart F in the first place: ending deferral of all income derived from foreign direct investment.

Table 1 is a brief summary of the key points of difference (or congruence) of view between “Congressional Tax Reform” and “Advisory Panel Reform.”

5. 1996 Fundamental Administrative Change in Core Architecture of Subpart F

In addition to the deliberate recent legislative changes, there was an administrative change in late 1996 that had (and continues to have) a profound effect on the anti-deferral regime established in 1962: the introduction of elective entity classification rules and the treatment of single member entities as disregarded entities. The “check-the-box” regulations, particularly the “disregarded entity” provisions thereof, have made the anti-deferral regime under subpart F elective in many situations that were not elective prior to the promulgation of the check-the-box regulations during the Christmas holiday in 1996. It is unclear whether the IRS and the Treasury at the time fully appreciated the rather obvious and foreseeable consequences that the disregarded entity portion of those regulations would have on subpart F. Subpart F was not originally enacted as, or designed to be, an elective regime. Any evaluation of fundamental reform options must determine whether or not the 1996 regulations that establish such elective pass-through and disregarded entity status for foreign business entities should be part of the basic system of taxing foreign income of U.S.-parented controlled foreign corporations. The costs and benefits to the various actors (taxpayers, the government, tax policymakers) will look very different depending on whether the core “baseline” includes a substantially elective approach to transactions and income potentially taxable currently under subpart F or is instead viewed as merely a temporary feature, or aberration, of the core principles governing U.S. taxation of income attributable to direct investment in foreign subsidiaries.

The disregarded-entity regulation has taken on a quasi-legislative aura. In 1998, the IRS issued Notice 98-11 in which it announced that the government intended to issue regulations that would severely curtail the ability provided by the check-the-box rules to elect out of subpart F. The Notice indicated that this would be accomplished by inventing, by regulation rather than by legislation, new categories of “virtual” or synthetic foreign personal holding company income from transactions between one or more “hybrid branches.” Some members of Congress expressed concern that such an approach should not be taken without strict adherence to general administrative procedure policies and procedures, including public notice and the opportunity for comment. The “hybrid branch” transactions described in Notice 98-11 would have been re-characterized as giving rise to a new kind of subpart F income, rather than being characterized as disregarded non-events under the general rule that gain or loss does not arise on “transactions” by a single taxpayer with itself. Temporary and ProposedRegs. were subsequently issued in March 1998, in T.D. 8767 and REG-104537-97.

Congress acted to discourage adoption of such or similar regulations without first allowing a significant period for public comment and Congressional study. Ultimately, the IRS and Treasury withdrew the temporary and proposed regulations and issued new proposed regulations that by their terms would become effective only after a five-year period of notice from the time regulations might be issued in final form. To date, the five-year period has not yet commenced.
**Table 1**

<table>
<thead>
<tr>
<th>Proposal</th>
<th>Legislation</th>
<th>Panel Report</th>
</tr>
</thead>
<tbody>
<tr>
<td>Repeal Foreign Base Company Sales Income</td>
<td>Proposed section 301, H.R. 5095, 107th Cong. 2d Sess. (2002) (&quot;Thomas Bill&quot;)</td>
<td>Recommends treatment as “Mobile Income” with no deferral and no “cross crediting” for taxes on income likely to be highly taxed. Mobile Income would include the present categories of Foreign Base Company Sales Income and Foreign Base Company Services Income.</td>
</tr>
<tr>
<td>Repeal Foreign Base Company Services Income</td>
<td></td>
<td>See JCT Options Report footnote 428 at p. 194.</td>
</tr>
<tr>
<td>Exclude Active Financing Income from Subpart F Foreign Personal Holding Company Income</td>
<td>Initially adopted in Taxpayer Relief Act of 1997, reversing the initial inclusion of such income in FPHCI in the 1986 Act, a provision that reversed the decision reflected in the 1962 Act to exclude active financial services income from subpart F. Temporary, but regularly “temporarily” extended, most recently by Emergency Economic Stabilization Act of 2008.</td>
<td>Unclear. Recommends treatment as exempt Foreign Business Income, except to the extent attributable to “investment” of financial institution assets. Unclear if a change in present Code Sec. 954(h) is intended.</td>
</tr>
<tr>
<td>Related Party Look-Through Exclusion from Foreign Personal Holding Company Income (and thus from subpart F)</td>
<td>TIPRA amendments to Code Sec. 954(c) excludes all related-party dividends, interest, rents and royalties, attributable to neither subpart F income or effectively connected income of the payer CFC, from foreign personal holding company income of the payee.</td>
<td>Exclude dividends, but not interest, rents and royalty payments that would generally be deductible under source country tax law. Panel Report conceptually uses “base erosion” of foreign taxable income as important criterion to use to categorize an item as (U.S.-taxable) “Mobile Income” or exempt Foreign Business Income. The TIPRA exclusion would thus be reversed.</td>
</tr>
<tr>
<td>Reduce Foreign Tax Credits to simplify FTC and to enhance “cross crediting”</td>
<td>Several prospective legislative eliminations of separate 10/50 basket commencing in 1997, followed by complete elimination in AJCA.</td>
<td>“Do something” (But apparently not provide complete look-through as with CFCs.)</td>
</tr>
<tr>
<td>a. Joint Ventures (10/50 Companies) Dividends</td>
<td>Intended to achieve full cross crediting for foreign income tax on all foreign source business income, whether from foreign single-country subsidiaries, joint ventures, royalties or export sales income.</td>
<td>If not exempt Foreign Business Income, it would be Mobile Income with no cross credit for high foreign tax on exempt Foreign Business Income. Would eliminate cross credit for high taxes on joint ventures against royalty income and export sales income. Would have effect of at least partially reinstating 1986 Act segregation of joint ventures from other units of the US MNC global enterprise.</td>
</tr>
<tr>
<td>b. Joint Venture (10/50 Companies) Interest, rents and royalties</td>
<td>Intended to reverse 1986 Act limitation on cross crediting among units of a US MNC and joint ventures (which were not to be treated as related units of a worldwide enterprise). More direct look-through for cases in which common control of borrower/lender or licensor/licenses not present-has not been enacted.</td>
<td>“Do something” Would eliminate cross credit for excess foreign taxes associated with dividends and branch profits of controlled and non-controlled foreign corporations against interest, rents and royalties from controlled foreign affiliates and non-controlled foreign affiliates.</td>
</tr>
</tbody>
</table>

Table continued on page 18
<table>
<thead>
<tr>
<th>Proposal</th>
<th>Legislation</th>
<th>Panel Report</th>
</tr>
</thead>
<tbody>
<tr>
<td>Controlled Foreign Corporation Dividends</td>
<td>Retain general basket cross crediting for all foreign taxes on general limitation basket comprised of high and low taxed income from related CFC and 10/50 (J.V.) dividends, active business royalties, related party dividends, interest, rents and royalties where payer under common control with payee, and look-through dividends from 10/50 (J.V.) companies.</td>
<td>Eliminate cross crediting for high taxes on earnings related to such dividends against low taxed foreign dividends, interest, rents and royalties, and export sales income. Dividends are exempt if attributable to income other than Mobile Income.</td>
</tr>
<tr>
<td>Interest, rents and royalties</td>
<td>..................................................................................................................................................................</td>
<td></td>
</tr>
<tr>
<td>Expense Allocations to Reduce FTC Limitation: Worldwide Interest vs. U.S. Group Interest Only</td>
<td>Reduce U.S. interest allocable to foreign source income to account for foreign interest expense incurred to produce foreign source income. Intention is to increase amount of foreign source income, the U.S. tax on which can be reduced by high foreign taxes on foreign business income. Postponed since enactment, probably not for the last time.</td>
<td>Deny all foreign tax credits on income likely to be subject to high foreign tax. Excess foreign taxes on such income cannot reduce U.S. tax on other foreign source income. Reverses the result of the change in interest expense allocation by another means.</td>
</tr>
<tr>
<td>Eliminate separate foreign tax credit basket for financial services income of financial services business.</td>
<td>Financial services income of a financial services taxpayer will be general basket income permitting cross crediting of excess foreign taxes on other general basket income and vice versa.</td>
<td>Any such income that is exempt Foreign Business Income will have no foreign tax credit. Any such income that is Mobile Income cannot benefit from cross crediting of excess foreign taxes on other foreign general basket income. Unlike to have excess credits on “Mobile Income.”</td>
</tr>
</tbody>
</table>

**Endnotes for Table 1**

1. Panel Report at 240 (“income from the sale of property purchased from or sold to a related person by a foreign corporation that is neither the origin nor the destination of that property”). There is a similar reference to “certain income from personal services” that appears likely to include present-law: foreign base company services income. The JCT Options Report contained proposals very similar to the Panel Report dividend exemption system. The JCT Options Report left open the possible elimination of foreign base company sales income and foreign base company services income. JCT Options Report, note 428, at 194.
2. Panel Report, at 240 (“Businesses would not receive foreign tax credits for foreign taxes (including both corporate level taxes and dividend withholding taxes) attributable to Foreign Business Income because this income would not be subject to tax in the United States.”) The common presence of high foreign taxes on such income would often make such income generally exempt from further U.S. tax under present law. The Panel Report “word” is thus, at best, word.
5. Section 12(b) of P.L. 87-834. (Code Sec. 954(c)(3), as added to the Internal Revenue Code of 1954 provided that foreign personal holding company income would not include “dividends, interest or gains from the sale or exchange of stock or securities derived in the conduct of a banking, financing or similar business. …”).
7. Panel Report, at 241 (“Anti-abuse rules would be needed to prevent passive investment income earned by financial services businesses from being treated as Foreign Business Income”).
8. Code Sec. 954(h) has objective, rather than “anti-abuse” tests to distinguish qualifying and nonqualifying income.
9. Section 103(b) of TIPRA added Code Sec. 954(c)(6).
10. Panel Report, at 240 (“certain types of foreign active business income that is not likely to be taxed in any foreign jurisdiction”).
13. Panel Report, at 240 (“Further rules would be needed to address the taxation of Foreign Business Income earned by a U.S. multinational that owns at least 10 percent of the stock of a foreign corporation that is not controlled by U.S. shareholders (so-called “10/50” companies”).
15. Code Sec. 954(c)(3) provides an exception
In the JCT Options Report, one proposed change would be to end, by legislation, the regulatory creature commonly referred to as a “disregarded entity.” The need for legislation, rather than just an administrative amendment to administrative regulations, is based on an a perception that there was an agreement, at least informal, between the Congress and the Executive Branch that no change in the disregarded entity rules would be made until Congress (and not just the Treasury, after following appropriate administrative procedures) had decided how to deal generally with policy issues in the core features of subpart F. 92

The issues posed by the introduction of substantial electivity into the architecture of subpart F are discussed below at Part II.K. (The Disregarded Entity Rules and Electivity Under Subpart F).

H. The Role of Discontinuities (“Abuses” or “Tax Arbitrage”) in the Pursuit of Tax Reform

The impetus for tax reform may not be confined to the perceived need to come up with an overarching unifying principle suitable for U.S. business income in the modern global economy, or even just the need to raise revenue. The impetus may also be importantly driven by a desire to deal with “abuses,” including “abusive” reduction in foreign tax bases. Abuses may be nothing more than different tax consequences for what may seem to be transactions that are taxed differently (either within the United States or in the United States compared to a foreign country) but which are essentially similar or even identical to each other. The “abusive” feature seems to require that the different tax consequences have been actively pursued, rather than accidentally suffered, by a taxpayer.

One source of “abuse” seems to reside in the different tax treatment of income and expense associated with debt versus equity. An alternative to the present-law system of distinguishing between dividends (nondeductible) and interest (deductible) has been proposed as a way to eliminate such tax differences and the resulting temptation to engage in tax abuse. 93 The impetus for this proposal is, at least in part, a perception that “financial engineering” will be able to move between debt and equity with no “real” difference, based primarily or even entirely on the desired tax consequences.

The asymmetry between the tax treatment of debt versus equity may also be bad policy without regard to the potential for abuse. For example, excessive debt by corporate businesses may be stimulated by the existence of a deduction for debt-financed capital. When there are reasons to change the basic structure, the virtue of doing so may be enhanced by also claiming to stamp out “abuses.”

Some commentators have characterized deferral of U.S. residual tax on foreign affiliate income as elective, based upon the choice of one piece of paper rather than another. 94 The perception that this is merely an election to be, or not to be, taxable, appears to support, at least at a visceral level, many of the proposals to eliminate deferral. 95 Such a characterization depends, however, on a certain mental model: a controlled foreign subsidiary (or even more strongly, a wholly owned foreign subsidiary). The characterization ignores (or defers for further consideration) partial ownership by U.S. shareholders. 96 Proponents of this view are most likely to point to the “abuse” that is most likely to occur when a choice is made with respect to wholly owned foreign business activities. They appear to see the need to stamp out this abuse opportunity as being so important that it overrides other tax and nontax considerations. One important problem with this particular mental model is that it ignores joint ventures as a common business model in the multinational global economy.

Even assuming, however, that we can afford to penalize U.S. MNCs that might usefully participate in joint ventures without doing serious injury to our economic well-being, the “problem” seems to have been routinely overstated in tax reform writings on the topic. If the “problem” associated with deferral consists of the cost to the government fisc of allowing a current deduction of expenses incurred to produce foreign income, before any income produced by such
expenditures will be subject to U.S. tax, completely ending deferral is overly broad. If there are “abuses” worthy of being fixed with respect to such a mismatch of expense and income, an adequate and proportionate remedy may be simply to defer such expense deductions until such time as associated foreign-related income is taken into account for U.S. federal income tax purposes.97 Discouraging international joint ventures by subjecting all income to current U.S. corporate income tax should not be a standalone goal of adopting anti-deferral proposals, but instead should be viewed as a price to be paid in order to get at abuses. The “price” (increased tax on non-abusive activity) should be tested against the benefit (ending some tax abuse).

Those who view cross crediting as an “abuse” may do so based on a mental image of two groups of essentially unrelated foreign source income somehow fortuitously (or even nefariously) combined in one taxpayer’s return. Those who look at a different global economy view cross crediting as desirable averaging of foreign taxes on income from the conduct of normal global business. Under that view, “credit averaging,” the ability to average taxes imposed by different sovereigns on generally related pieces of a global business is not abusive. This position is based on a different mental image: an interrelated or even a unified global business conducted on an interactive basis across national boundaries with different countries taking a tax bite wherever they can.

The abusive-cross-crediting mental model is particularly nettlesome to its enthusiasts if cross-crediting results from “trafficking” in foreign tax credits. The worry also attends to allowing foreign taxes to reduce U.S. taxes on U.S. economic activity, as may occur when royalties for U.S.-produced intangible property are treated in their entirety as general basket foreign source income, the U.S. taxes on which can be offset by possibly “unrelated” foreign taxes imposed on income from dividends from foreign corporations that may exploit different markets using different tangible and intangible resources than those that produce the offensive “foreign source” royalties.

Completely eliminating cross-crediting to preserve (or begin to impose) U.S. tax on royalties for the foreign use of U.S.-origin intangible property is a more attractive option if the risk of collateral damage is either minimized (or ignored) than when collateral damage is taken into account. For example, foreign-to-foreign royalties for foreign developed intangible property do not create untaxed income from domestic business activity, but the dividend-exemption proposals would eliminate a foreign tax credit from high taxed business income against income from foreign-origin intangible property. Similarly, multi-jurisdictional activities will ordinarily have several components of income, and recombin-ing the foreign income tax on manufacturing income with the income from selling the resulting product is not abusive in any obvious sense of the idea.

Moreover, foreign income taxes on either the manufacturing income or the selling income seem functionally and economically close to the income from the design intangibles or trademarks used by the manufacturing or selling enterprises to sell the resulting product to a customer in the same or other countries. Harm, and unnecessary harm, can be done to a normal, nonabusive, business if the mere possibility of abuse is the overriding concern.

Congress’ periodic forays into the “per country” limitation assume that single-country activities are unlikely to be abusive while multi-country com-
bimations are likely to be inspired by tax-abuse opportunities. The mental model supporting that assumption is likely to have predated the development of multi-jurisdictional free trade that has developed since the European Union became a major free trade area. So long as tax policy makers remain convinced that multinational activities by U.S. MNCs are not integral to the benefits Americans derive from participating in the global economy, those policy makers will rely on a mental model in which single country operations are virtuous, and multi-country operations are prone to mischief. If the abuse is so important that it must be stamped out at all costs, a solution focused on “abuses” will support ending deferral and cross-crediting, even for wholesome cross-jurisdictional activities that benefit U.S. economic activity, if that is necessary to “get” the “base company abuse.”

In the end, making sure that all abuses can be prevented may be impossible without also severely damaging ordinary business in a global economy. Pursuing tax policy primarily to stamp out occasional abuses, and relegating adverse collateral consequences for ordinary business in a global economy to a secondary importance, is likely to be unhelpful to the American economy in the long run. A whole new system, based on setting off on a journey into the realm of the known, the unknown and the unknowable, may be effective at pursuing currently known abuses, but it may entail collateral damage that could (and should) be avoided if the system were instead just tweaked to deal specifically, and proportionately, with the smaller universe of problems reasonable people can agree on.

I. Worldwide Tax; Corporations As Separate Taxpayers

From the commencement of the federal income tax until today, U.S. resident taxpayers have been subject to worldwide tax on all income from whatever source derived. Such income for shareholders includes dividends received from corporations. Foreign corporations are not generally subject to U.S. federal income tax except on income having a transactional nexus (such as “source”) with the United States. This is true whether or not the foreign corporation is wholly owned, partly owned or not owned at all, by U.S. taxable shareholders.

Corporations are, of course, mere legal fictions imbued with legal personality only for some purposes. They are the useful fiction to support the commitment of capital to a business enterprise without causing unlimited liability for those who invest capital but who do not manage the business (and particularly its liability-inducing actions). For some purposes, tax policy must treat corporations as “persons,” but for other purposes it seems better to think of corporations as mere agglomerations of capital provided by shareholders, of capital provided by creditors, and of services and intangible capital provided by managers and workers. The business enterprise conducted by the corporate “person” has an impact on each of the constituents of its agglomeration as well as upon other business enterprises (customers and suppliers) and the people and governments whose interests are affected by the activities carried out by the fictitious legal person and its several constituent components.

For the purposes of the analysis in this paper, it is assumed that the “classic” system of taxing corporations separately from their shareholders will continue. The “classic” system contemplates that income from business activity will be taxed twice: once when earned by the business activity (at the corporate level) and again when distributed as a dividend to the corporation’s shareholders. As noted by commentators and tax policy participants, any departures in favor of an “integrated” tax system make it necessary to consider adjustments to the existing platform of multinational income apportionment reflected in the network of double tax treaties.

The impetus for integration of the corporate-level tax on business income and shareholder-level tax on income from capital has not been a perceived need to reconcile the competing tax interests of source countries and residence countries. Instead, the cross-border implications are considerations to be worked out once the baseline system has been changed from “classical” to integrated.

The classical system provides a fairly simple analytic framework in which to consider the differences between income generated by business activity (“source”) and income distributed as return on investment capital (“residence”). In an integrated tax system, a similar determination will have to be made. Source countries will not readily cede primary taxing jurisdiction to the countries-of-origin of capital, with respect to income from business activity in the source country. Moreover, it has become increasingly clear that there is likely to be no single country-of-origin of capital. One way or another it will be necessary to track returns on capital separately from the business activity income in order to maintain a global economy with many taxing sovereigns which have
often distinct relationships to imported capital (i.e., when they are source countries) and exported capital (when they are residence countries). The integrated tax system seems to work best when the same country is the country of source and residence. That condition (capital raised and deployed in the same country) is probably less common than 20 years ago, or perhaps even than five years ago.

The analysis in this article will use the framework of the classical system in order to segregate business activity income from distributed income. Corporations can be used as analytic device to segregate business activity income from shareholder investment income. Shareholders can be used as the analytic device to deal with capital income (and return of capital) as withdrawn from business activity. The same concepts would have to be developed for an integrated system—a topic for the next round of fundamental tax reform.

In the ordinary case, shareholders will not be taxed under such a system on the income (if any) of the corporations in which they invest, until there is an actual distribution—a return to the shareholder of income on its capital investment. Such a return to shareholders is an amount that has been withdrawn from the capital stock of the corporation (and from the business conducted by it).

The dividend income may be characterized differently in the hands of distinct kinds of investors (passive portfolio investment income, income that is closely related to ordinary business income of the shareholder, etc.), but it always is distinct from the underlying business activity income of the corporation. It is distinct because it has been withdrawn from the capital stock of the business activity.

In an international context, the taxation by the residence country of a shareholder’s capital income is premised on the separate investment status of the capital provider—separate from the business activities of the corporation in the country or countries of source. The residence country exercises residual taxing jurisdiction over the return on investment, but the source country is supposed to have jurisdiction to tax (or not to tax) the income from business activity before such income becomes a return on investment to the shareholders.

Separate treatment of corporations and shareholders is also a basic building block in the existing network of bilateral tax treaties. Taxing shareholders on undistributed corporate income can of course be reconciled with the basic treaty framework, but in doing so it is important to try to keep straight whether the tax imposed by the residence country on undistributed income of a corporation in the source country is supposed to be an anti-abuse measure or instead the exercise of residence country tax jurisdiction over source country business income. Subpart F is presently supposed to discourage diversion of business activity attributable to inappropriate base erosion and to preclude inappropriate squirreling away of income from passive assets.

It is a quite different matter to proceed to comprehensive residence-country tax on undistributed source-country business income. Such a tax is effectively premised on the idea of residence-country taxing jurisdiction over foreign source business activity income, in preference to source country jurisdiction. That was the view of Professor Seligman in 1923. The proposals to end deferral without regard to behavioral characteristics (i.e., for reasons other than curbing distortions in the allocation of taxing jurisdiction) are in the author’s view fairly characterized as a tax on income (of the resident) before it has been realized by the resident in its capacity as earner of income on the capital provided by the resident. A corporation when it functions as a mechanism to allocate and apportion taxing jurisdiction over cross-border business income is not, in other words, merely a curious application of Moline Properties nor is it inherently insubstantial, the mere choice of a piece of paper to avoid paying tax on foreign business income. If the choice of a piece of paper is to be challenged, it is perhaps more sensible to preclude an election not to be taxed under a separate entity regime, and to treat foreign branches as separate entities as suggested below at Part III.B. (Eliminate Separate Regimes for Foreign Business conducted via Foreign Corporations vs. Branches and Other Passthrough Entities).

The discussion that follows assumes the corporations will continue to be treated separately from the shareholders. Further, it assumes that taxing the shareholders on undistributed income should be tested as the exception (to solve a specific problem) rather than the norm. For example, if the abuse is an inappropriate tax incentive to foreign direct investment compared to domestic investment, the effect (if any) on that choice of business investment location, of “deferral” until distribution, should be tested. If there is little or no effect, it would be reasonable not to blow through the “normal” division of taxing jurisdiction between source countries and the residence country.
J. President Obama: Possible 2009 Proposals

The 2008 Presidential election has touched on international tax issues. Much of the conversation seems to have been inspired by Senator Long's prescription for tax reform. In the international area, it appears that President Obama may share the traditional opposition to deferral that President Kennedy advocated in 1961. At the time this paper is in preparation, it is necessary to rely on reading tea leaves to divine what sort of anti-deferral plan President Obama actually has in mind.

The path to divining the scope of the eventual plan includes legislation most recently proposed in 2007 by Senator John Kerry. The proposal, the “Export Products Not Jobs Act,” would expand subpart F income (currently includible by a U.S. shareholder) to include all income of a controlled foreign corporation other than “home country income.” Basically, such active home country income would be limited to income derived within a single country from both manufacturing and selling for consumption in that country. In a global economy, that would be tantamount to eliminating deferral on earnings of controlled foreign corporations. The 2008 Democratic platform describes its intent to “end the tax breaks that ship jobs overseas.” The symmetrical use of terms between Senator Kerry’s proposed legislation and the 2008 Democratic platform suggests that the work begun in 1961, to end deferral altogether, is what may constitute fundamental “tax reform” by President Obama’s Administration.

II. Present Law: Selected Issues

A. General

This part of the article discusses some of the central issues in any examination and evaluation of international tax reform proposals.

- Residence-Based Taxation of “Domestic” Corporations: Which Agglomerations of Capital Should Be Treated as U.S. Residents and Which Should Be Treated as “Foreign”?
- Deferral vs. Current Inclusion of Foreign Affiliate Income.
  - The Cary Brown Model and the Present Value of Deferred Tax
  - U.S. GAAP Accounting for Undistributed Foreign Affiliate Income and Deferred U.S. Tax Thereon
- Disincentives to Repatriation: the “Repatriation Tax”
- Matching of Expenses and the Income to Which the Expenses Relate
  - Exempt Income/Disallowed Expense
  - Deferred Income/Deferred Expense
- Cross-Crediting: Which Foreign Taxes Against Which Income
  - How Should Items of Foreign Income and Foreign Tax Be Grouped?
- Related-Party Transactions and the Arm’s-Length Principle
- Business Competitiveness: Who Is Competing with Whom?
- Tax Competition Between Countries and the “Race to the Bottom”: What Role Should U.S. Tax Play in Backstopping the Tax Systems of Foreign Countries?
- Financial Services Industries
- The Disregarded Entity Rules and Electivity Under Subpart F
- International Joint Ventures
- Tax-Exempt Investors

The following discussion of each topic is intended to help better understand some of the diverse points of view that have attended, and will continue to attend, the continuous examination of the international provisions of the federal income tax.

B. Residence-Based Taxation of “Domestic” Corporations: Which Agglomerations of Capital and Services Should Be Treated As U.S. Residents and Which Should Be Treated As “Foreign”?

In discussing the several issues affecting the application of U.S. corporate income tax to U.S. multinational corporations it is useful to try to figure out which global companies are sufficiently “domestic” to be subject to worldwide U.S. tax and which are not. Domestic MNCs are subject, sooner or later, to U.S. federal corporate income tax on all income from whatever source derived, including income in respect of investments in foreign corporations. Foreign MNCs are not subject to U.S. corporate tax on all worldwide income, although foreign MNCs may be subject to substantial residence-based corporate tax on income from global operations outside their...
country of residence. Few if any countries outside the United States have provisions as burdensome on foreign operations as subpart F. Thus, it can make a difference if a company is characterized as a U.S. domestic MNC or as a foreign MNC.

The determination of whether a corporation is “domestic” (and thus subject to U.S. corporate income tax on worldwide income, including the income of its foreign affiliates) or “foreign” (and thus subject to U.S. corporate income tax only on U.S. source income or on income “effectively connected” with a United States trade or business) has ordinarily been based on the place of incorporation of the top-tier parent company. The place where the corporation’s employees are located, the place where some or all of the shareholders reside, the place where some or all of the management of the business is located, and the place where the corporation has deployed the capital invested in it by portfolio investors, are all irrelevant under the general rule for determining corporate residence.\textsuperscript{112}

Occasionally, using the place of incorporation as a reliable indicator of the taxable corporate residence has yielded to a perceived need to expand the reach of worldwide taxing jurisdiction over income from some combination of capital and labor that has struck Congress as bearing a close enough nexus to the United States to justify worldwide taxation.

Such “anti-abuse” measures have included the enactment in 1984 of Code Sec. 269B (“stapled stock”) and the enactment in 2004 of Code Sec. 7874 (“inversions”). Neither measure was supported by a rigorous analysis of the reasons for exercising the power to tax the worldwide income of the affected corporations differently than other foreign corporations having otherwise similar or identical places of doing business, sources of shareholder or creditor capital input, locational distribution of operating and strategic management, or location of business activities (such as subsidiaries and branches).

The anti-inversion politics were reflected in the JCT Options Report and the Panel Report. Each report recommends a selectively targeted expansion of U.S. tax residence (and consequent expansion of the U.S. worldwide income tax net) to include, in addition to domestic place of incorporation, a test based on a new and somewhat loosely defined\textsuperscript{113} notion of management location.\textsuperscript{114}

In the context of “fundamental” reform, it probably makes sense in evaluating reliance on tax residence as the basis for applying worldwide U.S. corporate income tax, to consider several preliminary issues:

- Who are we seeking to tax when we impose a tax on income realized by the fictional corporate “person”? The shareholders? The employees? The suppliers? The customers? The creditors?
- Can we, or should we, establish a system for the taxation of corporate foreign direct investment income without taking into account the sources of portfolio capital that is invested in the corporations that engage in multinational trade and investment? Should we simply assume that the vast preponderance of shareholder investors are resident in the country in which the parent of the MNC group is incorporated?\textsuperscript{115}

The problems in ascertaining answers to such preliminary questions are exacerbated by a critical paucity of specific information about the demographics of the shareholder-investor populations: We really do not seem to know much about the nationality or tax residence of the owners of General Motors or Toyota, BP or ExxonMobil, AT&T or Vodafone Group plc (formerly Vodafone/Airtouch), Siemens or General Electric. Gross data are available with respect to foreign direct investment by U.S. MNCs and U.S. direct investment by foreign MNCs.\textsuperscript{116} Gross data (or estimates based on surveys) are also available with respect to foreign portfolio stock investment in U.S. companies, as are such data with respect to U.S. portfolio stock in foreign corporations.\textsuperscript{117} What seems not to be readily available is the distribution of foreign portfolio investment in U.S. MNCs that might correspond, in whole or in part, to U.S. MNC direct investment within or without the United States. Is the inbound portfolio capital going primarily or entirely into U.S. business activity of domestic corporations, such as farming, or is it being managed by global business enterprises that deploy capital all over the globe and raise capital from all over the globe? Is more or less capital flowing into U.S. MNCs compared to domestic corporations conducting entirely domestic business operations through U.S. subsidiaries which have transactional relationships with “foreign” affiliates? Is U.S. portfolio capital flowing into foreign corporations engaged exclusively in foreign business activity or is some of it deployed in global enterprises such as BP or Royal Dutch Shell or Daimler or Toyota or Siemens or Philips, all of whom conduct significant U.S. business operations (through U.S. subsidiaries which have transactional relationships with “foreign” affiliates)?

A key component of the arguments in favor of ending deferral is the idea that fairness requires taxing
corporate income because the corporate income tax is really a tax on the portfolio shareholders. Fairness in such a context is a euphemism for a progressive income tax. If the portfolio shareholders of MNCs, domestic or foreign, are in fact well-to-do U.S. resident individuals, the argument is that the corporate tax is a tax burden properly borne by U.S. resident portfolio shareholder investors because U.S. portfolio shareholder investors are wealthier than other subsets of the citizenry and should therefore bear a greater proportion of any tax based on their greater ability to pay. In such a case, however, where the corporate worldwide income tax applies on a corporate residence basis, only the U.S. MNC’s portfolio shareholders (domestic or foreign) are subject to the full panoply of U.S. worldwide tax and anti-deferral measures established under the U.S. federal income tax system. The portfolio shareholder investors in a foreign MNC, whether the portfolio shareholder investors are U.S. or foreign, are given a reprieve from bearing their “fair” share of the cost of the U.S. federal government, at least until such foreign MNCs distribute dividends to U.S. portfolio shareholders. The domestic portfolio shareholder investors in a foreign MNC are given a reprieve from tax until distribution of dividends to them and in such event their distributed amount will be presumably enhanced by the benefits (to the foreign MNC) of the “interest free loan” that results from deferring all U.S. tax until realization by distribution to the U.S. taxpayers.

Even if it makes sense to restrict the implementation of “fairness” to the taxation of shareholders in “domestic” corporations, because that is the best we can do with the available taxing tools, it may be worth exploring the implications of imposing U.S. corporate income tax on the worldwide income of some but not all corporate participants in the global economy. One simple and sufficient justification may be then-Chairman Rostenkowski’s maxim expressed in the 1986 round of fundamental tax reform that the best source of tax revenue in a tax reform exercise is “the companies beyond the sea.” The concern that might intrude at this point in the argument is that portfolio capital investment (by domestic and foreign shareholder investors) might respond to unfavorable tax treatment of corporate income earned by a “domestic” or U.S. MNC compared to the tax treatment of similar or identical income of a similar or even identical “foreign” MNC. The foreign portfolio investor might invest in ABB rather than GE if the corporate tax burden were a material cost borne by one (GE) and not the other (ABB).

The concern that might intrude at this point in the argument is that portfolio capital investment (by domestic and foreign shareholder investors) might respond to unfavorable tax treatment of corporate income earned by a “domestic” or U.S. MNC compared to the tax treatment of similar or identical income of a similar or even identical “foreign” MNC. The foreign portfolio investor might invest in ABB rather than GE if the corporate tax burden were a material cost borne by one (GE) and not the other (ABB).

Another approach may be to assume away the problem, to assume that the “vast preponderance” of the investor shareholders reside where the MNC is incorporated. That seems to be the approach of at least some of the authors of the ABA Report in 2006. That approach may also be supported by various studies suggesting that there is a national bias among individual investors in favor of investment in corporations incorporated in the jurisdictions in which the investor resides. It would be worth finding out whether those assertions in those studies are still true, before expanding the tax burden on some but not all MNCs that manage portfolio capital invested in them from sources all over the world.

Another approach may be to assume (or prove) that portfolio investment is insensitive (in making location decisions as to the particular MNCs in which to invest) to different tax burdens on U.S. MNCs compared to foreign MNCs, although the management of corporations is supposed to be sensitive to tax differences in making direct investment location decisions as to where to invest.

Under this approach, concerns about possible “tax subsidies” to foreign direct investment by “U.S.” MNCs, could be addressed (by, for example, ending
deferral) without having to worry about the possible incentive to the portfolio investors to find alternative foreign MNCs to manage the direct investment deployment of the proceeds of portfolio equity capital invested by the portfolio investors. This approach is premised upon the perception that different folks have different levels of concentration on tax burdens in general, and exposure to residual U.S. tax in particular. This view is that other (nontax) factors overwhelm comparative corporate tax burdens in the decision-making by portfolio investors while comparative tax burdens on direct investment income are not overwhelmed by other factors. The difficulty with this approach is that it seems to be hampered by a lack of direct observation of the investment decision-making process used by portfolio investors (and their fund managers), either within or without the United States.

Another approach is to attempt to devise a tax system that would effectively lower the tax burden on corporate income to a point that would alleviate the incentive for U.S. MNCs to reduce the effective rate of tax on foreign source income by reducing the rate to one that approximates an assumed global rate on all income, both domestic and foreign. This is a sort of “no harm, no foul” approach that seeks to approximate the rate of corporate income tax that the putative foreign MNC (alternative portfolio investee) is likely to encounter in conducting the business that would otherwise be conducted by the U.S. MNC but for its diminished after tax return on investment.

In the end, we seem not to know enough about these variables to decide the best way to proceed. The lack of information does suggest, however, that caution is in order in imposing worldwide tax on undistributed income of “U.S.” MNCs while conceding that such a burden cannot (realistically) be imposed on “foreign” MNCs.

C. Deferral vs. Current Inclusion of Foreign Affiliate Income

Assuming we can identify with confidence the businesses that are sufficiently “domestic” that they should be subject to U.S. residence-based tax on their worldwide income, the next topic is deferral of residual U.S. residence-based tax on a U.S. MNC’s share of the undistributed income of non-U.S. affiliates. The term “deferral,” in the context of business income taxation, is used to describe the deferral of collecting U.S. residual tax on the undistributed income derived by foreign corpora-

tions in which U.S. taxpayers are direct investors (10-percent-or-greater interest in the equity). Another way of describing the issue is whether or not to impose U.S. tax on a U.S. taxpayer’s direct investment before any income is actually realized, in money or money’s worth, by the U.S. taxpayer (rather than by the foreign corporation in which the U.S. taxpayer is a 10-percent shareholder).

Naming the problem is a bit like agreeing on the shape of the table at which peace negotiations will be conducted. The name itself may have substantive implications for the definition of any perceived problem and how to test the adequacy of a potential solution. If the problem is agreed to be called “deferral,” the legitimacy of taxing the associated unrealized accretion to the U.S. MNC’s wealth is implicitly assumed, and a good reason not to tax the deferred income needs to be adduced and defended.122

If instead the name is “pre-realization taxation,” the idea of taxing unrealized accretions to wealth becomes a more problematic idea, akin to the law school hypothetical about taxing the accretion to wealth of a tenant based on the estimated increase in the market value of her lease compared to the contracted rental: theoretically sound if theory ignores consideration of complexity and a possible perception by rank and file taxpayers that the idea is wrongheaded in requiring liquidation of other assets to come up with money to pay tax on a net accretion to worth visible only to tax policy enthusiasts.123 Such pre-realization taxation is then viewed as an extraordinary act to be implemented only if there is a good reason to tax early—before the final amount of income is really received in money or money’s worth by the U.S. MNC direct investor.124

Under either naming convention, two issues need to be considered. First, how much is at stake for the government in waiting to collect tax until foreign affiliate income has been distributed to the U.S. MNC direct investor. Second, to what extent does the decision to tax early versus later affect important nontax concerns, principally a concern about the tax effect on business decisions by U.S. MNCs as to the location, in or out of the United States, at which to conduct substantial business activities.

Most arguments in favor of ending “deferral” rely on a present value analysis. In addition to the present value analysis used by economists, we also need to look at the U.S. GAAP125 treatment of two key components of the financial statement presentation of consolidated group earnings and income taxes:
1. Current inclusion of all earnings of all controlled subsidiaries whether domestic or foreign, and
2. The exclusion of a provision for residual U.S. tax on undistributed foreign earnings of foreign affiliates if there is a likelihood that such earnings will be reinvested "indefinitely" outside the United States.

1. The Present Value of Deferred Tax

The Advisory Panel's reform proposals rely in part on the assumption that "deferral" of U.S. corporate income tax on the undistributed earnings of foreign affiliates is, to some extent, always an economic benefit not available for comparable domestic earnings. The idea is that "deferral" of U.S. tax recognition until realization (by receipt of a dividend) results in a non-recoupable cost to the government equal, in present value terms, to the difference between collecting the tax now or instead having to borrow a like amount now, at interest, to pay currently for government services and transfer payments until the government borrowing can be repaid upon receipt of the tax in the future. In addition, advocates of ending deferral also ascribe to the present value difference, between a residual U.S. tax collected now and a residual U.S. tax collected later, important collateral economic consequences that they believe are likely to affect location decisions by U.S. MNCs: whether to make direct business investment (and create associated employment) in the United States or abroad.

The present value of a tax is zero if it is deferred permanently. Perpetual deferral is unlikely, although as discussed below U.S. GAAP appears to make that assumption in certain common circumstances. The location decision implications of the present value analysis are probably not as important as U.S. GAAP accounting considerations discussed below at Part II.C.2. (U.S. GAAP Accounting for Undistributed Foreign Affiliate Income and Deferred U.S. Tax on the Income).

The present value analysis works best when it is used to measure the notional cost to the government of deferring a U.S. tax collection. It is not usually given much attention by business or tax decision makers in publicly traded U.S. MNCs. Such decision makers generally are more sensitive to the impact on earnings per share of additions to the tax provision than they are to economic truth. The addition to the tax provision is governed entirely by U.S. GAAP and U.S. GAAP does not even permit the use of a present value discounting approach.

a. Kennedy Administration 1961 Proposals. The present value model was probably erected on the observations initially made in a paper published in 1948 by E. Cary Brown. The Cary Brown model has been used as an analytic tool to measure deferred tax in a number of different contexts. One such context is the taxation of foreign undistributed earnings from foreign direct investment. The decision to end deferral of U.S. tax on undistributed foreign affiliate earnings, if it was justified in the minds of its sponsors on the basis of needing to solve a Cary Brown model problem, was probably taken with no thought given to the special challenges inherent in trying to keep straight over a long timeline the variables attendant on first taxing undistributed income and later truing up the previously taxed income with the amount realized when an actual distribution of those earnings might actually occur.

The proposals (in 1962 and now) to end deferral altogether make more sense when the relevant income is based on fixed data points that can be used in constructing a yield curve corresponding to the present value problem identified in the model. Such proposals make much less sense when the data do not, and are very unlikely to, conform to overly simplified assumptions made to illustrate the problem or made to justify the proposed solution.

b. 2000 Treasury Subpart F Study. The Treasury applied Cary Brown model present value reasoning in setting the base assumptions of the 2000 Treasury Subpart F Study:

A. What is Deferral?

In simple terms, "deferral" is the postponement of current taxation on the net income or gain economically accrued by a taxpayer ... Deferral, however, also is a result of more basic structural features of the U.S. tax system (e.g., the general principle under section 1001 that the economic gain in property is only taxable when a realization event occurs).

This study focuses on one type of deferral that results from a basic structural feature of the U.S. tax system. The foreign income of a foreign corporation generally is not subject to U.S. tax, even if the foreign corporation is organized by a U.S. taxpayer who would be subject to full U.S. taxation on the foreign income earned by it directly. Thus, by organizing a foreign corporation,
a taxpayer can, absent special rules, defer U.S. taxation on foreign income until it is repatriated, for example, as a dividend. In this context, because of the time value of money advantage of postponing payments of tax that otherwise would be due currently, deferral allows the foreign income to be taxed at a lower effective rate than domestic income.129

The last sentence is a conclusion based on an application of the Cary Brown model to a set of assumed facts that may only occasionally occur in nature. Domestic income may itself benefit from other comparable deferrals that affect the effective rate. The sentence is only generally true if it is changed to the thesis that deferral may (or may not) under certain circumstances allow the foreign income to be taxed at a lower effective rate than domestic income.

c. The Search for Comparables and Data Points. Specifically (1) the assertion compares domestic and foreign income of a wholly owned subsidiary, not a partially owned joint venture; (2) even in the context of a wholly-owned subsidiary, the statement does not contemplate the effect of translation from a foreign functional currency into U.S. dollars, either in the original deferral year or the subsequent distribution year; (3) the statement does not consider the effect (on the calculation of the present values of future U.S. tax) of the likely offset of foreign taxes incurred by the foreign affiliate at one or more points during the period of deferral from U.S. tax130; and (4) the statement does not take into account the availability as an offset against domestic taxable income of domestic deductions (such as depreciation) in excess of income generated by assets acquired with taxpayer capital that is available to offset other taxable income of the U.S. taxpayer.

Nevertheless, since first asserted by Secretary Dillon on behalf of the Kennedy Administration, the naked assertion that deferral in and of itself necessarily confers a significant and problematic benefit on foreign investment income seems to have assumed the status of unimpeachable truth. Some commentators even go beyond the “interest-free loan” analogy to assert what seems to them an even more invidious comparison: forced equity investment by the government in foreign business, in an amount equal to the serious (but unquantified) amount of postponed U.S. corporate income tax on the present value of the expected future dividend from the foreign affiliate.131 Before launching a major change in how we tax U.S. MNCs, we should test the articles of faith.

d. Collateral Damage Concerns. There are collateral tax policy problems associated with solving the “deferral” problem that suggest that the problem should be measured in some common situations before deciding to go ahead. The end-deferral solutions increase the complexity of the Code, often exponentially, compared to realization-based taxation.132 There is also a not-inconsiderable risk of taxing income that may evaporate between the time of inclusion and actual realization by the U.S. MNC direct investor. Many end-deferral proposals, including the effective equivalents in the Panel Report and the JCT Options Report, do not seek to adjust future tax liabilities to reverse prior over-taxation that might have occurred as a result of taxing income that turns out not to be there when actual realization occurs.

In the international business context, ending deferral would also ensure that foreign business income does not benefit from lower source-country taxation. Doing so may also diminish competitiveness of U.S.-parented MNCs compared to the foreign-parented MNCs with which they may compete. For example, General Electric may compete with ABB of Switzerland. ABB has both U.S. subsidiaries and non-U.S. operations. GE has both U.S. subsidiaries and non-U.S. subsidiaries. The two sets of U.S. subsidiaries will compete on a fairly level tax playing field. ABB’s and GE’s foreign subsidiaries would not compete on a level tax playing field. Furthermore, the two sets of subsidiaries (domestic and foreign) ordinarily do business with each other.

Even if the risk of diminished competitiveness is not of a magnitude sufficient to bring down U.S. MNCs, or fully to offset the inherent advantages of the United States as a result of its natural geographic advantages (e.g., the fruits of the Louisiana Purchase), winning the West, etc.) and cultural advantages (beacon of freedom, compulsory public education dating back to the colonial Massachusetts “olde Deluder” legislation, etc.) there seems to be little reason to inflict tax costs on U.S. MNCs unless there is actually something important to be gained beyond eliminating foreign direct investment incentives that may have had little impact on the decision to make foreign direct investments.

This is particularly true if the ultimate effect will be to discourage direct investment by U.S. MNCs in foreign joint ventures with non-U.S. enterprises. The language of the 2000 Treasury Subpart F Study quoted above assumes without explanation that the relevant frame of reference is a domestic wholly-
owned subsidiary compared to a foreign wholly owned subsidiary. That “simplifying” assumption may be inaccurate (and increasingly inaccurate) as the United States business sector adapts to the changing landscape in the “global economy.”

e. Formulas to Measure the Time Value of Money.
We can deconstruct the economic cost (as distinguished from U.S. GAAP accounting cost) or benefit of tax “deferral” into the several constituents of potential economic comparison: (1) the benefit to the taxpayer, and (2) the cost to the government of carrying the amounts of deferred tax on undistributed income. The deconstructed components correspond to (1) the present value of a tax deduction of expenses incurred to produce the deferred income (at the “normal” rate of return), (2) the present value to the taxpayer of borrowing, interest-free, the amount of deferred tax associated with the deferred income, and (3) the return on investment corresponding to a premium for such contributors to wealth as intangible property or a better business model and other contributors to business success. Dealing separately with one or another of the several constituents of the problem may be possible, and adopting “solutions” applicable to one of the separate components may be simpler and less burdensome on such matters as “competitiveness” than the one-size-fits-all broad-brush solution: ending deferral altogether.

One way to use the present value model is to imagine an interest-free loan by the government to the taxpayer in the amount of the deferred tax. The present value cost or benefit is not the entire amount of the tax; the model generally assumes that tax will eventually be collected. The present value of the tax collected in the future is less than the present value if and so long as the government only collects 35 percent (or other effective rate of tax) on the ordinary-return income generated by the taxpayer’s deployment of its working capital in an amount equal to the deferred tax.

That is the problem flagged by the Cary Brown model. In thinking about solving the problem of deferral of U.S. tax on undistributed foreign affiliate earnings, however, complexity has been and will continue to be a major problem caused by any such solution. The experience with other pre-realization regimes put in place to solve the time-value-of-money problems associated with deferral of tax on unrealized accreted wealth suggests that application in an extended subpart F context is suboptimal. The other, much simpler, solutions when pre-realization income has been taxed, have brought excruciating complexity to the Code. The Devil is in the details.

f. Examples of Anti-Deferral Measures to Respond to the Problem.
A brief review of the history of several narrowly targeted anti-deferral measures implemented to deal with deferred recognition of taxable income suggests that pre-realization taxation works better, and is fairer, in some instances than in others. The income to be captured, and the tax to be accelerated, fit fairly neatly into present value formulas in some of those cases, unlike undistributed foreign affiliate earnings. Even in such optional cases, the provisions are often hard to apply. If the easy cases are hard, a fortiori the hard case of tax on undistributed foreign affiliate earnings will be harder. Such simple anti-deferral measures include (1) the accrual of original issue discount on a yield curve that reflects compound interest, (2) the imposition of an interest charge on deferred tax associated with an installment sale, and (3) the mark-to-market regimes for dealers in securities and for traders and investors in certain exchange traded futures contracts and interbank currency forward contracts. Each of these measures resulted in a considerable increase in complexity (compared to taxing only realized income) in order to achieve a theoretically correct result.

i. Accelerated Recognition Regimes.
In most of the regimes to which accelerated recognition has been applied, there is a reliable measurement tool available to quantify the taxable amount of the estimated change in wealth that will be taken into account for tax purposes. There has been a “market” on which
to base estimated changes in market value or interest accrued on a principal amount determined by the market value upon issuance. That estimate of change in wealth is then supposed to be sufficiently reliable that it is fair to tax the beneficiary of such accretion in order to support government services. The beneficiary can reasonably be required to make tax payments on such estimated accretion to wealth by liquidating other assets. Requiring pre-realization tax payments is supposed to be fair when the amount of wealth accretion is reasonably clear. Although the amount of undistributed foreign affiliate income may be clear when earned, the present value of that income when it will eventually be distributed is inherently unclear to the extent of currency fluctuation and different inflation rates in the source country compared to the residence country.

ii. Simple Measurement of Unrealized Wealth Accretion: Noncontingent OID and Deferred Payment Installment Sales. Original issue discount can be measured by applying fairly simple formulas to compare the redemption price at maturity with the issue price to derive an internal rate of return. Similarly, deriving the deemed interest on an installment sale is fairly straight-forward. There is a readily identifiable realization event (the sale) and there is a schedule of payments that can be used to generate an interest table.

iii. More Complicated Examples: Contingent OID and Installment Sales with a Contingent Payment. The original issue discount provisions encounter difficulty when the amounts to be realized are partly or wholly contingent. In such cases various simplifying assumptions must be made in order to permit a calculation to be made. The Supreme Court decision is National Alfalfa and certain similar subsequent Circuit Court cases illustrate some of the reasons why tax policy makers should be cautious in accelerating tax recognition to a pre-realization time. The formulas, in order to work, have to have certain data. Such data, if they do not exist, may have to be merely estimated or assumed.

In the cited cases, the simple assumption had been that arm’s length exchanges of publicly traded debt securities for publicly traded stock would produce a number that could be reliably used to measure the issue price of the debt and the sales price of stock. Unfortunately, the public trading prices for the stock disposed of and the debt issued to redeem the shares turned out to be different. Eventually the Treasury was able to solve this conundrum by a simplifying assumption as to which trading price should control. Nevertheless, it is noteworthy that even a calculation, such as the present value/future value used in the Cary Brown model, that can be reduced to a series of keystrokes on financial calculators can run aground when simplifying assumptions do not conform to observations in nature. Unlike the simple decision to require the trading price of debt to control a debt-for-stock exchange, valuing changes in the value of undistributed previously taxed income cannot be simplified into a few sentences in a single regulation.

iv. Another Cary Brown Tool: Marking to Market. The mark-to-market approach in Code Secs. 475 and 1256 suffers from challenges that are in some ways even harder than calculating the compound interest accrual amount at some point in time after original issuance and before actual payment. The challenges are germane because they illustrate the difficulty presented by using imperfect surrogates for cash in hand with respect to realized income.

(1) Code Sec. 1256. Code Sec. 1256 was an early experiment in mark-to-market measurement of unrealized wealth accretion. The Congress was very careful about extending pre-cash tax recognition of gains and losses on unsold contracts even to contracts listed for trading on an exchange. The statute limited such treatment to “recognized” exchanges because such exchanges were thought to have in place systems for marking to market to determine variation margin (i.e., a nontax commercial reason that would tend to discourage tax motivated distortions in valuation). There was also liquidity to support access to cash to pay tax on any mark-to-market gain. Marking to market was limited to transactions that occurred only on U.S. commodity futures exchanges that were thought to employ a unique system of accounting for every futures contract’s gain or loss on a daily basis. Under that unique system the mark-to-market gain or loss on a daily basis was credited as cash (gain) or called for cash margin (loss) every day. The investor was entitled to withdraw any such cash at such time (i.e., to convert the estimated accretion to wealth to actual realized accretion to wealth).

Notwithstanding the rather tentative beginning, mark-to-market recognition was subsequently extended to other transactions in which the values were thought to be sufficiently objective that income (or loss) recognition would not be unacceptably speculative. First, Code Sec. 1256 treatment was extended beyond exchange traded foreign currency contracts to include contracts (on the same exchange traded
currencies) that were entered into by participants in the “interbank market.”

(2) Code Sec. 475 and Imagining Markets to Make the Formulas Work. In 1993, Congress extended mark-to-market taxation to dealers in securities. In doing so, the simplifying assumption was made that dealer transactions in financial commodities could be reliably measured, before actual cash realization, by reliance on the notion of a hypothetical sale of unsold items for which a “market” existed and from which objective benchmark data could be gleaned. In addition, Congress decided that the same methodology should apply to notional principal contracts that, by their terms, could not be sold in a market transaction. Dealers in notional principal contracts engaged in numerous offsetting contracts involving the potential change in various components of interest rate risk, currency, risk and commodity risk, and such activity was translated by those dealers into pre-close out values in financial accounting income statements. Acceptable certitude was apparently thought to be available in the financial accounting methodology relied upon for various non-tax purposes by dealers in notional principal contracts.

The ensuing history of the tortuous path to acceptable valuation methods for marking to market over-the-counter notional principal contracts is an object lesson for those who might be tempted to rely on the tax benefits or costs illustrated by the Cary Brown model as a sure test of the theoretical need to accelerate tax collection to a pre-realization accretions to (or diminutions of) wealth. More than a decade has been spent by taxpayers, the IRS and the Treasury trying to synthesize a “market” that does not actually exist in order to quantify adjustments to value for various contingencies that are not reflected in publicly available objective data (notably the credit mark and allocation of general and administrative expense that a hypothetical buyer would take into account in attempting to value either an individual notional principal contract or a portfolio of such instruments).

v. Passive Foreign Investment Companies. Cary Brown model concepts have also been invoked as an explanation for Congress’ actions in enacting the passive foreign investment company (PFIC) regime. The PFIC regime incorporates several alternative mechanisms to capture the tax benefit otherwise resulting from the deferral of tax on income of a foreign mutual fund. The complexity of the provisions, and the presence of factual obstacles to ready compliance, suggest that caution is appropriate when seeking to solve the problem of tax deferral, at least the “Cary Brown model” part of the tax problem, by simply ending deferral in all forms.

One regime offered by the PFIC provisions is elective marking to market. That regime will work best when the assets of the PFIC are readily marketable securities (other than, of course, notional principal contracts whose valuation has already turned out to be elusive). The other two PFIC regimes are more germane to considering the Cary Brown model with respect to foreign direct investments (a ready market for shares in substantially owned foreign affiliates simply does not exist).

One such alternative regime is to permit full pass-through treatment so that each shareholder in a PFIC includes currently its pro rata share of the undistributed income, gain or loss of the “qualified electing fund.” This approach has proven to be difficult to apply because foreign capital pools have been reluctant to establish mechanisms to track and report U.S. tax data with respect to the securities held and disposed by the fund. Potential U.S. investors are then likely to forego investment if the alternate “interest charge” regime is too off-putting. Similar difficulties may attend U.S. shareholder investment in foreign business enterprises where the several direct investors are not all U.S. corporate taxpayers (i.e., multinational joint ventures). Unlike portfolio investment in PFICs, about which the potential disincentive to invest may be of little concern to U.S. tax policymakers, discouraging U.S. MNC participation in foreign joint venture direct investment may not be a matter of indifference.

The third Cary Brown remedy in the PFIC regime is the interest charge on eventual distributions. This approach has the virtue of deferring tax measurement until actual realization of cash, but only solves for one imponderable problem: what is the actual amount eventually and actually realized. This approach does not provide for the other necessary, but uncertain, data point: When was the income realized by the foreign fund? To deal with this imponderable, the PFIC regime makes the simplifying assumption that the income was earned ratably during each day of the U.S. taxpayer’s holding period, an assumption almost certain to be always incorrect. Again, the need for artificial assumptions, or for elusive data, are inherent weaknesses of any approach to taxing pre-realization income, gain or loss in order to solve the present value/future value problem identified by applying the Cary Brown model to simplified factual assumptions.
vi. Controlled Foreign Corporations. In 1961, the Kennedy Administration asserted that there was a time value of money problem worth solving in the “deferral” of tax on foreign affiliate undistributed income. The Administration argued that deferring tax on income derived by foreign subsidiaries of U.S. corporations resulted in a tax benefit for foreign investment in comparison with an alternative direct investment in a domestic business enterprise. This argument may have been based on the idea that the international tax provisions were a reasonable place to begin to apply solutions to the problem of interest-free loans when tax is deferred. The Administration also argued that tax haven abuses should be combated by ending deferral with respect to the examples of tax haven abuse it described.

As enacted, the Revenue Act of 1962 did not apply the Cary Brown model comprehensively to solve the time value of money problem associated with deferring residual U.S. tax on foreign affiliate undistributed direct investment income. Only the component of the proposal that addressed fairly specific tax haven abuses was adopted. Items of subpart F income in 1962 included portfolio investment income (“foreign personal holding company income”) and income readily deflectable to tax haven companies (called “base companies” in the legislation) by means of related-party sales, services, loans or licenses (the latter two categories of income being aggregated with portfolio investment income in subpart F “foreign personal holding company income”).

In a purely domestic environment, the corporate level tax on income derived from deployment of shareholder investment capital is collected currently as income is earned by the investee domestic corporation. The investee domestic corporation is in principle subject to tax on “its” income (but only if and when earned) while the second level of tax, on the shareholder’s income from capital, is deferred until the investee corporation makes a distribution to the investor shareholder. At that time the investor shareholder is taxed with respect to its income: the amount withdrawn from the capital of the business enterprise.

If the same U.S. shareholder investor invests in a foreign corporation (that is itself not subject to U.S. corporate income tax), the first level of U.S. tax on business income will not be collected from the business entity itself. If the same U.S. shareholder investor invests in a domestic corporation that, in turn, invests in a foreign corporation, the income of the foreign corporation will eventually be subject to the double U.S. tax on corporate business income. The domestic corporation will eventually include the income derived from the foreign direct investment of the shareholder investor’s capital, and in any event no later than an actual receipt by the domestic corporation of a dividend from the foreign corporation. The difference in timing can then be measured to determine present value effects as if the deferred tax were a loan.

The present value analysis works best when it is used to measure the notional cost to the government of deferring a U.S. tax collection. It is not usually given much attention by business or tax decision makers in publicly traded U.S. MNCs. Such decision makers generally are more sensitive to the impact on earnings per share of additions to the tax provision than they are to economic truth. The addition to the tax provision is governed entirely by U.S. GAAP and U.S. GAAP does not even permit the use of a present value discounting approach.

Dillon’s statement is not necessarily coterminous with the aggregate interest on deferred U.S. tax. For example, as discussed in Part II.E. (Matching of Expenses and Foreign-Related Income to Which the Expenses Relate), if a deduction of expenses allocable to the production of deferred income is also deferred, the present value of the remaining tax deferral would be significantly reduced. The remaining deferral would correspond to tax on the income earned by capital contributed from the taxpayer’s equity capital (for which no interest-like charge would be deductible under present law), plus income earned at a rate exceeding the financial rate of return on the allocable expenses and equity. Ending deferral altogether is thus not necessary to achieving substantial parity of present values for the U.S. corporate taxpayer of current tax versus deferred tax on income cor-
corresponding to non-deductible cost of investment in the activities producing deferred income of foreign affiliates. Ending deferral altogether is only necessary in order to reach present value parity for the U.S. tax on premium income of foreign affiliates that is not commensurate with the U.S. MNC investor’s deductible cost of capital.

Achieving that last piece of parity may be important in absolute terms, and it may also be important in order to preserve ideological positions about fairness or comparative advantage of U.S. versus foreign investment, etc., but it may come only with a disproportionate level of complexity, and erosion of the benefits of a level tax playing field (e.g., GE vs. ABB). A numerical example may help to focus on the separate components of the present value of tax deferral. Assume for purposes of this discussion that a U.S. MNC (“USCO”) has one wholly owned foreign subsidiary (“For-Sub”), and also conducts a domestic business. USCO has a cost basis in the U.S. business assets of 1000, and a cost basis in the equity of For-Sub of 1000. USCO has paid-in capital of 1000 and external debt of 1000. The external debt bears interest at six percent per annum (i.e., 35 basis points above the five-percent risk-free rate at which the government borrows).

Assume further that USCO has income from its investment in the U.S. business assets of 100, before allocation of any interest expenses, but after the allowance of 100 units of depreciation expenses. The debt is attributable (under any and all methods for determining such things) equally to the investment in U.S. business assets (500) and to the investment in For-Sub (500). For-Sub has current earnings of 100 per year, after allowance of 100 units of depreciation expense.

USCO’s interest expense (60) offsets only USCO’s domestic taxable income that would otherwise be currently taxable, unless and until For-Sub distributes a dividend to USCO. Of the 60 units, 30 are attributable to domestic source income. The other 30, although attributable to producing future realized foreign source income, is currently available to offset 30 units of USCO domestic business income. Under present law, in our example, USCO recognizes no income in respect of For-Sub’s 100 income prior to USCO’s realization of income from For-Sub dividends. Assume that For-Sub’s 100 income in year 1 will be invested at 7.5 percent per year, of which five percent is attributable to a risk-free rate of return, an additional one percent is attributable to enterprise financial risk that results in the six percent borrow-

ing rate on USCO’s on external debt of 1000, and an additional 1.5 percent of which is a premium return attributable to For-Sub’s intangible property (or to For-Sub’s superior business model, etc.).

For-Sub will thus have generated 206.1 at the end of year 11 (10 years of deferral), consisting of 100 units of year 1 income and 106.1 units of income derived from investing 100 at a compound annual rate of return of 7.5 percent. All of such 206.1 will then be distributed as a dividend to USCO at the end of year 11. USCO will then be subject to a tax at 35 percent times the amount distributed. Year 11 tax will be 72.14 (206.1 x 35%). The year 1 present value of 72.14 (collected after 10 years) with a five percent discount rate is 44.29. As noted above, the gross return on For-Sub’s assets and the reinvestment of that amount must be converted to the return on just the deferred tax.

If USCO is not required to pay 35 in tax in year 1, in respect of For-Sub’s year 1 income, For-Sub will retain a like amount, and will deploy 100 (of which 35 is attributable to the deferred U.S. tax) at its assumed opportunity rate of 7.5 percent (five percent return on capital at risk-free rate, and an additional one-percent return to cover a hurdle rate equal to the risk-based borrowing rate, risk and an additional 1.5 percent premium return in excess of cost of capital). In such event all of the year 1 income (100) and all income thereon will be distributed by For-Sub at the end of year 11 (i.e., after a 10-year deferral). At the end of year 11, USCO will pay full U.S. tax at 35 percent on the entire amount distributed.

That restated amount is then:

<table>
<thead>
<tr>
<th>FV</th>
<th>PV @ 5%</th>
</tr>
</thead>
<tbody>
<tr>
<td>Deferred Tax Amount Income on Deferred Tax Amount:</td>
<td></td>
</tr>
<tr>
<td>(35 @ 6% for 10 years): 27.68 US</td>
<td></td>
</tr>
<tr>
<td>Tax @35%</td>
<td>9.69</td>
</tr>
<tr>
<td>44.69</td>
<td>27.44</td>
</tr>
</tbody>
</table>

The present value of 35 if collected in year 1 is, by definition, 35. The present value in year 1, to the government, of a tax collection of 44.69 after 10 years deferral is 27.44 (assuming the cost to the government of borrowing 35.0 at the risk-free rate of five percent is the proper amount of “problem”). The present value to the taxpayer is somewhat different: the interest-free loan from the government replaces funds that we assume would otherwise cost the taxpayer six-percent interest to obtain. Using a six-percent discount rate decreases the present value of the deferred tax collection (44.69 to 24.95). The
difference may be important if the relevant problem is not merely funding government services for the deferral period but also includes the effect on taxpayer business investment location decisions of the interest charge effect of deferral.\textsuperscript{164}

The deferral problem measured as an interest free loan in the amount of the deferred tax can be addressed in a number of different ways:

- End deferral altogether.
- Mark-to-market the value of the taxpayer’s investment in the foreign affiliate deriving deferred income.
- Impose an interest charge on the deferred tax collection.

In looking at the variations on ending deferral that have been proposed through the years since 1962, it is useful to consider another possible approach to the “problem”: matching (and deferring) the expenses otherwise currently deductible against other taxable income until enough foreign-related income is taken into account in order to satisfy ourselves that global business income is paying its fair share without a boost from deferring U.S. tax on unrelated domestic business income. The components of such matching are more fully discussed in Part II.E. (Matching of Expenses and Foreign-Related Income to Which the Expenses Relate), below.

The result of such matching would be a diminution in the amount of deferred tax. The remaining deferred income and deferred tax may itself be exaggerated under some applications of the Cary Brown model, at least compared to an alternative investment in a U.S. subsidiary’s business. Such alternative domestic investment may itself not be immediately profitable, but interest to carry the investment would be currently deductible against other taxable income of USCO. Moreover, if loan proceeds are invested in a depreciable domestic business asset, the depreciation may itself exceed otherwise taxable income from such assets. Such excess depreciation would then be available to reduce otherwise taxable income from other USCO operations. Cary Brown model illustrations of the problem of deferred inclusion of income of foreign affiliates are rarely, if ever, adjusted in the comparison with domestic investment to take into account the present value of common domestic deferral situations (\textit{i.e.}, deductions taken before income is produced (if indeed any income is ever produced)).

The effect of reducing the amount of the problem to the present value of the deferred tax on undistributed foreign affiliate income in excess of allocable USCO expenses can be illustrated by the following example. Assume that For-Sub will distribute 30 units of income in year 1, in order to take full advantage of the interest deduction that would have been deferred under a matching approach. The deferred U.S. tax associated with For-Sub’s retained income (70) would then be reduced from 35 (100 x 35%) to 24.5 (70 x 35%). The cost to the government of such deferral would be the present value of the carrying cost of the deferred U.S. tax on 70 (24.50), reduced by the present value of the U.S. tax collected in year 11 on the income generated in years 2–11 on 24.50 at the risk-free rate of return (the government’s cost of carrying the deferral of tax). See Table 2.

The PV difference of 5.30 is about 15 percent of the baseline amount of tax of 35.

Achieving a theoretically (and perhaps politically) correct result for the last 15 percent of the PV cost to the government of carrying the deferred tax amount will entail much complexity.

The residual U.S. tax on deferred foreign income is also likely to be subject to reduction by some level of creditable foreign income tax associated with the foreign income. The amount of such creditable foreign income tax reduces (1) the deferred amount of U.S. tax whose present value should be compared with the present value of the base line currently collected U.S. tax amount, as well as (2) the present value of the base line currently collected U.S. tax amount.

<table>
<thead>
<tr>
<th>Year 1</th>
<th>Year 2-11 Income (24.50 Deferred Tax @ 6%)</th>
<th>Year 11</th>
</tr>
</thead>
<tbody>
<tr>
<td>US Tax on 30</td>
<td>10.50</td>
<td>Risk-free</td>
</tr>
<tr>
<td>US Deferred Tax (70 x 35%)</td>
<td>24.50</td>
<td>Risk return</td>
</tr>
<tr>
<td>Present Value Year 1</td>
<td></td>
<td>Ignore Premiums Year 11 Tax</td>
</tr>
<tr>
<td>Tax collected Year 1:</td>
<td>10.50</td>
<td>Deferred Tax</td>
</tr>
<tr>
<td>PV Year 11 Tax 31.28:</td>
<td>19.20</td>
<td>Total Year 11 Tax</td>
</tr>
<tr>
<td>Base Case (no deferral)</td>
<td>35.00</td>
<td></td>
</tr>
<tr>
<td>Difference (PV)</td>
<td>5.30</td>
<td></td>
</tr>
</tbody>
</table>
amount. For example, the reference present value, absent deferral, of 70 units of income (after allocation of U.S. expenses of 30) at an assumed foreign tax rate of 24.5 percent or more, would be zero. At an assumed foreign rate of 12.5 percent, the deferred U.S. tax after allocation and after foreign tax credits would be 12 (35 percent times 70 units U.S. taxable foreign income minus 12.5 percent times 100 units of pre-dividend foreign taxable income unreduced by USCO allocable expenses). If the correct reference rate (the tax on income from the substitute domestic investment) is lower than 35, the problem is exaggerated by using 35 as the base line tax to be compared, at least for that portion of the debate that expresses concern about the impact on location decisions.

The U.S. government cost of borrowing the deferred tax of 12 at five percent for 10 years would be further adjusted downward to reflect the collections of creditable tax by the foreign country at 12.5 percent on income on the deferred amount (70 times six percent, ignoring premium income).

The revised PV comparison of present tax versus deferred tax is illustrated in Table 3.

The difference in present value has been reduced to approximately 7.5 percent of the baseline amount of 35 even when applying the quasi-tax haven rate of 12.5 percent.

As noted above, the present value incentive to defer tax payment in these examples ignores the benefit of deferring tax on the premium return above the taxpayer's cost of borrowing, as well as the entire income on the after-tax component of year 1 income (65). In effect, Year 2 would represent a new “Year 1” of tax deferral with a larger amount to consider: 100 units of operating income in For Sub plus the premium amount of return on the Year 1 deferred tax amount plus the aggregate return on 65 units of “after-tax” deferred income (65). The relationship between the year 2 present values of year 2 versus year 12 tax collections would not change in relative terms but the absolute amount of deferred tax would increase.

In the example, before taking into account foreign creditable taxes and USCO allocable expenses, if For-Sub derived a premium return of 20 percent rather than 7.5 percent, the deferred tax in respect of the deferred tax of 35 in year 2 would increase to 7 (20 x 35%), of which 2.1 would be taken into account under our prior analysis. The additional “loan” of 4.9 would then have a present value of 3.27 if collected at the end of year 11, compared to 4.9 if collected in year 2. In addition, tax on the income on the undistributed after-tax 65 would also be deferred: 35 percent times (65 x 20%) = 4.55. The aggregate year 2 tax deferred in respect of the amounts not built into the Cary Brown present value for year 1 is thus 9.45. The year 2 present value of 9.45 lent tax free to the taxpayer, deployed at six percent and taxed at 35 percent in year 11, but discounted back to year 2 at the five-percent risk-free rate, is 7.56 with a net present value cost to the government in year 2 of 1.89 (9.45 – 7.56). This is still a pretty modest amount to justify the elaborate architecture necessary to true up all the changes that will certainly occur in the income value of the year 11 distribution compared to the amount in respect of that income taken into account in year 1 if then taxed on an undistributed basis.

The problem of increasing the absolute amount of taxes deferred may have consequences greater than a simple percentage comparison of the present values of current versus deferred tax collection. Nevertheless, it should be generally true that the present value of the deferred tax on the income on deferred tax is a relatively small amount compared

### Table 3

<table>
<thead>
<tr>
<th>Year 1</th>
<th>Year 2-11 Income (12.0 Deferred Tax @ 6%)</th>
<th>Year 11</th>
</tr>
</thead>
<tbody>
<tr>
<td>US Tax on 30</td>
<td>10.50</td>
<td></td>
</tr>
<tr>
<td>US Deferred Tax (70 x 35%)</td>
<td>24.50</td>
<td>Risk-free return</td>
</tr>
<tr>
<td>Risk return</td>
<td>1.94</td>
<td></td>
</tr>
<tr>
<td>Credible Foreign Tax</td>
<td>(12.50)</td>
<td>Ignore premium</td>
</tr>
<tr>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Net deferred Tax</td>
<td>12.00</td>
<td>Credible Foreign tax 9.49 x 12.5% (1.19)</td>
</tr>
<tr>
<td>Net U.S. Tax</td>
<td>2.13</td>
<td>Deferred U.S. Tax Collected</td>
</tr>
<tr>
<td>Total U.S. and Foreign Tax</td>
<td>15.32</td>
<td></td>
</tr>
<tr>
<td>Present Value Year 1</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Tax collected Year 1: (US and Foreign)</td>
<td>10.50</td>
<td></td>
</tr>
<tr>
<td>12.50</td>
<td></td>
<td></td>
</tr>
<tr>
<td>23.00</td>
<td></td>
<td></td>
</tr>
<tr>
<td>PV Year 11</td>
<td>15.32:</td>
<td>9.41</td>
</tr>
<tr>
<td>Base Case (no deferral)</td>
<td>35.00</td>
<td></td>
</tr>
<tr>
<td>Difference (PV)</td>
<td>2.59</td>
<td></td>
</tr>
</tbody>
</table>
to the “principal amount” of deferred tax. The Cary Brown model is thus chasing a relatively small return to achieve the goal of collecting 100 percent of the interest on deferred tax rather than 35 percent of that assumed future income at the assumed interest rate.

The bigger problem is permanent deferral of the tax on operating income. If deferral is permanent, the present value of the future tax will be zero. If foreign taxes are low enough to yield a significant present value for present U.S. tax collection, even after allowing a foreign tax credit, permanent or quasi-permanent deferral will cost the government something. The amount can be reduced in most cases by allocating deductions against associated long-term deferred income rather than permitting such expenses to reduce the taxable amount of other income that is not really related to the deferred income the expenses were incurred to produce. But there will always be that last piece that will beckon to be solved, when deferral is potentially permanent and as a result the present value of the deferred tax collection may be zero.

Is there a reasonable basis to assume permanent deferral? Is there a reasonable basis to assume a zero foreign tax rate? With respect to the former question, the answer is probably no, although U.S. GAAP seems to assume that it is reasonable to make such an assumption. With respect to effective foreign tax rates of zero, the answer is also probably no. There is a limit to the amount of investment that can be absorbed in zero tax countries, some of which may be disappearing under pressure from the community of high tax countries.

2. U.S. GAAP Accounting for Undistributed Foreign Affiliate Income and Deferred Tax on the Income

This leads us to the curious world of accounting according to U.S. GAAP for deferred tax on foreign affiliate income. In that world, permanent deferral may be encouraged and the effect of such encouragement may actually be a problem of sufficient size to affect location decisions. In effect, under certain circumstances, U.S. GAAP accounts for deferred U.S. tax on undistributed income of foreign affiliates as if deferral were a permanent exemption from U.S. tax on foreign subsidiary income that has been included in consolidated financial statements. The same undistributed income of the foreign affiliate is reported in the consolidated financial statements as if it were freely available for distribution to shareholder investors in the U.S. MNC parent company. The combination of foreign affiliate income inclusion in the consolidated financial statement, on a basis not adjusted for tax barriers to accessing that income to make distributions to shareholders, and the lack of any provision for eventual U.S. tax on that income, might provide significant incentives to invest in activities that project to public investors in the U.S. MNC a lower overall effective rate of tax than the rate of tax that essentially identical investments in comparable domestic direct investment would bear.

That said, it still remains a matter of speculation how much effect the U.S. GAAP eccentricity (in accounting for deferred taxes on undistributed foreign subsidiary income) may have on the overall flow of U.S. MNC direct investment capital. Public finance economists tend to focus on the present value comparisons, and there appears to be little literature that examines the effect of the deferral impetus provided by U.S. GAAP accounting for deferred tax on undistributed and indefinitely reinvested foreign earnings. It remains generally true that fundamental business planning is likely to precede consideration of tax incentives or disincentives with respect to any particular investment location. In order to save 35 cents of income otherwise spent on taxes, it is necessary first to earn a dollar of income. Once it is clear that a dollar can be earned in either of two locations, the marginal difference in tax becomes important. It is at this point that the U.S. GAAP rules, and their curious asymmetry between domestic and foreign affiliates in the consolidated financial statements, may play an important role in location decisions.

a. Consolidation of All Majority-Owned Subsidiaries

Statement of Financial Accounting Standards No. 94 provides that generally no distinction shall be made between foreign and domestic subsidiaries. In pertinent part, the Financial Accounting Standards Board explained its amendment of prior standards of U.S. GAAP:

This Statement ... amends ARB No. 43, Chapter 12, ‘Foreign Operations and Foreign Exchange,’ to narrow the exception for a majority-owned foreign subsidiary from one that permits exclusion from consolidation of any or all foreign subsidiaries to one that effectively eliminates distinctions between foreign and domestic subsidiaries.

As discussed below, however, the asserted equivalence between foreign and domestic subsidiaries is
deliberately not implemented in the provision for deferred tax liabilities pursuant to Statement of Financial Accounting Standards No. 109. The other items that affect the consolidated statement of income and loss, and assets and liabilities are generally taken into account by applying equivalent rules to both domestic and foreign subsidiaries.

FAS 94 specifically changed the principles previously in effect under ARB No. 43, Chapter 12, ‘Foreign Operations and Foreign Exchange.’ Paragraphs 8 and 9 thereof (in effect prior to the 1987 adoption of amendments that became effective for accounting periods after December 15, 1988), provided:

In view of the uncertain values and availability of the assets and net income of foreign subsidiaries subject to controls and exchange restrictions and the consequent unrealistic statements of income that may result from the translation of many foreign currencies into dollars, careful consideration should be given to the fundamental question of whether it is proper to consolidate the statements of foreign subsidiaries with the statements of United States companies.

It is important to note that U.S. tax contingencies that might affect the presentation of a “realistic” value of any foreign subsidiary income in consolidated financial statements were not a factor in ARB No. 43, Chapter 12, as adopted in 1972 and have never been a factor thereafter in applying the principles (“realistic” values) enunciated in FAS 94. Only foreign exchange controls, or foreign exchange translation concerns, merited explicit admonitions about the risk of an unrealistic value for undistributed income of foreign subsidiaries.

In presenting current income, gain or loss in respect of members of the consolidated group, no adjustment is made to reflect potential changes reflecting the time value of money. All income, gain or loss of a foreign affiliate is taken into account without regard to U.S. tax-based friction that might impair the amount ultimately available or might delay its availability. U.S. tax effects are taken into account under a different set of rules, largely self-contained and separate from the rules for reflecting the income on which such tax might be imposed. Those rules, discussed below, govern additions to (or subtractions from) the annual provision for current and deferred tax liabilities and tax assets.

This segregation of U.S. tax effects from other effects (foreign exchange controls or foreign currency conversions) is asymmetrical, at least to a lay reader of accounting literature, with the different prescriptions for realistically taking into account other potential impairments of the value of foreign subsidiary earnings. For example, ARB No. 43, Chapter 12, “Foreign Operations and Foreign Exchange,” as amended at the time FAS 131 was adopted in June 1997, now provides:

4. A sound procedure for United States companies to follow is to show earnings from foreign operations in their own accounts only to the extent that funds have been received in the United States or unrestricted funds are available for transmission thereto.

5. Any foreign earnings reported beyond the amounts received in the United States should be carefully considered in light of all the facts.

Statement of Financial Standard No. 131, Disclosure about Segments of an Enterprise and Related Information, discusses the requirements for reporting revenues from foreign operations. Nothing in FAS 94, or in FAS Statement No. 131 contemplates treating potential U.S. tax as a barrier to reflecting in consolidated financial statements “foreign earnings beyond the amounts received in the United States” within the intention of Paragraph 5 of Chapter 12 of ARB No. 43. Such exposure to incremental U.S. tax, in the event of a distribution, is simply not viewed as a cognizable or measurable “restriction” on funds of foreign subsidiaries. Instead, the correct place to deal with such taxes, if taxes are to be taken into account at all, is in the annual provision for current and deferred income taxes.

b. Additions to the Provision for Current and Deferred Tax Liabilities. FAS 109 governs the treatment in financial statements of current and deferred tax liabilities. Tax expense for any year consists of the sum of (1) current taxes payable, plus (2) deferred tax expense, minus (3) current tax refunds and future refundable amounts.

Discounting to present value is specifically prohibited. A dollar of tax liability that may not be paid for 10 or more years in the future is added to the income tax expense for the year in which it is accruable as a full dollar, not the discounted present value of that dollar in the year it is first properly recognized as a deferred tax liability. FASB specifically rejects use of Cary Brown principles (“discounting”) in measuring the financial disclosures of the amount of future tax.
In a significant departure from the principle of equivalence between domestic and foreign subsidiaries, two different rules are established for the treatment of future taxes (“deferred tax liabilities”) of foreign subsidiaries and domestic subsidiaries. FAS 109 amended APB Opinion 23, “Accounting for Income Taxes—Special Areas,” to provide, in replacement Paragraph 10:

Temporary Difference. The Board believes it should be presumed that all undistributed earnings of a subsidiary will be transferred to the parent company. Accordingly, the undistributed earnings of a subsidiary included in consolidated income should be accounted for as a temporary difference unless the tax law provides a means by which the investment in a domestic subsidiary can be recovered tax free. However, for reasons described in FASB Statement No. 109, Accounting for Income Taxes, a deferred tax liability is not recognized for (a) an excess of the amount for financial reporting over the tax basis of an investment in a foreign subsidiary that meets the criteria in paragraph 12 of this Opinion and (b) undistributed earnings of a domestic subsidiary that arose in fiscal years beginning on or before December 15, 1992 and that meet the criteria in paragraph 12 of this Opinion. The criteria in paragraph 12 of this Opinion do not apply to undistributed earnings of domestic subsidiaries that arise in fiscal years beginning after December 15, 1992, and a deferred tax liability shall be recognized if the undistributed earnings are a taxable temporary difference.

FAS 109, in amending APB Op. 23 in 1992 thus preserved, for foreign subsidiaries only, Paragraph 12 of APB Opinion 23 that permits ignoring future U.S. taxes that would be due in the event of distribution, if and so long as the foreign nontaxable reinvestment of such earnings is expected to be for the indefinite future: 12. Indefinite reversal criteria. The presumption that all undistributed earnings will be transferred to the parent company may be overcome, and no income taxes should be accrued by the parent company, if sufficient evidence shows that the subsidiary has invested or will invest the undistributed earnings indefinitely or that the earnings will be remitted in a tax-free liquidation. A parent company should have evidence of specific plans for reinvestment of undistributed earnings of a subsidiary which demonstrate that remittance of the earnings will be postponed indefinitely. Experience of the companies and definite future programs of operations and remittances are examples of the types of evidence required to substantiate the parent company’s representation of indefinite postponement of remittances from a subsidiary. If circumstances change and it becomes apparent that some of the undistributed earnings will be remitted in the foreseeable future but income taxes have not been recognized by the parent company, it should accrue as an expense of the current period income taxes attributable to that remittance; income tax expense for such undistributed earnings should not be accounted for as an extraordinary item. If it becomes apparent that some or all of the undistributed earnings of a subsidiary on which income taxes have been accrued will not be remitted in the foreseeable future, the parent company should adjust income tax expense of the current period; such adjustment of income tax expense should not be accounted for as an extraordinary item.

The provisions of APB Op. 23, specifically Paragraph 12 thereof, do not apply to undistributed income of a domestic subsidiary, even if determining the correct amount of the provision is complicated. For undistributed earnings of domestic subsidiaries, the controlling concern is limited to the accurate reflection of shareholders’ equity:

It is at best conjectural that U.S. MNCs are even aware of the insights of Professor Brown or the interest-free loan notions constructed on his insights. It is also unlikely that any U.S. MNC has, in making cost comparisons among U.S. and foreign investment locations, calculated the earnings per share effect of any interest savings of the sort described in the Treasury 2000 Subpart F Study.
171. Not recognizing a liability for the deferred tax consequences of Opinion 23 and U.S. steamship enterprise temporary differences overstates the shareholders’ residual ownership interest in an enterprise’s net earnings and net assets. The government has a claim (a right to collect taxes) that precludes shareholders from ever realizing a portion of the enterprise’s net assets. A tax obligation is not a component of shareholders’ equity. The Board considered whether payment of income taxes for the Opinion 23 and U.S. steamship enterprise temporary differences might be a contingency as that term is used in Statement 5. The Board concluded that there is no uncertainty that a tax obligation has been incurred for those temporary differences. The amount of the government’s claim will never revert to the benefit of the shareholders unless there is a change in the tax law. The possibility of a change in the tax law in some future year is not an uncertainty as that term is used in Statement 5.184

FASB explained itself, in differentiating between deferred tax liability with respect to undistributed earnings of a domestic subsidiary and with respect to undistributed earnings of a foreign subsidiary, in part on the basis of perceived “complexity” of determining the amount of future U.S. tax (a worrisome problem even without trying to adjust (by discounting) for present values of future amounts whose distribution dates could not be confidently assumed):

173. Complexity was one reason Statement 96 did not require recognition of a deferred tax liability for Opinion 23 and U.S. steamship enterprise temporary differences. Information received from constituents has convinced the Board that calculation of a deferred tax liability for undistributed foreign earnings that are or will be invested in a foreign entity indefinitely may sometimes be extremely complex. The hypothetical nature of those calculations introduces significant implementation issues and other complexities that occur less frequently in calculations of a deferred tax liability for an expected remittance of earnings from a foreign entity. For that reason, the Exposure Draft proposed to not require recognition of a deferred tax liability for undistributed earnings that are or will be invested in a foreign entity indefinitely. Based on respondents’ concerns about complexity, however, the Board decided to extend that exception for foreign undistributed earnings to include the entire amount of a temporary difference between the book and tax basis of an investment in a foreign subsidiary or foreign corporate joint venture that is essentially permanent in duration regardless of the underlying reason(s) for that temporary difference.185

The exception to the general rule applies only to foreign subsidiaries. The justification was explained as resting on, in addition to complexity concerns, two other pillars: (1) the need to compromise (sic), and (2) the omission of discounting.186

These are the present rules. They have been re-examined by FASB from time to time since 1992, and reaffirmed most recently in connection with the FASB/IASB Convergence project.187

The U.S. GAAP rules do not affect the cost to the government of tax deferral, expressed with respect to any given amount of deferred tax. That cost is adequately measured by the present value analysis that measures the cost of the government having to borrow funds to carry the deferred tax. The rules might, however, affect location decisions, and included in such location decisions are decisions whether to repatriate undistributed earnings for potential deployment in domestic investment. To the extent the absolute amount of deferred tax is increased, the absolute size of the government’s problem will, of course, also increase as a result of the U.S. GAAP stimulus.

D. The “Repatriation” Tax

1. The “Problem”: Discouraging Use of CFC Assets to Make Investments in the United States Rather Than Abroad

The Panel Report refers to the “repatriation tax” as a problem created by the present U.S. tax system:

... the U.S. multinational does not pay U.S. tax on the subsidiary’s earnings in Country X until the earnings are repatriated to the United States. The repatriation tax is elective and, as a result, distorts business decisions. If the U.S. multinational redeploy earnings abroad by reinvesting ... in an active business, for example, it may avoid the U.S. tax on the earnings. To do so, the U.S. company may forego more attractive investments in the United States or may have to fund investments at home through costly borrowing that would be avoided if there were no repatriation tax on the foreign earnings.188
The JCT Options Report also makes the same argument in support of its proposal to move to a system that discards deferral of recognition by the U.S. shareholder of its share of the undistributed income and associated foreign tax (for purposes of the foreign tax credit), and to go instead to a system under which deferral is ended and "repatriation" (actual or "deemed") is not a taxable event because all undistributed income of a controlled foreign corporation will either be permanently exempt or immediately taxable.


Both Reports are devoid of any discussion of (1) the role of U.S. nontax financial statement accounting principles in the U.S. MNC’s decision with respect to whether and how to "repatriate" assets of a controlled foreign corporations that have been produced by the controlled foreign corporation’s earnings, and (2) the impact (on the U.S. MNC’s asset deployment decisions) of U.S. tax rules that impose tax on the United States shareholders pro rata share of the undistributed earnings of a controlled foreign corporation when that foreign corporation invests in various “United States property.”

The Reports also do not define "repatriation" and thus do not discuss the different U.S. tax treatments of asset-deployments that might be alternatives to actual or constructive dividends to the U.S. shareholder. Such nontaxable asset deployments can take the form of repayments of loan principal, or, if there were no Code Sec. 956, loans to U.S. affiliates or equity investment in U.S. subsidiaries or branches of the controlled foreign corporation. Such alternative investments are sometimes viewed as “the problem.” Nontaxable opportunities to use undistributed foreign earnings in U.S. business investment are the "problem" because they make it possible to extend indefinitely the period of deferral of residual U.S. tax on the income from U.S. MNCs the original direct investment in the controlled foreign corporation.

In many respects the solution to the “repatriation tax” problem suggested by the Panel Report and the JCT Report reflects the implicit acceptance by the authors of those reports of the 1962 arguments that tax on undistributed income of a controlled foreign corporation should not be deferred until there is a shareholder realization of economic benefit akin to a dividend, but rather that U.S. tax should be imposed as soon as possible when no longer needed in a business thought worthy of the deferral privilege. The exemption provided for dividends from certain business activities (“Foreign Business Income”) is, under such a view, really just an administrative convenience, since imposing the U.S. tax on the currently includible income from such operations would be largely offset by host country income tax. The simplification gains result from ignoring the income (and foreign tax) that are likely to provide insubstantial net residual U.S. tax on such income.

The present-law “deemed” repatriation regime under Code Sec. 956 needs to be better understood in order to determine whether the asserted “problem” of discouraging investment in the United States requires fundamental tax reform or whether instead the asserted problems can be adequately addressed by a more narrowly crafted change in Code Sec. 956. As a preliminary matter, it is worthwhile to take another look at the application of U.S. GAAP to potential investment by a controlled foreign corporation in U.S. direct investment.

3. The Role of U.S. GAAP in Deferral and Repatriation

There are three features of U.S. GAAP accounting that play a determinative role in deferral and repatriation decisions:

1. Netting. Assets and liabilities are not generally netted against each other, including, most importantly, quick assets and cash.

2. Combined Foreign and Domestic Income. Consolidated group earnings of the publicly traded parent include earnings of both domestic and non-U.S. group members. Netting.

3. No Present Value Discount of Future Tax Payment. Tax liabilities are taken into account at their full amount, (without discounting to present value to reflect deferred payment of the actual liability) in the year when it becomes clear that the liability will eventually be incurred; the accrual is charged to income in that year and not to retained earnings on the balance sheet (i.e., the tax accrual affects earnings per share in the year of accrual of the tax, not in the future year of payment of the tax and not the year the earnings previously accrued as income. Netting: Intragroup Debt vs. External Debt. Borrowing to fund investments, rather than using existing liquid assets available within the consolidated group, has negative consequences under conventions commonly used by creditors and investors to measure
financial well-being of a consolidated business enterprise (i.e., leverage ratios, etc.). The existence of separate items for such assets and liabilities is thus a factor that encourages distribution of excess assets, or other withdrawal of such assets, from a controlled foreign corporation in order to enable the parent to retire external debt. In contrast, related-party borrowing transactions to and from members within the consolidated group are not reflected as liabilities of the group; such intragroup debt is eliminated in consolidation. In the absence of a tax accrual under Code Sec. 956 occasioned by a loan from a controlled foreign corporation, U.S. MNCs would be expected to borrow (at arm’s-length interest rates) from related controlled foreign corporations in order to avoid inflating external liabilities on published financial statements. As discussed below, Code Sec. 956 generally taxes United States shareholders on the principal amount of any such intragroup loans from affiliated controlled foreign corporations to U.S. group members, except for a narrow exception designed to permit U.S. MNCs to make short-term end-of-quarter loans to permit pay downs of external debt at intervals coinciding with quarterly financial statement dates.\textsuperscript{194}

Combined Foreign and Domestic Income. As discussed above in Part II.C.2.a. (Consolidation of All Majority-Owned Subsidiaries), there is often no differentiation in the consolidated earnings per share between earnings in foreign members and earnings in domestic members of the combined group.\textsuperscript{195} Thus, a dollar of earnings in a controlled foreign corporation often can be reflected as a dollar of combined group earnings for purposes of the earnings-per-share calculation, whether or not the dollar is distributed to the U.S. consolidated parent. This factor tends to encourage deferral, particularly if ending deferral will translate into a current period charge against earnings, with the attendant potential impact on share trading prices in a market that uses earnings per share as a yardstick to measure share value. There is no financial statement incentive to distribute earnings or withdraw assets if consolidated group earnings per share will be reduced by an addition to the tax provision because of such a transaction.

No Present Value Discount of Future Tax Payment. A third key feature of U.S. GAAP accounting is that it does not apply present value concepts to reflect, in income or expense, the present value of either the income that will be realized in money when received by the parent in the future, or the residual U.S. income tax that would be incurred by the parent in respect of the receipt of any such taxable realization of dividend income. Further, when a triggering event occurs, and continued non-accrual of residual tax is terminated, the charge for future income tax on such foreseeable distributable earnings is treated as a current year tax charge. In other words, current earnings per share, in the year permanent future foreign reinvestment is no longer foreseen, will be adversely affected by the accrual of U.S. residual income tax in respect of earnings that have already been included, often free of a provision for residual U.S. tax, in prior years’ earnings. The continued accumulation of an unreflected potential deferred tax charge in respect of residual U.S. taxes on prior years’ earnings may strongly encourage a determination that the conditions for ending the deferral will never occur: i.e., that the earnings will be permanently (or “indefinitely”) reinvested outside the United States.

If U.S. GAAP were to change, to force a conclusive presumption without exceptions that all income reflected in the consolidated statements would be distributed eventually to the U.S. MNC parent, in order to permit realization by ultimate shareholders, the disincentive to repatriation under U.S. GAAP accounting would be substantially reduced.\textsuperscript{196} The same U.S. GAAP result could be achieved by terminating all deferral as a matter of U.S. tax law, but, as discussed below, that would be essentially a collateral consequence of ending deferral for reasons other than concerns about present tax law encouraging asset deployment outside the United States by means of a repatriation tax or repatriation trigger.

4. Code Sec. 956 and “Effective Repatriation”

a. The Normal Rules for Taxing Shareholders on Corporate Income. The “repatriation tax” problem is sometimes ascribed to an incremental U.S. tax that will be incurred on distributions of income. This is a sort of “common meaning” notion of the word “repatriation.” In fact, however, the triggering events under Code Sec. 956 that attract residual U.S. tax on undistributed earnings include a variety of transactions far removed from dividends or comparable shareholder benefits. The nondistributions are nonetheless loosely characterized as “effective repatriation.” Indeed, constructive dividends would not be taxable under Code Sec. 956, but would be taxed instead as real dividends under the ordinary rules applicable to dividends. The nondistribution repatriation transactions often have little or nothing to do with conferring benefits on
a shareholder in its capacity as shareholder. Under Code Sec. 956, however, the arm’s-length terms of any loan are irrelevant.

The principal amount of the loan is taxed as if it were a dividend because something quite different than a surrogate dividend is targeted by Code Sec. 956. The reason for imposing a tax on undistributed income of a controlled foreign corporation is a determination as to which milestone in the business cycle of a foreign affiliate is the correct point at which to end the “deferral privilege.” That milestone was first placed in 1962 and has been moved occasionally thereafter. The milestones get moved from time to time, but they have not yet been moved to a point resembling dividend-equivalence (corresponding to conferring benefits on shareholders that would, under general U.S. tax principles, be treated as dividends, to the extent of such benefits).

How and why did the milestones get placed where they are?

b. The Foundation in the 1962 Act: The “Three Mile Limit” Test. In 1962 the benefits of “deferral” were materially curtailed for United States shareholders in controlled foreign corporations. The basic idea originally proposed by President Kennedy was to end deferral altogether for foreign direct investment in business activities in developed countries. The original proposal contemplated continued deferral for investment in “less-developed countries.” The President’s proposal went on to provide for an end to deferral for income derived even by less developed country corporations if and to the extent the earnings were deployed in assets not integral to the benign country corporations if and to the extent the earnings were subjected to tax in the hands of the United States shareholder. The income for which the “deferral privilege” was continued was, however, subject to a further condition. In a singularly opaque explanation, the Senate Finance Committee described a substitute provision (in substitution for the version originally devised to accelerate U.S. tax on earnings withdrawn from investment in less developed countries). The substitute provision, new Code Sec. 956, was intended to end deferral if a controlled foreign corporation acquired various kinds of assets with a nexus to the United States (“United States property”).

The provisions as enacted in 1962 adopted what might best be characterized as the “territorial waters” view of repatriation: United States assets, whether or not related to the United States shareholder, would be United States property. Once safely within the protective umbrella of United States shore defenses, the assets would be deemed to have been “repatriated” and thus no longer in need of deferral to support the competitive needs of the controlled foreign corporation operating outside the United States:

Generally, earnings brought back to the United States are taxed to the shareholders on the grounds that this is substantially the equivalent of a dividend being paid to them. The exceptions noted above, however, are believed to be normal commercial transactions without intention to permit the funds to remain in the United States indefinitely. ...

The end of deferral was not tied to conferring a benefit on a related party (i.e., a dividend-like transaction). The “repatriation” was instead more nearly akin to the trigger in the House bill that was based on withdrawal of assets from a qualified investment in less developed country activities. The exception for “normal commercial transactions” referred to in the quoted language appears to be based on this aspect of the House Bill. At least in 1962, “repatriation” was something in the nature of euphemism for a much more expansive concept than the conventional meaning of repatriation suggested by comparisons to repatriation resulting from actual dividends or comparable shareholder benefit. It remains important, however, to remember that triggering the end of deferral of U.S. tax on active foreign business income has never had its historical or theoretical underpinnings in an idea that the tax should be imposed only when or to the extent that there is the constructive equivalent of a dividend to the United States shareholder. Linguistically, the term “repatriation tax” seems to be a deceptive or at least misleading cognate.

c. The Tax Reform Act of 1976 and “Effective Repatriation.” In 1976, Congress recognized that some undesirable collateral damage might result from the original structure of Code Sec. 956. The problem was identified as discouraging portfolio investment in the United States by controlled foreign corporations. As noted above, Code Sec. 956 initially taxed investments in unrelated party debt and equity (i.e., portfolio investment). In 1976, the United States suffered from a balance of payments deficit. Code
Sec. 956 was amended to limit its triggering events to loans to (or equity investments in) related parties.\textsuperscript{202} Portfolio investment by controlled foreign corporations in the United States was intended by Congress to be encouraged in order ameliorate adverse consequences to the nation’s balance of payments.\textsuperscript{203}

Since 1976, the triggering event to end deferral, in addition to actual distributions, has been tied to a combination of the “territorial waters” element and some feature of relatedness (in order to preserve the ability of a controlled foreign corporation to make portfolio investments and thus limit the potential damage to the U.S. balance of payments deficit). The income on such portfolio investment would remain subject to the normal subpart F treatment of foreign personal holding company income. Only the principal amount of the portfolio loan or portfolio equity investment was protected from accelerated U.S. tax recognition at the U.S. shareholder level of undistributed foreign affiliate income. Parity between U.S. and alternative foreign portfolio investment by controlled foreign corporations was the focus of Congressional concern.

One particular passage in the Committee Reports concerning the purpose of Code Sec. 956 has had considerable impact on the interpretation of Code Sec. 956 by the IRS and some courts. The language describes a new thought, “effective repatriation.” Its contours are rather obscure, much like the original 1962 Act legislative history describing “repatriation”:

> Your committee believes that the present scope of the provision is too broad. In its present form it may, in fact, have a detrimental effect upon our balance of payments by encouraging foreign corporations to invest their profits abroad. For example, a foreign corporation looking for a temporary investment for its working capital is, by this provision, induced to purchase foreign rather than U.S. obligations. In your committee’s view a provision which acts to encourage, rather than prevent, the accumulation of funds offshore should be altered to minimize any harmful balance of payments impact while not permitting the U.S. shareholders to use the earnings of controlled foreign corporations without payment of tax.

> In your committee’s view, since the investment by a foreign corporation in the stock or debt obligation of a related U.S. person or its domestic affiliates makes funds available for use by the U.S. shareholders, it constitutes an effective repatriation of earnings which should be taxed. The classification of other types of investments as the equivalent of dividends is, in your committee's view, detrimental to the promotion of investments in the United States. Accordingly, your committee's bill provides that an investment in U.S. property results only if the foreign corporation invests in the stock or obligations of a related U.S. person or in tangible property which is leased to, or used by, a related U.S. person.\textsuperscript{204}

No discussion accompanied this conclusory assertion, so the particular differences the Committee had in mind (if any) between funds that have been made available to a corporation by related lenders, even if on identical terms, rather than unrelated lenders were not discussed. For example, the reasons for relevance or irrelevance of interest rates and terms identical to those provided by unrelated parties were not discussed.

One difference Congress may have had in mind might have been the elimination of intragroup debt under U.S. GAAP, as contrasted with the reflection of third party debt for purposes of determining various factors affecting creditworthiness and interest rates. This is unlikely, however, since it was soon thereafter recognized by the IRS that financial statement benefits alone were insufficient to trigger taxation based on “repatriation.”\textsuperscript{205}

\textbf{d. Administrative Expansion of “Effective Repatriation.”} In 1988, the IRS expanded the scope of triggering events to end deferral by eliminating the “one-year rule” that had been incorporated in the initial regulations under Code Sec. 956 in 1964.\textsuperscript{206} In T.D. 8209\textsuperscript{207} the one-year rule was deleted in favor of an exception that restricted the exception from “United States property” to certain kinds of “ordinary” trade receivables and service receivables. The IRS explained itself in terms that imply that the premise of Code Sec. 956 is the proper time to end deferral rather than a concern about benefits conferred on a shareholder that would approximate a constructive dividend:

> The Service is concerned that, under the current regulations, CFC’s may make successive loans with a maturity of less than one year as a means of loaning their earnings to related U.S. corporations on a long term basis in avoidance of section 956.\textsuperscript{208}
Loans at arm’s-length interest rates would thus be picked up as the occasion to end deferral, even if they had a maturity of less than one year.

Taxpayers immediately sought, and obtained, a limited carve back of the regulation to accommodate the practice of very short-term loans back to permit “cleaning up” quarter-end financial statement presentation of external liabilities. Thus, the “shareholder benefit” of financial statement presentation of external liabilities, net of foreign affiliate liquid assets, was apparently accepted by the IRS as not constituting a taxable “effective repatriation.” Nevertheless, the concept of “effective repatriation” was subsequently expanded to include short term loans that were actually repaid before the relevant testing date (year-end) but re-borrowed within a “relatively brief” period thereafter.

In Rev. Rul. 89-73, the IRS explicitly stated that the anti-repatriation goals of Code Sec. 956 were not limited to dividend-equivalent transactions between a controlled foreign corporation and its United States shareholder (or affiliates):

However, the application of section 956 is not limited to the standard enunciated in these cases for treating an advance to a shareholder as a dividend, because section 956 is intended to prevent the tax-free repatriation of earnings even in circumstances that would not otherwise constitute a dividend distribution. The facts and circumstances of each case must be reviewed to determine if, in substance, there has been a repatriation of the earnings of the controlled foreign corporation. If a controlled foreign corporation lends earnings to its U.S. shareholder interrupted only by brief periods of repayment which include the last day of the controlled foreign corporation’s taxable year, there exists, in substance, a repatriation of the earnings to the U.S. shareholder within the objectives of section 956.

The resulting structure of the anti-deferral regime is to prevent any U.S. investment of retained earnings of a controlled foreign corporation in what might be, in the words of the Panel Report, “more attractive investments in the United States.” This can be fairly characterized as a self-inflicted wound to the foot, if concern about investment in the United States is really of concern to anyone worried about the repatriation tax.

5. The Potential Solutions to “the Problem” (If There Really Is a Repatriation Problem)

The repatriation tax “problem” can be dealt with in a number of ways: (1) currently taxing all undistributed foreign affiliate income, (2) permanently exempting all foreign affiliate income from tax, (3) a combination of exemptions from tax for some undistributed foreign affiliate income and current tax on other foreign affiliate income (such as proposed by the Panel Report), or (4) by simply modifying existing law to limit taxable “repatriations” to dividends, or perhaps “almost dividends” such as below-market loans to affiliates or purchases of parent company stock. In such event, the Code would exclude from Code Sec. 956 the kinds of business investment in United States assets that the Advisory Panel might have had in mind as worthy of encouragement if only the “repatriation tax” could be eliminated.

If the problem is the supposed deterrent effect on U.S. investment, the most direct route to eliminating this problem would be to limit the taxable event to actual dividends (and corporation-shareholder transactions treated as constructive dividends under general U.S. tax principles) and to eliminate some or all of the various “deemed repatriations” that currently arise when a controlled foreign corporation acquires for its own account various items of “United States property.” If, however, the real tax policy concern is perceived inequity in the taxation of foreign affiliate income compared to domestic affiliate income, taxing deemed repatriation may be a useful component in a regime whose first priority is to avoid any favoritism for foreign business income, regardless of the collateral damage to the American economy resulting from diminished competitiveness and diminished business investment in the United States. In such case, however, the description of the problem as somehow based on eliminating a “repatriation tax” is confusing and misleading.

The repatriation “problem” exists only with respect to foreign source income for which available credits for foreign income taxes paid, whether initially imposed on the same income or other income in the same basket, is lower than 35 percent. The most common situations in which the “repatriation tax” arises include:

- Income from activities in countries with low effective tax (e.g., Ireland, Malaysia, Singapore)
- Income “deflected” by base erosion away from a normally high-tax country (e.g., Germany) to a normally low-tax country (e.g., Ireland) by
means of intercompany payments of interest, rents or royalties.

- Foreign source income subject to little or no foreign income tax in amounts sufficient to “absorb” all excess foreign tax credits on any highly taxed foreign source income. For example, a U.S. MNC with high-tax operations in Country Y, low-tax operations in Country X and substantial export sales “foreign source” income and/or substantial foreign source royalty income. If one assumes that the export sales income and the royalties are structurally inescapable because of the basic business model, they may use up the Country Y excess foreign tax credits. The pool of low-taxed Country X earnings is potentially subject to a “repatriation tax.” The event triggering the tax is the distribution of earnings, which can be deferred (perhaps indefinitely) without doing any harm to the ordinary operation of the business (except for encouraging foreign rather than U.S. deployment of such earnings in new investments).

The Panel Report proposes solving the problem by subjecting the low tax Mobile Income pool of active Foreign Business Income to current U.S. tax whether or not it is distributed. The proposal is overkill if it is really supposed to be a solution to the problem of discouraging repatriation. The disincentive to U.S. investment can just as easily be removed by preserving deferral until there is an actual or constructive dividend and by permitting non-dividend-like investments in the United States. 218 In any event, it is not clear how much tax revenue is affected. In the modern era, Code Sec. 956 is as likely to be a tool used by taxpayers to effect selective recognition of undistributed foreign-affiliate income 219 as it is to be useful in affecting location decisions based on the 1962 assumptions that (1) returning to the safety of U.S. waters is an irresistible magnet, and (2) the income attracted by such magnetic effect should be taxed in order to preserve capital export neutrality with respect to the original investment decision to make a foreign direct investment that might generate tax-deferred income.

The amount of undistributed foreign income thought to be potentially exposed to the “repatriation tax” may be increased by the prior allowance of deductions for expenses incurred to produce those earnings (undistributed earnings of controlled foreign affiliates not otherwise taxed currently to the United States shareholder). Such deductions are allowed against any income, including domestic income. The U.S. MNC taxpayer may thus perceive the incremental U.S. tax exposure on a taxable repatriation transaction to be larger than it would be if such expenses had been matched against foreign-related income that includes income produced by such expenses. Having already taken the benefit of the deduction for tax purposes against foreign-related income that is not foreign-related, the recognition for tax purposes of foreign income (consisting of earnings for which financial statement effect has been already given), may be perceived by the taxpayer to be an incremental tax on the distribution of the foreign earnings unreduced by the expenses incurred (and deducted) to produce the income.

As discussed at Part II.E. (Matching of Expenses and Foreign-Related Income to Which the Expenses Relate), expenses allocable to foreign source income are currently deductible without regard to deferral of some foreign-related income in a controlled foreign corporation. Upon distribution of earnings, any foreign taxes associated with such distributed earnings (i.e., paid by the controlled foreign corporation affiliate) will be creditable only up to the extent of the applicable limitation for that year. The applicable limitation is reduced by the amount of U.S.-group deductions allocated against the foreign source income. Thus, even high-taxed earnings may be undesirable to repatriate if the limitation has been reduced by U.S. deductions.
Such a situation arises, for example, when the “gross up” for foreign taxes paid on earnings is added back to taxable income, but the aggregate loss allocation to the “grossed up” amount of foreign source income reduces the foreign tax credit limitation to zero. Many taxpayers complained, after enactment (in the 1986 Act) of the special allocation rules for United States shareholder-level interest expense and general and administrative expense, that the resulting “overall foreign loss” would discourage dividend distributions even from high tax operating subsidiaries in countries such as Canada or Germany. Having paid taxes at rates in excess if 35 percent on such income would not prevent incurring additional U.S. tax on the dividends from such companies, if the relevant limiting fraction for “general basket” income was below the amount of such dividend income. The “repatriation tax” problem associated with the “gross up” for foreign taxes would be avoided, under the Panel Report, by eliminating the foreign tax credit and the gross up for creditable foreign taxes. This seems to be an application of Chairman Rostenkowski’s definition of tax reform: taxing companies beyond the sea in order to avoid taxing you and me.221

To the extent “cross-crediting” is reduced or eliminated, the disincentive to repatriate may be increased with respect to low taxed income. This possibility is referred to somewhat obliquely, in the Panel Report and the JCT Options Report. The dividend-exemption response to this potential increase in the disincentive is to ensure that all income is either taxed currently or entirely exempt from U.S. corporate-level tax. The Panel Report and the JCT Options Report thus incorporate the “solution” for the repatriation tax proposed by advocates of completely ending deferral: tax it all now, and eliminate cross-crediting for any high-taxed income in the system.

The “problem” of disincentives for repatriating high-taxed foreign income would also be addressed in part by disallowing the U.S. expenses incurred to produce such high taxed foreign income (because such high-taxed income would be generally exempt from U.S. income tax). The Panel Report and the JCT Options Report make that recommendation. Since such allocated expenses would rarely, if ever, be allowed as a local deduction against host country taxable income of the controlled foreign corporation affiliate, the impact might be a significant disincentive for U.S. MNCs to invest in high tax foreign countries.

### E. Matching of Expenses and Foreign-Related Income to Which the Expenses Relate

Matching of expenses that are deductible at the U.S. taxpayer level is now required for purposes of limiting the amount of U.S. tax that can be offset by foreign income taxes. The matching proposals in the JCT Options Report and the Panel Report would extend this to other taxpayers, specifically those not now affected by the foreign tax credit limitation. This part of the article will examine the various effects of implementing a matching regime and how those affects vary depending on the groupings of income and associated expense.

#### 1. Matching of Expense As Equivalent to a Partial End to Deferral

As discussed above in Part II.C.1.e. (Formulas to Measure the Time Value of Money) deferral of residual U.S. tax on undistributed income of foreign affiliates can be deconstructed into the tax on three income components. The first consists of the deferred residual U.S. tax on income attributable to a risk-free rate of return on the amount of the initially deferred tax (the government’s deferral problem). The second is tax on the additional return that reflects the enterprise’s cost of borrowing; this is the return that must be provided to debt or equity investors by the U.S. taxpayer in order to attract capital investment in an amount equal to the tax amount that is the putative “loan” by the government. The third component is the excess over the return necessary to cover the cost of raising capital (income on amounts such as equity that are not connected to deductible expenses, plus a “premium” that might be associated with special value assets such as intellectual capital, intangible property or even just a better business model). The Year 1 deferred residual tax, plus residual U.S. tax on the income derived by the deployment of the retained assets corresponding to the deferred tax, is the accretion to wealth that is the subject matter of a discussion about current collection or deferred collection of tax. This part discusses the relationship between USCO’s deductible expenses and undistributed income derived by a foreign affiliate in which USCO is a direct investor.

a. Dividend Exemption Proposal Is an End-Deferral Proposal. The dividend exemption system in the Panel Report222 is predominantly a way to end deferral. A simplifying step is added to provide an exemption
from residual U.S. tax on certain foreign business income, where the residual U.S. tax, after allowance for creditable foreign tax, would generally be negligible. In such an exemption system, matching of expenses that are disallowed with exempt income has much the same economic effect as the effect of accelerating recognition of a portion of the undistributed foreign affiliate income, or of deferring deductions under a realization-based deferral system: an amount of income otherwise not taxed at all, or not taxed currently, is included in the U.S. tax base and is currently taxable. If other taxable income (such as domestic business income) would be reduced by the matched deduction, matching will increase the tax base by the allocated amount.

b. The Rangel Bill Expense Deferral Proposal. The Rangel Bill would apply the dividend-exemption system proposals in the Panel Report and the JCT Options Report, but with a twist. Instead of exempting certain foreign income, and denying a deduction for expenses allocable to exempt income, the Rangel Bill would defer deductions for expense allocable to deferred income.

The Rangel Bill expense allocation would be to a narrow class of income (income of foreign affiliates to be realized eventually as dividends to the U.S. taxpayer). The effect would be similar to the Panel Report proposal in that it would ignore as income recovered to the U.S. federal tax net other foreign source income, no matter how closely related to the dividend-producing activities. Thus, interest income from a foreign affiliate would not be treated as recovering the expenses allocable to the equity part of the U.S. taxpayer’s aggregate capital investment in a foreign affiliate.

Because income from foreign direct investment in the form of debt (i.e., interest) is most likely to be subject to low foreign income tax, the effect of this approach to matching is to ensure that a foreign business is deconstructed into supposedly separate pieces, and to deny the U.S. tax benefit of a deduction for an amount of allocated expenses that in fact were incurred to support a foreign direct investment operated as an integrated business.

At this point in the analysis, it is useful to concentrate on the important difference between expense matching on a narrow basis and expense matching on a broad basis. Narrowly based expense matching is essentially punitive in nature: it seeks to break foreign business activities into high and low foreign tax pieces, and to ensure that the piece that bears high foreign tax does not get combined with the low tax piece in the U.S. tax return. This is accomplished by either expense disallowance (under the dividend-exemption proposals) or deferral (under the Rangel Bill) of expenses attributed to just a piece of the overall business income.

In contrast, a broad-based expense allocation approach has a different goal: ensuring that expenses incurred to produce foreign-related income (whether subject to high, low or no foreign tax) do not reduce U.S. tax on income that is not foreign-related. It basically seeks to put a U.S. MNC in the same position it would be in if it conducted either a wholly domestic or a wholly foreign-related business and did not combine those businesses in a single corporate income tax return. Foreign targeted business should pay for itself, but it has been generally good for the United States and its citizens to have participated in the global economy since World War II. U.S. MNCs who are the principal agents of that participation can be required to do so without a subsidy in the form of a tax reduction on their domestic business income unrelated to cross-border trade and investment, but they should not be punished by tax provisions that would slice and dice their foreign-related business activities in arbitrary ways.

The Rangel Bill describes its narrow expense matching proposals as a revenue raiser, and the ancillary discussion of the proposal has not suggested that it is conceptually motivated by goals such as efficiency, fairness, administrability, etc. The JCT Options Report included essentially the same proposal with an estimated revenue increase for the government. The Advisory Panel Report did not “score” its proposal, but it is likely the proponents were aware that it would help to maintain revenue neutrality as a “pay-for” for other revenue losses.

Whatever the actual motivation behind the various proposals, the building blocks are interesting. Expense matching and ending deferral are alternatives that end up with overlapping results. This may be merely a fortuitous coincidence or perhaps there is more than one way to skin a cat.

c. Approximate Equivalence of Deferred Expense and Accelerated Pre-Realization Income Recognition. A pre-distribution inclusion in the U.S. shareholder’s income of undistributed foreign affiliate income, in an amount equal to the deferred tax invested at the financial rate of return, is comparable to the present value of a deferral or disallowance of an otherwise deductible expense item of the U.S. shareholder. To
a significant extent the disallowance or deferral of an otherwise currently deductible expense will have the same effect on the government as an inclusion of a portion (less than all) of the otherwise deferred undistributed income. The question will be whether the amount of additional benefit for the government that would be achieved by ending all deferral, rather than only increasing revenues by deferring or disallowing deductions, is worth the burden on the government and taxpayers involved in getting the additional amount. The answer depends on various factors, including how much residual U.S. tax on the income in excess of an ordinary rate of return on the associated expense. A realization-based (deferral) system will eventually capture the amount of additional benefit for the government.

Expense matching is the simpler piece of any anti-deferral puzzle. The more complicated piece involves measuring the amount of taxable undistributed income and then later adjusting the tax base when (not if) the amount distributed “from” the previously taxed income is different than the original amount.

d. Undistributed Income in Excess of Ordinary Return on Disallowed Deduction. Matching of expense (and the associated disallowance of a deduction) will not capture the income that exceeds a financial rate of return on the associated expense. A realization-based (deferral) system will eventually capture the amount in excess of the financial rate of return. An exemption system will not. As a result, the proposed dividend exemption systems generally seek to narrow the classes of exempt income to income that is likely to be generally subject to low residual U.S. tax. This is reinforced by limits on cross crediting. The classes of active business income excluded from the exemption system (“Mobile Income”) are to be still taxable to the U.S. shareholder before distribution. As noted by various commenters, this ensures retaining much of the complexity of present law’s regime for dealing with previously taxed income.

2. Matching Entails Complexity

Matching of expenses itself entails some complexity. Conventions need to be adopted to associate fungible expenses with discrete income producing components of a global enterprise. Even tracing of nonfungible expenses can be labor intensive. In addition to the complexity inherent in dividing a U.S. taxpayer’s aggregate deductible expenses into various traced and apportioned components, matching will also entail the burden of basis adjustments. If expenses are deferred and never restored, and if the associated direct investments are sold or exchanged, the taxable amount of any proceeds of a sale or exchange, if any, should be measured by providing an increased basis for the asset disposed of. For example, if the relevant grouping of assets, to which otherwise deductible expenses are allocated, includes all foreign direct investment equity positions, it will be necessary to sub-allocate the deferred or disallowed deductions as increases to the basis of each of the foreign direct investment positions. A convention would then have to be devised to make that allocation, and any such convention is likely to involve some departure from perfection. For example, allocation based on relative cost basis of various equity positions, increased by adjustments to basis for exempt or previously taxed income, will be the simplest convention, but, as with the existing-law foreign tax credit approach to a similar allocation procedure for interest expense, that convention will tend to overweight new assets that may have been acquired at inflated prices compared to older assets of essentially identical value. Simplicity is not free; it is just one more factor to be taken into account and accepted or rejected, when all factors are being considered.

3. Expense Matching Is Easier Than Taxing Undistributed Income and Tracking Previously Taxed Income

The expenses-matching part of the puzzle is also easier than the other pieces because the expenses in question are wholly within the U.S. shareholder’s control, recorded on its books of account, and can be measured once and for all in U.S. dollars. Access to foreign data is not required. It is not necessary to consider the U.S. shareholder’s ability to control distributions of income of less than wholly owned foreign affiliates on which the U.S. shareholder would be taxed (“Mobile Income”). Many U.S. MNCs have substantial experience in dealing with this complexity because of the need to make allocations of expenses made to determine the limitation on the amount of U.S. tax that can be reduced by a credit for foreign income taxes.

4. Denying a Deduction Anywhere

a. Generally. The effect of making such an allocation to determine the foreign tax credit limitation under present law, for purposes of determining the limit on the amount of U.S. taxes that can be offset by the foreign tax credit, is, in many cases, the economic equivalent
of denying a deduction for the allocated expenses.\textsuperscript{227} Such allocated expenses are of a type rarely if ever allowed as a deduction by the source country where the income is earned and also rarely if ever allowed by the country of tax residence of the U.S. taxpayer’s foreign affiliate. Such expenses are typically comprised in large part of U.S. shareholder level interest expense, general and administrative expenses and U.S. licensor development expenses for intangible property. The source countries, and foreign residence countries, like the United States, will not permit deduction of \textit{shareholder} level investment expense against income otherwise taxable to the investee corporation.\textsuperscript{228} Thus, such expenses, if not deductible at the foreign affiliate level, and if effectively disallowed through operation of the foreign tax credit formula, “will not be deductible anywhere.”\textsuperscript{229}

This assertion suffers from a failure to focus on one salient feature of the relevant deduction: such a deduction only reduces tax on income \textit{other} than the income it was incurred to produce. If the taxpayer has no other income, the allocation of expenses against the numerator of the foreign tax credit limiting fraction would have no tax effect. The combined U.S. and foreign tax on the income would be the greater of the U.S. rate or the foreign tax (which would have been imposed on a larger amount of income than if the U.S. expenses had been taken into account to reduce foreign taxable income). Is special treatment of interest incurred to carry an exempt or deferred income-producing asset appropriate?

Similarly, in a deferral or exemption context, the allowance of a current deduction for expenses incurred to produce deferred or exempt income operates to reduce U.S. tax on income \textit{other than} the deferred or exempt income. If there were no such other income, the allocation of such expenses would have no tax effect.

\textbf{b. Asymmetry with Domestic Equity Investment.} Interest expense incurred to invest in domestic equity \textit{will} be deductible against other income of the U.S. MNC, even if the domestic equity investment never produces income subject to U.S. tax. Disallowance of interest expense (or deferral until foreign source income is taken into account for U.S. tax purposes) will thus disfavor foreign direct investment compared to comparable domestic investments. Interest is specifically asymmetric with other expenses subject to general capitalization requirements. Interest may be subject to specific capitalization requirements, such as interest incurred to carry a position in a straddle,\textsuperscript{230} and interest incurred to carry investments in tax-exempt property.\textsuperscript{231}

The asymmetry with domestic-investment-related interest (or with domestic investment-related general and administrative expense) does not appear to result from a departure from sound general tax principles. Instead, the treatment of interest as generally exempt from matching and capitalization principles appears to be itself a departure from general tax principles that has been made to achieve simplification. By treating foreign direct investment-related interest (and general and administrative expense) as effectively capitalizable, tax policy will have simply weighed simplicity against matching and concluded that matching makes more sense in a foreign direct investment context. It must be remembered that the effect of doing otherwise is to reduce tax on \textit{other} income and the exclusion of the foreign direct investment income eventually to be produced from the tax base (either temporarily or permanently) is an appropriate basis to discriminate in favor of the risk taken in unsuccessful domestic investments and against risk takers in unsuccessful foreign business investment. In other words, it may be reasonable to require the foreign-investment risk taker to take the bitter with the sweet if all foreign undistributed direct investment (business) income is not to be taxed as if it were fully distributed.

\textbf{5. Expense Matching As Half a Loaf}

Opponents of the present realization-based (deferral) regime who also object to a territorial exemption approach are likely to believe that expense matching is an appropriate, but not sufficient, means to achieve ideal taxation of the U.S. MNC’s share of undistributed foreign affiliate income. First, with only expense matching the government is not made whole for the tax otherwise collectible (if deferral were ended altogether) in respect of (1) ordinary (financial rate) return income on the corporate U.S. MNC equity capital invested in the foreign affiliate (for which there is no U.S. shareholder-level deduction to defer or disallow), and (2) premium returns above the level of return used to calculate and compare present values of current vs. deferred residual U.S. tax in an amount corresponding to the deferred or disallowed deduction. Second, they argue that the implicit tax-free loan to U.S. taxpayers that invest in foreign affiliates, compared to the lack of an equivalent tax-free loan to domestic enterprises, affects location decisions in ways injurious to U.S. jobs and to the progres-
sive income tax principle that wealthy U.S. resident capitalists should assume a higher burden of tax than labor or other less advantaged taxpayers. 232

The asserted location-decision effect appears to be theoretically rather than empirically based. It is at best conjectural that U.S. MNCs are even aware of the insights of Professor Brown or the interest-free loan notions constructed on his insights. It is also unlikely that any U.S. MNC has, in making cost comparisons among U.S. and foreign investment locations, calculated the earnings per share effect of any interest savings of the sort described in the Treasury 2000 Subpart F Study. 233

Apart from the effect on location decisions, it appears that the “ideal” of taxing U.S. taxpayers on unrealized accretions to wealth, in the form of undistributed earnings of foreign affiliates, may entail more complexity than the difference in present values (between the present value of residual U.S. tax after expense matching and residual U.S. tax after completely ending deferral) may be worth.

6. Illustrative Calculation of Tax Effect of Deferring or Disallowing Expenses Matched to Foreign Income

Those differences have been described at Part II.E.1 (Matching of Expenses as Equivalent to a Partial End to Deferral) above. We can review some of the comparisons again in this Part II.E.6. The differences in such comparative present values of residual U.S. tax are likely to be even smaller in comparing a regime in which there is deferral of deductible expense and deferred residual U.S. tax collection on undistributed foreign affiliate income than under an exemption system that compares disallowed (permanent) expense and permanently exempt income (with a resulting zero residual U.S. tax in the future). Under either comparison, however, the incremental U.S. tax to be captured with respect to excess income, compared to ordinary return income captured by matching expenses with a category of foreign income, is likely to be small enough that the difficulty in achieving theoretical “ideal” taxation may just not be worth it.

a. Foreign Tax. In Part II.C.1.f.vi. (Controlled Foreign Corporations), USCO realized income from U.S. operations and also owned 100 percent of the stock of For-Sub. USCO’s share of For-Sub’s undistributed income in Year 1 was equal to USCO’s pre-U.S. tax income from domestic operations. Such pre-tax income was 100, before deducting USCO interest expense of 60: one-half (30) was allocable to USCO’s investment in For-Sub and one-half (30) was allocable to USCO’s domestic business operations.

In the absence of allocation (and consequent disallowance of a current deduction), 30 of interest attributable to USCO’s investment in For-Sub (and in its eventual realization of For-Sub’s earnings) would reduce USCO’s tax on 100 units of domestic income by 10.5 (30 times 35-percent U.S. corporate tax rate). USCO’s current year tax would be (100 – 60) x 35%, or 14 units of tax. If the 30 units of interest deduction “really” attributable to the production of foreign income were either deferred or disallowed, the U.S. tax base would be increased from 40 to 70 (100 minus only 30 “domestic” expense). The United States would then collect, in Year 1, 24.5 units of tax (70 x 35%) instead of 14 units of tax. The full 35-percent rate would have been applied to actual net U.S. income.

If we assume that For-Sub pays zero foreign tax, the U.S. government, by exempting or permitting deferral of tax on the additional 70 (For-Sub 100 – 30 allocable interest), foregoes or postpones additional tax of 24.5 (70 x 35%). If For-Sub were to borrow the amount (500) that now generates a deduction of 30 against USCO’s “other” income the result would be the same: the amount of residual U.S. tax would be reduced to 35% x 70 (100 – 30 interest), or 24.5.

If we change our assumptions to include the likelihood that For-Sub pays foreign income taxes, the residual U.S. tax (24.5) would be further reduced. For example, if For-Sub paid foreign tax at 12.5 percent of 100, the residual U.S. tax, on a fully distributed basis, would be reduced initially to 12 (24.5 – 12.5). 234

It is worth noting that disallowing 30 units of Year 1 deductible expense corresponds to an inclusion of additional taxable income in Year 1 in the same amount. As noted above in discussing the Cary Brown present value model, a partial end of deferral in Years 2 through Year “n,” corresponding to the “ordinary” yield on the amount of deferred tax, will never recoup for the government the entire present value of the deferred tax. 235

Instead of approaching the government’s problem by relying entirely on accelerated recognition of all of For-Sub’s income, if part of the problem were to be instead dealt with by delaying or denying a deduction for allocable expenses in excess of foreign-related income, the compounding problem referred to in the preceding paragraph would be correspondingly ameliorated. To the extent of the accelerated tax
collection attributable to the delayed or disallowed deduction, all of the government’s borrowing cost is captured whereas, when pursued by means of a post Year 1 acceleration of income, only 35 percent of the return or deferred tax is captured by the future year’s tax on the future year’s income.

Thus, if USCO’s deduction for 30 units of interest is disallowed or deferred, the tax equivalent benefit, compared to a Year 2 tax on For-Sub’s undistributed income attributable to deployment of the interest-free loan, is the same as Year 2 tax at 35 percent on 1.50 units of income. In order to derive 1.50 units of income, For-Sub would have to deploy 10.5 units (the amount of deferred tax) at 14.286 percent or 30 units at the five-percent risk-free rate. The current effect of matching thus very substantially reduces the amount of the Year 1 problem and the compound interest effect of that problem.

b. Foreign Creditable Taxes. We are most likely never dealing with a situation in which the residual U.S. tax on deferred foreign affiliate income is 35 (before allocation of expenses). We are instead in a world in which the residual U.S. tax will be reduced by creditable foreign income taxes on For-Sub (or appropriately related foreign source income of USCO). If we assume that For-Sub will be subject to an effective rate of tax of 12.5 percent (a “low” rate of tax compared to such relatively higher tax trading partners as Germany, France, Japan and the United Kingdom) the gap between ending deferral by expense matching and completely ending deferral on low-taxed income will be smaller. The remaining problem, to be solved in order to achieve what some consider to be the ideal tax system, would be significantly smaller.

The residual tax on 70 units of income (i.e., after taking into account 30 units of allocable expense) would be 24.5 (70 x 35%). The foreign tax credit would reduce this residual U.S. tax to 12 (24.5 minus 12.5 foreign tax). In effect, 10.5 of currently increased U.S. tax attributable to expense allocation, plus a 12.5-percent foreign tax, together eliminate two-thirds of “the problem.”

The remaining third (less, if the foreign tax rate is higher, more if the rate is lower) is the amount of the government’s “investment” at risk, the “stakes” in the battle over deferral. Solutions for this “risk factor” can be found in several approaches. One would be to continue the present deferral regime rather than adopt an exemption regime, so that there is always an assumed present value to an assumed future collection of residual tax. Another would be to limit exemption to circumstances in which the residual U.S. tax is likely to be even smaller than in our hypothetical: by limiting the exemption system to countries with significant amounts of foreign income tax that would substantially reduce or eliminate residual U.S. tax if the For-Sub income in question were not directly exempt from tax.236

c. Increasing Residual U.S. Tax by Denying Foreign Tax Credits. The proposal in the Panel Report is to exclude from exemption237 all items of income likely to be taxed at a low or zero rate under foreign law: (1) base erosion income deflected from a normally high tax jurisdiction by intercompany sales or services (the equivalent of current law foreign base company sales income and foreign base company services income, and (2) base erosion income from related-party payments of amounts likely to be deductible under foreign law, such as interest and royalties.

The Panel Report and the JCT Options Report proposals would eliminate the potential reduction of residual U.S. tax with respect to income not falling into either of the two categories of possible solution described above: (1) expense allocation with a present value equal to significant amounts of income inclusions in future years, and (2) income exempt only if likely to be subject to a high rate of creditable foreign tax.

d. Low-Tax Same Country Foreign Business Income. One category of foreign income that under the dividend-exemption proposal would be permitted to enjoy exclusion from U.S. residual tax (over and above the portion thereof effectively taxed via expense matching) is low taxed single country income (i.e., income generated in low-tax countries that has not made its way to a low-tax country by means of income deflection from a high-taxed country or base erosion transactions that result from deductible payments by a high tax affiliate to a low-tax affiliate). The retention of this conceptual class of income that would not ever be taxed at a high rate has attracted disapproval on the part of some opponents of deferral.238

7. Other Countries Do Not Do This. So What?

In considering the possibility of expanding the matching principle, whether in a territorial system by disallowance, or in a deferral system by expense deferral, a key “competitiveness” issue must be noted. No other OECD239 trading partner applies such comprehensive matching to its multinational enterprises.
to measure matching of directly traceable expenses, but none allocates expenses under formulas comparable to the scope of those used to calculate the foreign tax credit under present U.S. law. The resulting adverse impact on competitiveness of the affected class of U.S.-parented MNCs must be weighed against the hoped-for benefits: improved horizontal equity between U.S. MNCs (some who have and some who do not have excess foreign tax credits) in their foreign direct investments, and horizontal equity between U.S. MNCs and wholly domestic business enterprises when they contemplate productive direct investment opportunities within and without the United States. Other OECD member countries have to date, either deliberately or accidentally, opted for a system that reduces the residence country tax burden on foreign business activity (“competitiveness”) rather than perfect matching of expense and intended income.

8. What Kinds of Income Should Be Combined for Purposes of Matching?
The Panel Report uses only dividends entitled to dividend exemption as the relevant income category to which expenses would be allocated (and disallowed). This is symmetrical with the other components of the proposal that would exclude from the benefits of exemption any low-taxed active foreign business income assigned to the Mobile Income category, as well as other foreign-related income from export sales and royalties from the exploitation of intangible property. The guiding principle appears to be to eliminate the tax-based economic benefits of “cross-crediting.” The premise seems to be that high-taxed income (foreign tax) should be exempt from residual U.S. tax, but such high foreign-taxed income should not be available to average down the effective rate of residual U.S. tax on foreign source income likely to have been generally subject to a low rate of foreign tax: (1) deflected business income and (2) base erosion income.

Another approach to expense matching would be to expand the pool of income eligible for deferral or exemption to include the components of active foreign business income that were included from territorially income in the JCT Options and Advisory Panel proposals. Such expanded grouping might be undertaken in order to allow U.S. MNCs to conduct business in a global economy with some of the efficiencies available to competitors in supplying markets in multi-nation trade blocs such as the European Union.

In considering categories of income that might be added to dividends in an exemption or deferral system, a key first question will be whether export sales income now subject to special source rules and royalty income should be re-characterized as domestic source income. This issue is discussed more fully in Part II.F.8. (Effect of Source Rules on Cross-Crediting), below. In the end, however, such items should be added back as foreign-related income if we wish to retain for the citizenry the full benefits of participating in the global economy.

a. Narrow Income Exemption, Narrow Expense Matching. The Panel Report proposes “narrow” matching. It does so in the context of a comprehensive effort to eliminate “cross-crediting.” The issues involved need to be addressed separately with respect to two categories of income, the residual U.S. tax on which is currently reducible by “excess” foreign tax credits. First, there is royalty income for the use of U.S. origin intangible property that ordinarily bears no foreign tax and includes in an economic sense compensation for the value of U.S. domestic inputs. Second, there is foreign low-taxed income that has been removed from the jurisdiction in which the primary business activity giving rise to such income is conducted by means of “income deflection” and “base erosion.” The Panel Report would eliminate the use of foreign tax credits from the country in which such primary business is conducted to reduce U.S. tax on income so removed from the tax base in the high-tax state.

The two targeted classes of income are really quite different. Royalty income for the foreign use of U.S.-origin intangible property may be viewed as really comprised of both U.S. domestic inputs (domestic source) and foreign inputs (foreign source) source components, with the U.S. domestic source component equal to the value of the domestic inputs as of date of export, and the foreign component equal to an implicit interest charge on a deferred sale of such property. The allowance of a cross credit for foreign taxes on foreign affiliate income is viewed by some as an allowance of a credit for foreign taxes against U.S. taxes on U.S. domestic income. Such a credit can then be characterized as inconsistent with the core theory underlying the foreign tax credit limitation that was introduced in 1918. If this is a problem (after so many decades), it can be readily dealt with by the simple expedient of adjusting the grouping of foreign-related income with which such income can be combined for purposes of both expense allocation...
and foreign tax credit limitations. Implementing territorial taxation in order to deal with this “problem” is clumsy and overbroad, even if it does enable scoring of the measure as a significant revenue raiser.\textsuperscript{289}

If cross-crediting of subsidiary taxes against U.S. tax on royalties for foreign use of U.S.-origin intangible property is adjusted to deal with the agreed-upon problem,\textsuperscript{290} the remaining class of income affected by the elimination of cross-crediting is active foreign business income that has been subject to a low rate of foreign tax because of income deflection and base erosion transactions. In order to evaluate the desirability of doing so, we should first examine how much of the problem remains if we first apply expense matching against a broader pool of foreign active business income than just the piece attributable to equity in the “normal” tax home of an active foreign business.

The impetus to consider such examination is the disquiet expressed by Assistant Secretary Olson in 2003\textsuperscript{251} that the existing regime for multi-jurisdictional business is already capable of erratic and counter-competitive effects of a U.S. MNC engaged in global commerce compared to foreign MNC competitors. Before exacerbating the problem, compared to the present system, by not only effecting current taxation of the U.S. MNC on undistributed foreign affiliate income, but also by eliminating the credit now available to offset U.S. tax on the low-tax piece of the global business income by taxes on the high-tax piece, we need to understand exactly what U.S. interest we are pursuing. It cannot be justified as merely collateral damage occasioned by the need to “get” that royalty income by hook or by crook.

\textbf{b. Broad Income Exemption, Broad Expense Disallowance.} Under a broader matching approach, all income from foreign-related activity and direct investment realized by a U.S. shareholder would be aggregated. All expenses associated with the production of aggregate foreign direct investment income would be treated uniformly. In such an exemption system, all expenses associated with both loans to, and equity investment in, a foreign affiliate, would be disallowed. All dividends and interest would be exempt from residual U.S. tax.

To the extent that the dividends are from high-tax affiliates, the aggregation of interest would simply approximate the effect under present law when excess credits from the equity portion of the investment are available to offset U.S. residual tax on the interest income.

The difference between the present system and an exemption system would be the treatment of two situations: (1) taxpayers that do not have significant deductions associated with foreign direct investment income, and (2) taxpayers whose foreign operations are subjected to a low rate of foreign tax. With respect to the first category, no form of territoriality and expense matching will protect the interests of the U.S. fisc; only taxing the income, now or later, will keep the U.S. fisc whole. With respect to the second category, the principal target seems to be Mobile Income: Income moved out from a normally high-tax environment to a low-tax environment by income deflection or base erosion.

By allocating expenses against such income, some of the benefit to the U.S. MNC is lost. The government will be made whole to the extent of the tax associated with the disallowed expense deduction, but not with respect to the foreign affiliate income in excess of that return on the tax attributable to the disallowed deduction. The intended effect of expense allocations now integrated into the foreign tax credit limitation will be extended to taxpayers that are not affected by the foreign tax credit limitation.

In our USCO example, For-Sub has 100 units of Year 1 income and incurs foreign tax of 12.5 percent. USCO has 30 units of interest expense allocable to its investment in For-Sub. USCO also has incurred 24.5 units of U.S. tax on its 100 units of U.S. source income (reduced to 70 after deducting 30 units of interest expense allocable to domestic business activities).

If USCO were to restructure its investment in For-Sub to establish a one-to-one debt-to-equity ratio, and if the rate of interest were six percent (USCO’s enterprise borrowing rate), what tax difference would that change make under a broad exemption, broad matching system? USCO would have a debt investment in For-Sub of 500 and an equity investment of 500. USCO would continue to incur 60 units of interest expense, of which 30 would be allocable to the aggregate investment in For-Sub (1000 Foreign Direct Investment Assets over 2000 Worldwide Direct Investment Assets).

Interest expense of 30, if disallowed as a U.S. tax deduction, would be equal to the amount of exempt interest income under the broader exemption system. From a U.S. tax standpoint, on these facts, there is no U.S. tax difference. From the standpoint of \textit{combined} \textit{U.S. and foreign} tax, however, the overall tax burden on USCO has been decreased. The U.S. will continue to collect 24.5 units of tax on the domestic income.
For-Sub will, however, reduce its tax burden from 12.5 to 8.75 (12.5% x 70).

The difference in combined tax burden is not necessarily a problem that affects revenue support for U.S. government services or transfer payments. It is, however, a cause of worry if it affects location decisions by U.S. MNCs that may in turn lead to lower levels of U.S. employment, a decrease in funding for arts and sciences, etc. These are worthy of concern, but they are not, strictly speaking, tax concerns. They are tax policy concerns to the extent that tax policy actually causes some or all of these pernicious effects.

There is considerable disagreement about the empirical support for these worries expressed over the past 40 plus years about foreign base erosion. Economists have testified before Congressional committees that the bulk of cross-border direct foreign investment is laterally or horizontally between high-tax jurisdictions rather than from high-tax to low-tax countries in response to tax differences. Nevertheless, it is commonly supposed that differences between various combinations of income and foreign tax thereon should theoretically have, and have in practice had, a significant effect on investment location decisions.

Whatever the merits of the positions on business investment location decisions, the government’s fiscal interest will be better protected by a deferral of tax rather than an exemption from tax, in cases where the foreign subsidiaries and affiliates will generate income in excess of the financial rate of return on USCO’s disallowed deductions. In a realization/deferral system, U.S. tax will eventually be collected on such additional income.

Under such a system, broad inclusion of the matched income pool would result in current inclusion of a minimum amount of income, but the system would be indifferent as to whether that inclusion was accompanied by base erosion or income deflection. Protecting a foreign country against a base reduction would not be an affirmative goal of the system. The goal would be to avoid erosion of the domestic business activity income tax base that might result from allowing deductions for expenses incurred to support generating income in the global economy.

In addition, in order to recognize the full benefit for the U.S. economy of all foreign-related activities, the expense matching pool should be expanded to include not only foreign source business income but also export sales and royalty income from U.S. origin intangible property.

F. Cross-Crediting

The foreign tax credit is intended to limit or avoid double taxation of income from cross-border transactions and investments. A “cross credit” allows a reduction in U.S. tax on one item of income by foreign taxes on other items (whether or not related to each other). The “other” (low-taxed) item is thus shielded from U.S. tax rather than from “double” tax, to the extent such other low-tax items bears no tax or a tax below the U.S. effective rate. The allowance of a foreign tax credit, and foregoing U.S. income tax on income of taxpayers otherwise subject to U.S. tax, can result in a fiscal or tax expenditure for the benefit of foreign countries that tax the same or other income of the same taxpayer. The benefits of cross-crediting are available only to taxpayers with excess foreign tax credits. Similarly situated taxpayers without excess foreign tax credits for foreign taxes on other sources or items may have different tax costs than taxpayers who do not have foreign investments, when considering the U.S. tax associated with income from other similar business activities or from similar anticipated business investment.

It is important to bear in mind that the “other” income is often closely connected to the income that bears the high foreign tax. The disagreement between advocates and opponents of cross-crediting (credit averaging) is often based on using different factual examples of what is going on.

For those who worry about “cross-crediting,” the example they worry about is foreign taxes on one basket of income offsetting U.S. income on completely unrelated “other” foreign source income. For those who think that the system properly permits “credit averaging,” the example is components of income from integrated cross-border businesses being sliced into pieces that make sense to tax collectors but not to businessmen. Income from operations in a multi-country undertaking, involving purchasing, manufacturing, selling, licensing and financing activities, is part of a whole. U.S. taxes are taxes on related income. Foreign taxes on the various pieces are taxes on related income.

It thus depends on the business model that is being tested. Are we testing a series of isolated unrelated items of income versus generally related items of income from a global business? If we tax a global business as it if it were a series of disjointed unrelated activities, the global business will be adversely affected for the wrong reasons. If we tax a series of disjointed unrelated activities as if they were part of a
The United States has not attempted to ensure that foreign income taxes not reduce U.S. income tax only on an income item-by-item basis. Instead, the foreign tax credit for foreign taxes paid or accrued in any year was originally allowed against U.S. income taxes otherwise due on income from foreign countries imposed its tax was “income” for U.S. tax purposes.

2. Per-Country Limitation

At various points, the United States has limited the relevant grouping of income and foreign income tax to components smaller than aggregate income from the entire world outside the United States. From 1932 until 1954, the United States limited the foreign tax credit to the lesser of the result under the general overall limitation for all foreign source income or from a single country (the “per-country limitation”). The alternate per country limitation limited the credit to U.S. income tax otherwise due on income from sources within the same country imposing the creditable foreign income tax. From 1954 to 1960, the per-country limitation was the sole method. From 1960 until 1975, the “per country” limitation was elective: the taxpayer could choose to apply either the overall limitation or the per country limitation. It was eliminated altogether in 1976 when the general overall limitation was made the exclusive limitation methodology. The Treasury proposed in 1984 and 1985 that the general limitation be entirely replaced by a per country limitation.

The JCT Options Report and the Panel Report did not suggest revisiting the per country limitation, perhaps because the role of the foreign tax credit would be greatly diminished under the partial territoriality systems proposed therein. Some economists have referred to it as a conceptually sound but complicated approach to tightening the relationship between the foreign tax credit and avoiding double taxation.

A per country limitation makes the most sense in a world in which international business is conducted on a country-by-country basis. In such a world, a German market is supplied by goods manufactured and sold in Germany, with limited cross-border purchases of materials or cross-border sales of finished products. The same model would be replicated, for example, in France, Italy, Spain, the United Kingdom, etc. In such a world, offsetting taxes paid or payable to Germany in respect of German manufacture and sale against U.S. income taxes on income from French manufacture and sale might be viewed as allowing the reduction of residual U.S. tax on French-source income by unrelated German taxes.

Even assuming there might ever have been a problem with cross-crediting German taxes against U.S. tax on French source income, the “unrelated” status of such French source income is for most U.S.-parented MNCs likely a thing of the rather distant past. The evolution of the European Union, the establishment of the Euro as a single currency in much of the European

1. Cross-Crediting and Its Origins

“Cross-crediting” is a term used to describe the use of foreign income tax on one item (or group of items) of foreign source income to reduce U.S. income tax on other items (or group of items) of foreign source income. The United States has not attempted to limit the allowance of a foreign tax credit against U.S. income tax only on an income item-by-item basis. Instead, the foreign tax credit for foreign taxes paid or accrued in any year was originally allowed against U.S. income taxes otherwise due in the same year or accrued in any year was originally allowed against U.S. income taxes otherwise due in the same year with respect to the same or any other income of the taxpayers, domestic or foreign. The basic limitation on this credit, effected by means of a limiting fraction introduced in 1921, was designed only to ensure that foreign income taxes not reduce U.S. income tax on U.S.-source income. In this original simple form, the limitation mechanism would not limit the credit for foreign tax so long as these was enough foreign source income of any kind to produce U.S. tax on foreign source income at least equal to the amount of foreign tax on all foreign source income. The limitation in 1918 was purely qualitative: a credit would be allowed so long as the foreign tax was an “income tax.” There was no requirement that the U.S. tax item subject to foreign tax be measured for foreign tax law purposes in imposing the tax in the same way income or time of recognition would be determined under U.S. concepts. The change in 1921 was quantitative: so long as the foreign income tax was an “income tax” the limitation would be applied to overall income but limited to U.S. tax otherwise due on overall foreign source income.

Thus, if in any year a U.S. taxpayer paid or accrued foreign income tax of 100, and if the applicable U.S. tax rate was 25 percent, it was only necessary that the U.S. taxpayer have aggregate foreign source income of 400. The tentative U.S. tax on that amount would be 100, and that tax could be reduced by the 100 of foreign income tax, whether or not the 100 of foreign income tax was imposed on items deemed to be domestic U.S. source or foreign source income, and indeed whether or not the base on which the foreign country imposed its tax was “income” for U.S. tax purposes.
Union, and the enormous change in communications infrastructure have already changed the business model for many U.S.-parented MNCs and for the foreign-parented MNCs with which they compete.

In the new economic model, goods are likely to be produced in locations that enjoy location advantages (other than exemption from border taxes and tariffs) from materials and components originating within or without the country of manufacturing (of the finished product) and destined for sale in yet other countries. At various stages in the economic process, different sovereigns may assert taxing jurisdiction over the taxpayer and its constituents and affiliates. The most common means to assert such jurisdiction would be by means of a determination that more of the income belongs to the unit subject to a particular sovereign’s taxing jurisdiction, and less to a related or unrelated party not as easily taxable. In addition, a taxing jurisdiction may seek to assert taxing jurisdiction over foreign affiliates of a legal entity subject to taxing jurisdiction by asserting that the local unit is a taxable permanent establishment of the otherwise nontaxable foreign taxpayer.

In such a world, preventing cross-crediting of compound foreign taxes on one or more pieces of the income of a global business will result in allowing a credit for less than all the foreign taxes on the same or closely related items of income from an integrated business. The tension between allowing a cross-credit for foreign taxes on unrelated items of foreign source income, and denying a credit for all the taxes imposed by all sovereigns who take a bite out of the same apple is not easily resolved.

Under a tax policy that pursues elimination of abuses at all costs, the tension is likely to be resolved by preventing cross-crediting. Under a tax policy that pursues a goal of avoiding double taxation of business income of U.S.-parented MNCs, the tension is likely to be resolved by allowing cross-crediting.

The devolution of nations into smaller tax units which have simultaneously joined larger free trade blocs further reinforces the notion that cross-crediting makes more sense, on balance, than either a per country limitation or a per item per country limitation. Taxes formerly imposed by Czechoslovakia are now imposed by two countries and the same is true of various other “national” constituents of the European Union (the former Yugoslavia is now at least four countries including the newer Serbian Yugoslavia, Slovenia, Croatia, etc., some of which are in the EU, some not).

The current “problem” category for those who worry about cross-crediting is largely related to royalties for U.S.-origin intangible property. That problem can be addressed without a wholesale overhaul of the foreign tax credit.

3. 1986 Act “Basketing”

In 1986, a comprehensive structure to limit “cross-crediting” was introduced as a replacement for the prior law general limitation approach. Under this new regime, foreign business income was segregated from foreign “passive” income, financial services income was segregated from other forms of foreign business income, and foreign business income from corporate joint ventures (“10/50 companies”) was separated from all other foreign business income. Each 10/50 company was in its own “basket,” thus approaching elements of an item-by-item limitation where income from each joint venture was an “item.”

The reasons offered by the Congress in 1986 for its introduction of the anti–cross-crediting measures remain “of interest” in the present analysis. There are two basic reasons for the 1986 Act basketing regime, one theoretical and one practical. The theoretical reason is that the United States should not forego tax on otherwise low-taxed income derived from foreign direct investment by corporations subject to worldwide tax. By permitting the combination of high-taxed and low-taxed foreign income, the attractiveness of investments in low-tax countries may be enhanced vis-à-vis alternative investments in the United States, the income from which cannot be subject to reduced U.S. tax because of excess credits attributable to operations in high-tax countries. The more practical reason, and the one given by Congress at the time, is that segregating high and low foreign tax pools raises tax revenue.

A prominent feature of the dividend-exemption territorial regimes discussed below is the effective elimination of cross-crediting of foreign income taxes on what would become, in the new system, exempt Foreign Business Income, against other, likely lower taxed, items of foreign business income (such as foreign base company sales income and foreign base company services income). Indeed, the tax increase associated with implementation of the JCT Options Report version of territoriality, $54.8 billion for the nine years 2006–2014, is attributable in some significant part to the denial of present-law benefits of cross crediting excess foreign corporate income tax on business income of foreign subsidiaries against
U.S. income tax otherwise collectible with respect to income from royalties and other low-tax foreign source income items.\textsuperscript{264}

4. Problems Associated with “Cross-Crediting”

The problems associated with cross-crediting, according to critics of cross-crediting, include:

- Cross-crediting permits excess foreign tax credits to be used to reduce U.S. income tax that might otherwise be collected with respect to low-taxed foreign source income.\textsuperscript{265}
- Cross-crediting provides taxpayers who have excess foreign tax credits with an incentive at the margin to place new investments abroad rather than in the United States, when the income that such new investments will generate abroad will be taxed abroad at rates lower than the U.S. rate and the excess foreign tax credits from other activities (past or present) will be available to reduce or eliminate U.S. tax otherwise due on such low-taxed foreign income. This would create an incentive to choose foreign over domestic investment.\textsuperscript{266}
- Cross-crediting has the unintended effect of reducing the pressure on foreign countries to reduce their tax rates.\textsuperscript{267}
- A similar thesis is that cross-crediting results in a subsidy by the U.S. fisc of foreign high-tax jurisdictions to the extent of the foregone U.S. tax that would otherwise be collected with respect to low-taxed foreign source income.\textsuperscript{268}
- Cross-crediting is broader relief than is necessary to achieve the stated goal of the foreign tax credit, which is the elimination of double taxation of the same income.\textsuperscript{269}

5. In Defense of Cross-Crediting (Credit-Averaging)

The principal argument in favor of allowing cross-crediting is that the overall limitation, with cross-crediting within the same general business income basket, is consistent with the integrated nature of U.S. multinational operations abroad.\textsuperscript{270} Segregating components of multi-jurisdictional business operations into components based on the general imposition of foreign tax or the general deductibility of expenses under foreign law would encourage tax-driven distortions of business decisions and activities.

In addition, measures to prevent cross-crediting introduce great complexity. It becomes necessary to draw lines between items of income that are not segregated for non-tax purposes (e.g., currency gains and losses in respect of receivables for sales income from sales by affiliated buyers/resellers within and without their country of incorporation versus such gains and losses in respect of receivables associated with in-country sales). In addition, making appropriate allocations of expense to the favored or disfavored groups of income is complicated.

6. Illustration of Cross-Crediting and Expense Allocation

The operation of the limiting fraction, and of cross-crediting, is probably best explained by using simple numerical examples. Taxable income and creditable foreign tax are measured under conventional U.S. recognition rules. Income of foreign corporations is not taxed to their U.S. shareholders until distributed, (or until taken into account by the U.S. shareholder under the anti-deferral rules of subpart F). Foreign taxes are taken into account when the U.S. taxpayer pays or accrues liability for the foreign tax. A U.S. corporate taxpayer is deemed to have paid any foreign income tax paid by its foreign affiliates (>10% ownership) as and when the U.S. shareholder is treated as receiving a dividend from the foreign affiliate. A similar deemed payment of foreign taxes occurs when the U.S. corporate taxpayer includes its pro rata share of the undistributed income of the foreign affiliate under one of the anti-deferral provisions, to the extent of foreign income taxes paid by the foreign affiliate.

The basic system is sometimes referred to as being based in large part on the principle of “capital export neutrality.” Capital export neutrality is achieved when income tax imposed on income from deployment of direct investment capital will not affect the location decision for the productive activity that will use the capital. A “pure” capital export neutrality system would impose current income taxation on all income derived from business activities anywhere in the world, including income derived by foreign affiliates but not yet distributed to the U.S. shareholder, current recognition of all losses from all such activities, and a credit against U.S. income tax for all foreign income taxes imposed on any such activities (domestic or foreign). More specifically, a “pure” capital export neutrality regime would allow a full credit for foreign income taxes in excess of the effective rate of U.S. income tax on such foreign source income. The economic effect of allowing an unlimited foreign
The foreign tax credit would be to allow foreign tax to offset U.S. federal income tax on U.S.-source income. Similarly, allowing foreign losses to offset otherwise taxable worldwide income can result in the reduction of U.S. income tax otherwise due on U.S. source income.

The federal income tax applied more-or-less pure capital export neutrality for two years at the dawn of the modern income tax (1918 to 1921) although income of foreign affiliates was not taxable to the U.S. shareholder until dividends were received. In 1921, a limitation system was put in place, the effect of which was to prevent foreign income taxes from offsetting U.S. taxes on domestic income.

The United States has consistently rejected a “per item” approach to implementing capital export neutrality. Under a per item approach, only the foreign income tax on a particular item of income could offset U.S. income tax on the same item (determined under U.S. tax rules concerning what the relevant “item” might be). To the extent U.S. tax on an item or items of foreign income is offset by foreign income tax on other items, the effect is characterized as “cross-crediting.”

An item of income that has been subject to a rate of foreign income tax greater than the effective rate of U.S. tax due on that item will be taxed at a lower overall combined effective rate (U.S. plus foreign) on that item if the “excess” foreign tax credit can offset U.S. tax otherwise due on another item of foreign source income that has either been subject to foreign income tax at a rate lower than the U.S. tax otherwise due with respect to that item or even subject to no foreign tax at all. Such an effect is referred to, apparently pejoratively, in the Panel Report.²⁷¹

The foreign tax credit is calculated on the basis of year-by-year snapshots. Taxes are associated annually with categories or baskets of income to which they are deemed to be related under U.S. tax principles. Expenses are also allocated annually to a category or basket (rather than a particular item) of income realized or expected to be realized in the future. Expenses so allocated to a category or basket reduce the numerator of the limiting fraction for the total amount of U.S. tax on worldwide income that can be reduced by foreign taxes attributed to that category. The limiting fraction, in simple terms is:

\[
\text{U.S. Tax Otherwise Due On Worldwide Income} \times \frac{\text{Foreign Source Income}}{\text{Worldwide Income}}
\]

The economic effect of allocating an item of expense against the numerator of the limiting fraction (“Foreign Source Income”) can be the equivalent of denying a deduction for that item for federal income tax purposes. For example, if the U.S. tax rate is 35 percent and the foreign tax rate is 35 percent, and if a corporate taxpayer has worldwide income of 200, foreign source income of 100 and domestic source income of 100, there would be, in theory, a total worldwide tax burden of 70, consisting of 35 U.S. corporate income tax on domestic source income and 35 foreign income tax on foreign source income.

### U.S. Taxpayers Subject to Tax on Worldwide Income

![U.S. Tax Otherwise Due]

<table>
<thead>
<tr>
<th>U.S. Source</th>
<th>150</th>
</tr>
</thead>
<tbody>
<tr>
<td>Expenses</td>
<td>&lt;50</td>
</tr>
<tr>
<td>Net</td>
<td>100</td>
</tr>
<tr>
<td>Foreign Source</td>
<td>120</td>
</tr>
<tr>
<td>Expenses</td>
<td>&lt;20</td>
</tr>
<tr>
<td>Net</td>
<td>100</td>
</tr>
<tr>
<td>200</td>
<td></td>
</tr>
</tbody>
</table>

`U.S. Tax @ 35% x 200 = 70`

The application of the limiting fraction would, in simple terms, be to limit the total creditable amount of all foreign income taxes to 35:
If the U.S. “sees” foreign source income differently than the foreign taxing jurisdiction, by, for example, allocating against foreign source income 10 of the 50 units of interest expense initially treated as U.S. expenses, the aggregate U.S. tax “otherwise due” would remain at 70, but the maximum amount thereof that could be offset would be reduced from 35 to 31.50: “fundamental” alternatives. The territorial systems go directly to deduction disallowance rather than depend on the indirect effect of generating an incremental unit of noncreditable foreign tax by means of allocating deductible expenses against the numerator of the limiting fraction. The direct disallowance approach will affect two kinds of taxpayers who are presently unaffected by the foreign tax credit limiting fraction:

1. Taxpayers with sufficient excess limitation that the reduction of the numerator does not limit the amount of U.S. tax that can be offset.

2. Taxpayers that have so little limitation that no foreign tax credit is taken because income with associated foreign tax credits is avoided (“deep excess credit taxpayers”).

Cross-crediting enables some, but not all taxpayers, to avoid the effect of allocating expenses against the numerator of the limiting fraction. There are several kinds

---

**Table:**

<table>
<thead>
<tr>
<th>U.S. Otherwise Due</th>
<th>Times</th>
<th>Foreign Source Income</th>
</tr>
</thead>
<tbody>
<tr>
<td>70</td>
<td></td>
<td>100</td>
</tr>
<tr>
<td><strong>Limitation:</strong> 35</td>
<td><strong>Foreign Tax Credit:</strong> (35)</td>
<td></td>
</tr>
<tr>
<td><strong>U.S. Tax Due:</strong> 35</td>
<td></td>
<td><strong>Worldwide Income 200</strong></td>
</tr>
</tbody>
</table>

**Calculation:**

\[
70 \times 100 = 35
\]

\[
\frac{200}{70} = 31.5
\]

---

**Table:**

<table>
<thead>
<tr>
<th>U.S. Otherwise Due</th>
<th>Times</th>
<th>Foreign Source Income</th>
</tr>
</thead>
<tbody>
<tr>
<td>70</td>
<td></td>
<td>90</td>
</tr>
<tr>
<td><strong>Limitation:</strong> 31.5</td>
<td><strong>Foreign Tax Credit:</strong> (31.5)</td>
<td></td>
</tr>
<tr>
<td><strong>U.S. Tax Due:</strong> 35.0</td>
<td></td>
<td><strong>Worldwide Income 200</strong></td>
</tr>
</tbody>
</table>

**Calculation:**

\[
70 \times 90 = 35
\]

\[
\frac{200}{70} = 31.5
\]
Tax Reform: International Tax Issues and Some Proposals

of transactions and structures that can provide “excess limitation,” and that can be managed to do so.

Excess limitation arises when a taxpayer has foreign source income subject to an effective rate of foreign income tax lower than the U.S. rate. Such excess limitation may arise from four basic sources of foreign source income recognized for U.S. tax purposes that are, from a U.S. standpoint, subject to low or no foreign income tax at the time they are included:

- **Export sales from the United States.** The foreign source income from exports may be based on passage of title and risk of loss in a foreign country in situations in which the U.S. taxpayer has insufficient nexus with the destination country to attract foreign income tax under foreign law. Present law further applies an arbitrary apportionment to determine the U.S.-source component and the foreign source component of goods manufactured in the United States and exported to a foreign destination.

- **Foreign source royalties and interest.** Royalties are sourced entirely in the country of use of intangible property such as patents, trademarks, copyrights and know-how. Unlike tangible property, no amount is treated as U.S.-source based on the fair market value on date of export. Royalties are generally deductible under the laws of many countries and often subject to exemption from source country tax under domestic law or by operation of a bilateral treaty to which the source country is a party.

Interest is sourced in the country of the obligor (subject to certain look-through exception rules that will “re-source” to domestic sources interest in some circumstances in which the obligor derives U.S. source income from which the interest is treated as paid). Interest is generally deductible under the laws of many countries and often subject to exemption from source country tax under domestic law or by operation of a bilateral treaty to which the source country is a party.

- **Base Erosion of High Tax Country Business Profits.**
  
  (a) Base Case. The effective tax rate on foreign source income in foreign countries may be reduced by various “base erosion” transactions. As noted above, royalties and interest are typical examples. Such base erosion may also occur via transfer pricing that effectively decreases the foreign tax base while increasing the amount of U.S.-source income from sales of goods, services or intangible property to an affiliate in a high-tax country.

  (b) Cross-Border Arbitrage. The effective tax rate may also be reduced by transactions that are treated as deductible payments in the country of source (thus reducing the foreign tax base) but as a non-taxable event for U.S. tax purposes. Examples range from circular cash flows described in IRS rulings (e.g., Rev. Rul. 80-154, 1980-1 CB 68) (favorable to the taxpayer) to transactions that depend on hybridity of either instruments or entities, e.g., the “hybrid branch” transactions described in Notice 98-11, 1998-1 CB 433) (unfavorable to the taxpayer). The end result is that the net business profits in a nominally high-tax jurisdiction may be subject to a lower rate of tax than the nominal rate without a corresponding inclusion of income for U.S. tax purposes. When taken into account, such lower taxed foreign source income may then be available to increase the aggregate limitation of the amount of U.S. income tax that can be reduced by other foreign income taxes taken into account when the lower-taxed foreign business profits are taken into account.

(2) **Tax Haven (Base Country) Transactions.** Income from business operations in a high-tax country can be reduced by the same base erosion transactions described above, but effected by means of transactions between two or more foreign subsidiaries or affiliates. This is the general subject matter of subpart F.

(a) Cross-Crediting in the General Basket: Foreign Base Company Sales or Services Income. Related party transactions between an affiliate in a low-tax country and an affiliate in a high-tax country will reduce overall foreign tax to the extent of profits allocable to the economic contribution of the low-tax country affiliate. Some categories of income are particularly “mobile” in the sense that they can be derived by a corporation in a low-tax jurisdiction based on minimal activities in that country. Among
the most important items of income in this category are “foreign base company sales income” and “foreign base company services income.” When such income of the low-tax affiliate (“base company”) is taken into account by the U.S. corporate taxpayer, it will typically be low-taxed or even non-taxed foreign source income for purposes of the foreign tax credit limitation calculation in the year of inclusion in the U.S. shareholder’s taxable income.

(b) Cross-Crediting in the General Basket: Related Party Foreign Personal Holding Company Income. Payments of related party interest and royalties from a high-tax country affiliate to a low-tax country affiliate will reduce the effective rate on the overall profits of the business enterprise by the amount of tax reduction in the high-tax country that is not taxed at a comparably high rate in the lending or licensing affiliate’s country. Such items are typically referred to as “foreign personal holding company income.” When taken into account by the U.S. shareholder of the low-tax country lending or licensing affiliate, the income will typically be low-taxed or even non-taxed foreign source income for purposes of the foreign tax credit limitation calculation in the year of inclusion in the U.S. shareholder’s taxable income.

(c) Disregarded Entity/ Disregarded Transactions. Excess limitation can be increased, or excess foreign tax credits decreased, by reducing the amount of foreign tax imposed on foreign subsidiary income by means of “transactions” that exist for foreign tax law purposes, but are deemed not to exist for U.S. tax purposes. The “check-the-box” regulations, are the primary U.S. tax underpinning of such transactions, although not the only source of “international tax arbitrage.” For example, differences in treatment of debt and equity under different tax systems have been the subject of regular re-examination for many decades. This issue is also discussed below as a feature of the concern expressed by some commentators about the “race to the bottom” Part II.I. (Tax Competition Between Countries and the Race to the Bottom: What Role Should U.S. Tax Play in Backstopping the Tax Systems of Foreign Countries?).

(d) Separating Foreign Source Income (U.S. Law) from Foreign Income Tax (Foreign Law). Such excess limitation can also arise from transactions entered into in order to separate, under U.S. tax rules, the foreign income from the foreign tax to which it has been subjected under foreign law. For example, two controlled foreign corporations may establish a partnership to conduct business through lower-tier companies and may seek to allocate the foreign taxes to one controlled foreign corporation partner while allocating the income to another. The income of the controlled foreign corporation to which the income has been allocated, with only a reduced allocation of foreign taxes, would then be available as low-taxed foreign source income when taken into account by the U.S. shareholder.

The quantitative implications of increased “limitation” (low-taxed or nontaxed foreign source income) can be illustrated by the same example used for the “normal” case. Assume, before adding the incremental low-taxed foreign source income, that the taxpayer has U.S. source income of 110, foreign high-taxed income of 90 (both after the expense reallocation in the previous example) and an opportunity to generate foreign low-taxed income of 10 (perhaps royalties that are exempt under a bilateral tax treaty from source-country withholding tax). Such low-taxed royalties, in our over simplified example, would come from replacing 10 of U.S. source income.

Before expense reallocation to reduce the numerator, the taxpayer would have domestic income of 100 and foreign source income of 100.

<table>
<thead>
<tr>
<th>U.S. TAX OTHERWISE DUE</th>
<th>GROSS INCOME</th>
<th>NET</th>
</tr>
</thead>
<tbody>
<tr>
<td>U.S. Source:</td>
<td>50</td>
<td></td>
</tr>
<tr>
<td>Expenses:</td>
<td>&lt;50&gt;</td>
<td>100</td>
</tr>
<tr>
<td>Net:</td>
<td>100</td>
<td>100</td>
</tr>
</tbody>
</table>

High Taxed

<table>
<thead>
<tr>
<th>Foreign Source:</th>
<th>120</th>
</tr>
</thead>
<tbody>
<tr>
<td>Expenses:</td>
<td>&lt;20&gt;</td>
</tr>
<tr>
<td>Net:</td>
<td>100</td>
</tr>
</tbody>
</table>

U.S. Tax @ 35% x 200 = 70
As before, the limiting fraction will initially limit the total amount of U.S. tax that can be offset by foreign tax to 35.

\[
\text{U.S. Tax Otherwise Due: } 70 \quad \text{Times} \quad \text{Foreign Source Income 100} \\
\frac{70 \times 100 = 35}{200} \quad \text{Worldwide Income 200}
\]

Again, if we allocate 10 units of expense away from domestic U.S. source income to foreign source income, total creditable tax will be reduced from 35 to 31.5 \((i.e., 35\text{ percent of the 10 units}).

\[
\text{U.S. Tax Otherwise Due: } 70 \quad \text{Times} \quad \text{Foreign Source Income 90} \\
\frac{70 \times 90 = 31.5}{200} \quad \text{Worldwide Income 200}
\]

In response, the U.S. taxpayers may redeploy assets previously generating U.S. source income (or high taxed foreign source income) to generate low-taxed foreign source income, such as related party interest or royalties. We have assumed a change of 10 units of domestic source income to 10 units of low-taxed foreign source income:

\[
\begin{array}{c|c|c}
\text{U.S. TAX OTHERWISE DUE} & \text{GROSS INCOME} & \text{NET} \\
\hline
\text{U.S. Source:} & 150 & \text{<40>} \\
\text{Expenses:} & <40> & 110 \\
\text{Net:} & 110 & 110 \\
\hline
\text{High Taxed Foreign Source:} & 120 & \text{<30>} \\
\text{Expenses:} & <30> & 90 \\
\text{Net:} & 90 & 90 \\
\hline
\end{array}
\]

\[
\text{U.S. Tax } 35\% \times 200 = 70
\]

The net effect is that the reallocation of expenses, away from domestic income, to foreign source income has not had any economic impact for the taxpayer that has generated low-taxed or nontaxed foreign source income. Two otherwise identical taxpayers, vis-à-vis the high-taxed foreign income-producing activities, may have quite different tax consequences with respect to the significance of incurring foreign income tax on the same items of high-taxed foreign income depending upon what may be wholly unrelated income from unrelated business activities. Conversely, the appeal of an investment to produce low-taxed foreign source income is greater for a taxpayer with excess credits than for a taxpayer that, sooner or later, will pay full U.S. tax on low-taxed foreign income without the benefit of the cross-credit. In addition, the disparate U.S. tax treatment may stimulate various activities by taxpayers to reduce foreign income tax or to generate additional foreign source income limitation. As with beauty, the perception of the significance of such stimuli seems to be in the eye of the beholder.

A taxpayer may also be insulated from the “intended” economic consequence of allocating expenses against the numerator of the limiting fraction (foreign source income) if the taxpayer already has a zero limitation. Such a limitation can arise, for example,
when a taxpayer suffers overall foreign losses. The “worldwide” system only operates with respect to income currently taxable to the U.S. taxpayer. Foreign source income derived by foreign corporations, including subsidiaries of a U.S. taxpayer, is not taxable until distributed or included under various anti-deferral provisions such as subpart F. If a taxpayer does not claim a foreign tax credit, the expenses incurred to produce foreign income are currently deductible against U.S. taxable income even if no income is derived in the current year from the foreign investments. At some point it is assumed that there will be foreign income from the investment that generates deductible expenses, but, in the short run, the foreign tax credit limitation has no impact. If the short run is long enough, some commentators characterize the deferred income inclusion as the equivalent of an exemption. A direct disallowance of a deduction in this situation is preferable under matching principle concepts to an indirect disallowance via an inoperative foreign tax credit limitation.

7. Cross-Crediting and Insulation Against “Proper” Consequences of Doing Business in High-Tax Countries

In addition to the ameliorating effect of cross-crediting on the treatment of expenses allocable to foreign income, cross-crediting may also affect the impact of high foreign taxes generally on location decisions for direct investment by a U.S.-parented MNC. If a particular foreign country imposes tax at, say 50 percent instead of the assumed U.S. effective rate of 35 percent, the relative attractiveness of the high-tax country as an investment destination for U.S. direct investment capital compared to a domestic U.S. investment, may be enhanced if the discouraging effect of “excess” foreign taxes can be ameliorated or eliminated by generating additional low-taxed foreign source income instead of additional U.S. income that will be fully taxed without potential for reduction by excess foreign tax credits. Opponents of cross-crediting tend to concentrate on high effective tax rates in foreign countries. Proponents of cross-crediting tend to focus on the double taxation aspects that appear when the United States allocates against foreign source income expense items that are not deductible in the host country (shareholder interest expense, general and administrative expense, and similar items).

8. Effect of Source Rules on Cross-Crediting

The United States uses source rules to describe the classes of income subject to U.S. corporate income tax when derived by nonresident aliens and foreign corporations. It uses the same rules, with various specific modifications, for determining the contours of an appropriate group of income items within which to permit cross-crediting. Two items of “foreign source income” that deserve special consideration in this review are income from the export sale of tangible property treated as inventory and income from royalties for the use of intangible property outside the United States.

a. Export Sales. The source rules are complicated by their dual function: (1) describing the boundaries for the assertion of U.S. taxing jurisdiction over the income of foreign persons (both corporate and individual), and (2) describing the items or groups of income that are, or are not, appropriate for conceding primary taxing jurisdiction to another country. The latter function is achieved by permitting a foreign tax credit against U.S. tax on what the United States determines to be “foreign source” in the same category. Thus, a foreign tax credit will not be allowed for foreign taxes on U.S. source income, unless there is other foreign source income in the same category.

The United States has determined that, for U.S. federal income tax purposes, the source of income from the sale of tangible personal property should generally be at the residence of the seller of the property. This general rule was enacted as part of the Tax Reform Act of 1986. Prior to that enactment, U.S. tax law had generally treated the source of income from the purchase and resale of both tangible and intangible property to be the location where the sale occurred. The place where the sale of tangible property “occurred” was determined, under U.S. tax law, based on the place where the tangible property was located when title and risk of loss passed from the seller to the purchaser.

The “passage of title” test was occasionally challenged by the IRS. Although the policy reasons for such taxpayer-specific challenges were not discussed at length in the leading cases that effectively established the passage-of-title test as dispositive, one aspect is particularly relevant in examining cross-crediting: Passage of title alone is almost never a sufficient nexus with the destination country to attract income tax under the laws of the destination country.

Indeed, quite to the contrary, under all the bilateral treaties to which the United States is a party, mere
passage of title to goods located in the destination country is not enough to support destination country taxation of the seller on the sales profit. The mere passage of title, without the presence in the destination country of an office or fixed place of business, or employees, or agents that have and habitually exercise the power to contract on behalf of the foreign seller, is not a “permanent establishment.” Business income of the residents of one country is not taxable by the other (source or destination) country under such treaties unless such income is attributable to a permanent establishment of the resident in that other country.

Under most or all of the U.S. tax treaties with the countries to which a large proportion of U.S. exports are shipped, therefore, the imposition of foreign income tax is prohibited by agreement with the United States. If the relevant “item” of income to be protected against double taxation is merely the sales profit on a particular sale of a particular item of property, such item, under the usual treaty provisions, is not subject to “double” taxation by the residence country and the destination country. As a matter of U.S. domestic tax law, such item of income is treated as having its source in the destination country notwithstanding the typical treaty prohibition on the imposition of source country income tax on that income. If the aggregate activity giving rise to the item of sales income is combined with income from domestic or foreign situs activities related to the total global economy, the combination of the “item” of export sales property with other foreign related income is a sensible way to avoid double taxation on the total pool of income from foreign-related activities.

Congress from time to time before 1986 addressed various aspects of the operation and consequences of the source rules for personal property sales. In 1986, Congress undertook a comprehensive review and adopted a “reform” of the prior source rules. As a general matter, the new regime was intended to provide source rules for defining taxing jurisdiction that looked to “the location of the economic activity generating the income, taking into account the jurisdiction in which those activities are performed.” In its explanation of the underlying policy, the Staff of the Joint Committee on Taxation stated:

Congress noted that the foreign tax credit mechanism was originally established to eliminate double taxation of the same income by the United States and foreign countries. Congress did not believe the potential for double taxation existed where income had little likelihood of attracting foreign tax. With the above in mind, Congress modified prior law’s source of income rules to ensure that the United States will assert proper tax jurisdiction over the activities of foreign persons and, with respect to U.S. persons, will treat as foreign source income only that income which is generated within a foreign country which is likely to be subject to foreign tax.

This guiding principle restricting cross-crediting generally to income “which is likely to be subject to a foreign tax,” is used in various contexts to test income for purposes of eligibility for exemption (under territorial approaches), deferral versus current inclusion (under subpart F) and application of treaties to various kinds of income from transactions that might result in double “nontaxation.” When establishing the principle in 1986, however, Congress decided not to apply the rule at the level of specific items of income from export sales of inventory property. New Code Sec. 865(b) was included in order to preserve the ability to cross-credit foreign income taxes imposed on other foreign source income. This was a convenient drafting approach to preserve a broader aggregation of foreign-related income, the overall corporate income tax on which could be offset by foreign income taxes on various constituent pieces of the overall pool.

Congress explained its actions in words that may have continuing persuasiveness:

Congress recognized that prior law’s source rules from sales of personal property sometimes allowed U.S. taxpayers to freely generate foreign income subject to little or no foreign tax, but was concerned that its repeal for sales of inventory property would create difficulties for U.S. businesses competing in international commerce. Moreover, with the substantial trade deficits of the United States, Congress did not want to impose any obstacles that might exacerbate the problems of U.S. competitiveness abroad.

As sometimes occurs when Congress is unsure about the desirability of an action it is either taking or foregoing, or the durability of the consensus achieved to enact a provision, Congress also directed the Treasury to conduct a study and to report to Congress the results thereof. Again, the terms of the mandate for the Trea-
sury study may still be pertinent today in the effort to strike the correct tax policy balance between the core tax purpose of the foreign tax credit (avoiding international double taxation) and the impact of tax rules on U.S. trade. The Treasury rendered its mandated report in 1993. In that report the Treasury concluded that the stimulative effect of the passage-of-title test on exports would likely be offset by increased imports (an assertion that did not purport to be premised on empirically observed data). In addition, the Report stated that it was not really possible to state the effect of the export incentive (apart from the theoretical balancing by imports and currency rate adjustment) because it was not possible to measure how much of the tax benefit was reflected in price reductions to export customers.

In response to, or perhaps notwithstanding the Treasury report, no change has been made since 1986 in the source rules for export sales income.

b. Royalties. The treatment of royalties as having a source entirely within the country of use of the licensed item of intangible personal property is asymmetrical with the sourcing of income from the sale of tangible personal property that may have a value based on the same property.

As discussed above, income from the sale of inventory tangible personal property is subject to a special source rule based on location of the tangible inventory asset when title and risk of loss pass to the buyer. If the inventory has been purchased and resold, the resale profit may be entirely foreign source. The amount of income attributable to such purchase and resale will be limited to the difference between the arm’s-length price paid to the manufacturer and the arm’s-length price paid to the foreign purchaser. The amount of income conceptually attributable to the value of the U.S. manufacturing function (that is embedded in the manufacturer’s sales price to its first customer) remains U.S.-source, and the U.S. income tax otherwise due on manufacturing income cannot be reduced by a foreign tax credit for foreign income taxes on other foreign source income.

If there is a direct export sale by the manufacturer, there is an arbitrary division of the gross income from the sale provided under Code Sec. 863(b): 50 percent is treated as arising in the United States (presumably the value of the manufacturing input) and 50 percent is characterized as foreign source (presumably the value ascribed to the foreign source sales component). The arbitrary rule may be viewed as a surrogate for applying an arm’s-length allocation between the value of the domestic inputs to the manufacture of inventory and the sale thereof. The surrogate approach may be justified as a rule of convenience rather than constituting an intentional subsidy.

Thus, when there is no foreign nexus other than passage of title, there is in such cases at least some taxable income attributed to the value of the U.S. input. A somewhat similar rule pertains to interest on loans. In the case of loans, interest income is sourced in the country of the borrower. The amount received by the lender attributable to repayment of principal is not treated as income. However, if such loan arose from a taxable transaction, the income from that transaction would be sourced separately from the determination of the source of the interest. Thus, only the value (interest) in excess of the export value of the money (principal) generates foreign source income based on the characteristics of the borrower (rather than the source of the economic activities giving rise to the income embodied in the principal).

In the case of royalties for the use of intangible property, however, the entire amount of the royalties is treated as having a source in the country of use of the licensed property. In comparison with a sale, for example, the value of the U.S. production inputs to the intangible property is not treated as U.S. source income while the same inputs to the production of tangible property would give rise to some U.S. source income. Indeed, to the extent the income recognized on the export sale of tangible personal property includes intangible property, all of the income will be sourced under the rules applicable to tangible

Are we testing a series of isolated unrelated items of income versus generally related items of income from a global business? If we tax a global business as if it were a series of disjointed unrelated activities, the global business will be adversely affected for the wrong reasons. If we tax a series of disjointed unrelated activities as if they were part of a global business, some undeserving U.S. MNC will get away with something. Which is it to be?
personal property. This asymmetry might affect the means selected by a taxpayer to exploit the value of intangible personal property.

In comparison with interest on a loan, the component of the royalty that corresponds to recovery of the “principal” (and any income comprised therein) is sourced in the country of use of the intangible property.

Royalties resemble export sales foreign source income in that they often have borne little or no foreign income tax. Like foreign source income from the sales of goods to a country in which the taxpayer has no “permanent establishment,” royalty income often benefits from an exclusion of foreign income tax pursuant to a bilateral income tax convention with the United States. Thus, if the “item” of income is viewed in isolation from the other components of a taxpayer’s activities in the global economy, the royalty item is unlikely to incur double taxation (other than withholding taxes in some countries). If the royalty income is viewed in the context of the overall activities in the global economy, however, it is generally sensible to include foreign-related royalties in the overall pool of foreign-related income. In other words, “source” is not a sacred word; it is only a tool to identify items of income that share some nexus to business income derived from participation in the global economy and that are properly aggregated for purposes of expense matching and foreign tax credit limitations.

Expenses incurred to produce the licensed intangible property are allocable against the foreign source royalties under a formula designed to reduce the gross foreign source royalty by the amount of research and development expense incurred to produce such or similar intangible property. After such allocation, however, all of the net income is treated as foreign source income. No amount of the “profit” associated with the value of the intangible property at the time of export will be treated as U.S. source. Excess foreign tax credits can then offset any U.S. tax otherwise due on such profit. It might be argued that such cross-credit has the potential to stimulate foreign exploitation of intangible property if the resulting foreign source income is subject to a lower combined rate of U.S. and foreign tax (because of cross-crediting) than domestic-source royalties that are fully taxable without the benefit of cross-crediting. The possibility does not seem to have been empirically confirmed and may instead be only a theoretical possibility in speculating on the effect of marginal tax rate differences on location decisions concerning where to exploit assets.

For many years, Congress has sought to establish the balance it prefers between (1) the general tax policy of matching expenses to the income generated (or expected to be generated) by the activities to which such expenses relate, and (2) the assumed or anticipated impact on U.S. research of any reduction in the ability to cross-credit foreign income taxes on other foreign source income against the U.S. income taxes potentially due with respect to such royalty income.

The productive activities underlying the creation of intangible property may be more mobile than the underlying activities for the manufacture of tangible personal property. In addition, many producers of intangible personal property may not have a significant amount of excess foreign tax credit. A sizeable group of producers of intangible property may effectively forego or reduce the current deduction of costs incurred to produce intangible property, in return for enjoying the benefits of “ownership” of the resulting intangible property being vested in a foreign affiliate. For such taxpayers, cross-crediting may not be an economically efficient means to reduce U.S. income tax on the income realized as a result of the successful development and exploitation of intangible personal property. For them, deferral (or territorial exemption) for income in excess of the financial rate of return on foregone expense deductions may be the best option.

In deciding whether or not to eliminate cross-crediting against income from foreign use of intangible property it must be determined whether the elimination of cross crediting will lead to modification of taxpayer behavior in a way that will be inconsistent with the various periodic determinations by Congress that U.S.-based research activities should either benefit from tax incentives or at least not be taxed less favorably then would be the case of the same activity were to be conducted outside the United States.

Only a subset of all intangible property producers is affected by the benefits (or lack of benefits) of cross-crediting. Taxpayers who do not perceive a sufficient benefit (or any benefit) from cross-crediting have an incentive to place income from exploitation of intangible property in low-taxed foreign subsidiaries. One way of doing so is for the U.S.-parented MNC to engage in a joint undertaking with its foreign subsidiaries to develop future intangible property. As discussed below, the price of doing so, for the U.S. affiliate conducting research and development, under present law is to forego a current U.S. federal income tax deduction for the portion of research expenditures
that is offset by reimbursement “cost sharing” payments received from foreign affiliates. Such foreign affiliates bear the risk of unsuccessful research to the extent of their cost sharing payments.

If the IRS vigorously applies the newly issued temporary cost sharing regulations, to increase the amount of income attributable to the U.S. members of the research and development “joint venture,” some intangible property producers have suggested that they may modify their behavior to retain the deferral benefit for the profit component associated with research and development. The current benefit is achieved in significant part by having an affiliate in a low tax jurisdiction bear risk associated with underwriting some portion of the research and development costs for U.S.-based research and development. If the allocation of income attributable just to risk is changed to emphasize a premium value associated with the actual value of the U.S.-based workforce doing the research, it is possible that some significant portion of the intangible property producers will modify their behavior in order to minimize properly avoidable tax. There would be a tax incentive (of uncertain importance compared to trained workforce, legal and practical security of crown jewel intellectual property, etc.) to relocate the high value research and development (R&D) workforce to a low-tax jurisdiction in order to sustain a substantial allocation of income to the activities of that valuable workforce, rather than rely only upon risk of ownership as the arm’s-length factor to support income allocations. Skeptics assume that assertions of this incentive may be merely empty threats and taxpayer exaggerated rhetoric. For purposes of evaluating the benefits of cross-crediting, the practices of those who do not now rely on cross-crediting may be informative. They are regular participants in “cost sharing” agreements to co-develop valuable intangible property within a group of related parties, some foreign, some domestic.

By eliminating cross-crediting for the taxpayers who do not now utilize deferral (at the price of foregone deductions), and who rely on cross-crediting to reduce the tax burden on royalty-based compensation for U.S.-situs research and development, there will be a U.S. tax incentive to modify behavior to mimic the behavior of those taxpayers who rely on the cost-sharing approach (forego current deduction in favor of capturing deferral benefits for deferred profit on the investment of nondeductible expenses of research and development activity). In other words, elimination of cross-crediting is likely to increase the incentives for recipients of related party royalties to change their behavior: by eliminating the royalties they now receive in favor of some other form of either current receipt (if available), or foreign reinvestment with no current receipt. The pool of taxpayers who may perceive a location incentive to relocate actual research and development activity will be expanded beyond the group which currently has asserted the possibility (cost sharing taxpayers) to include the population of taxpayers who presently take advantage of cross-crediting excess foreign tax credits against royalty income. It is unlikely that such taxpayers will simply ignore a dramatic increase in their U.S. federal income tax liability.

Elimination of cross-crediting with respect to royalties must therefore be tested with respect to (1) the stability of the projected continuing royalty flows, and (2) the effect on location decisions for research activities. The JCT Options Report and the Panel Report suggest tentative conclusions that, based on observations of location incentives and their effect on manufacturing activities, there is no definitive or conclusive evidence that multinationals would relocate existing U.S. operations to foreign tax-friendly jurisdictions. The comparability of manufacturing location decisions on the one hand and research and development location decisions on the other probably should be carefully vetted. There are already fairly extensive reports about increased investment by “high tech” companies in research and development facilities in countries such as China, India and Russia. Such increased research and development investment may be unaffected by U.S. tax incentives or disincentives to retaining U.S.-based research and development. It would be an unacceptable outcome, however, if tax policy decisions to tax income from U.S.-based research activities were made on a visceral basis that the companies are just bluffing. The kind of labor involved in research and development may well be more mobile than labor generally, and the functions may be replaceable by foreign-based workforces that are increasingly well educated.

We will need to consider, in particular, whether the kind of value added by a U.S.-based research and development capacity may be vulnerable to the same sort of “idea mobility” or technology mobility that has attended commerce and industry for a very long time. If we intend to base tax policy toward the taxation of royalties on an assumption that U.S.-based research and development cannot get away (because
U.S.-based research and development is and always will be intrinsically superior to foreign-situs research and development or because a U.S. enterprise would never move its “crown jewels” overseas), we had best test that assumption by data that includes the views of the people who actually are involved in deciding where to conduct research and development for MNCs, rather than rely on economists who are constrained by the need to infer the reasons for behavioral decisions by indirect data such as tax returns rather than by direct observation.299

G. Related-Party Transactions and the Arm’s-Length Principle

There has been considerable discussion about the “problem” of ownership of high-value U.S. origin intangible property by tax haven affiliates of U.S. MNCs.300 Indeed, the “Microsoft problem” discussed below in this Part attracted the attention of the WALL STREET JOURNAL and then the worry of the then-Chairman of the Senate Finance Committee. One way that the worrisome ownership is acquired by tax haven affiliates is by cost sharing arrangements under which a foreign affiliate invests in the ongoing R&D activities of related persons, often U.S. affiliates. The price paid by the foreign affiliate to acquire ownership of the intangible property is tested under an arm’s-length principle.

Should the arm’s-length principle be used to apportion income from high-value intangibles between related parties based on assumption of “risk” by a low-tax affiliate, when the risk is borne by capital provided to the low-tax affiliate by a U.S. affiliate (or other high-tax country affiliate)? Should the risk-adjusted arm’s-length principle be used to apportion income between U.S. taxpayers and affiliates in countries with which the United States does not have a bilateral tax treaty?

1. Discussion

Code Sec. 482 provides the IRS with the authority to distribute, apportion or allocate between or among commonly controlled organizations, trades or businesses various items if necessary to (1) prevent evasion of taxes, or (2) clearly reflect income. The items include gross income, deductions, credits or allowances. The IRS and the Treasury have established the principle, as a matter of unilateral domestic U.S. tax policy, that Code Sec. 482 should be applied by relying on a model in which unrelated parties dealing at arm’s length would enter into the same or a similar transaction. The arm’s-length modeling approach frequently suffers from difficulties in finding data involving unrelated party transactions that are clearly comparable to the related party transaction being tested. The resolution of disputes between the government and taxpayers often depends on the resolution of conflicts between competing forensic economists.

The stakes are high in allocating items associated with cross-border transactions and investment. Income that would be currently taxable, if allocated to a domestic corporation, may be deferred from current U.S. tax if allocated to a foreign subsidiary under arm’s-length principles. Further, such items, if allocated to a foreign affiliate of a foreign-parented MNC, will be permanently excluded from the U.S. tax base.301

Although the “arm’s-length” (modeling) approach is now firmly entrenched in U.S. tax policy, it has sometimes produced results that are disagreeable to the IRS, the Treasury, Members of Congress and commentators. The dissatisfaction sometimes finds expression in assertions that the taxpayer in a particular case, or a class of taxpayers, have “gotten away with” some inappropriate reduction in U.S. corporate income tax liability because of the difficulties encountered in enforcing the arm’s-length standard. The complaints include notions that the federal government has been “out-lawyered” as well as assertions that the taxpayers have, but impede access by the government to, information that would, if proven, support the government’s asserted increase under the arm’s-length model, of income of a U.S. taxpayer affiliate.

A contrary view is that the arm’s length model approach is flawed precisely because of its reliance on hypothetical data to support theoretical constructs. Some adherents to this view assert that a better approach to apportioning income among commonly controlled enterprises would be to rely on formulary apportionment in a manner similar to the approach taken by the several states.302

Changing to formulary apportionment would entail a substantial revision to the existing bilateral tax treaties to which the United States is a party. For that reason alone, without regard to the theoretical advantages or disadvantages of formulary apportionment of income from cross-border transactions and investment, the prospects for undertaking the necessary review of such an approach are remote. A comprehensive departure from existing policy of asserting the arm’s-length model will not be included in any of the proposals likely to be considered in the foreseeable future.303 Nevertheless, it is worth noting that the statutory language in Code
Sec. 482 does not compel application of the arm’s-length modeling approach as a unilateral exercise of the U.S. taxing power over transactions with foreign affiliates of U.S. taxpayers. On the contrary, except as required by tax treaties, the clear reflection of income may be better served by a different approach to some related-party transactions.

The recent and relatively high-profile reaction to the Microsoft problem might suggest that arm’s-length modeling of the right price is not to the taste of all tax policy makers. The supposed “wrong result” involved Microsoft and its Irish subsidiary, Round Island One, Ltd. The “problem” has been described in the financial press. In that article, Microsoft’s “obscure subsidiary” with a “thin roster of employees” was characterized as a “key component in a drive by Microsoft to place its intellectual property and other assets in tax havens.”

The Microsoft “problem” (transfer of intellectual property to tax havens) was the subject of a 2006 colloquy between then-Chairman Grassley of the Senate Finance Committee and then-Secretary of the Treasury Snow:

The Chairman. * * *

On another point, recent articles in the Wall Street Journal and New York Times have reported how U.S. multinationals have been able to dramatically reduce their worldwide tax liabilities by transferring intangible assets to subsidiaries in low-tax countries—and Ireland is a good example—and particularly technology companies and drug companies have transferred an increasing—amount of their income-generated intangibles offshore to avoid U.S. tax.

For example, the Wall Street Journal reported that a four-year old Irish subsidiary of Microsoft called Round Island One, Limited, “has a thin roster of employees, but controls more than $16 billion in Microsoft assets. Virtually unknown in Ireland, on paper it has quickly become one of the country’s biggest companies, with a gross product of nearly $9 billion in 2004.

According to the article, much of this profit is from licensing software code that originated in the United States. Reporting this profit in Ireland helps Microsoft save half a billion dollars in annual tax revenue.

The press reports indicate that it is through cost sharing arrangements that companies like Microsoft are able to accomplish such dramatic tax savings.

These companies enter into cost sharing arrangements with their foreign subsidiaries, giving those subsidiaries the right to a share of whatever income or loss is generated by the intellectual property developed under the arrangements. Instead of receiving royalties from their foreign subsidiaries, the U.S. parent receives buy-in payments up front.

Our international tax regime has operated, since 1918, under the fundamental principle of deferral, under which active business earnings earned by subsidiaries of U.S. multinationals are not subject to U.S. tax until those earnings are repatriated to the U.S. parent, usually in the form of a dividend, but also in the form of royalties for the use of intangible property developed here at home.

The reason for this rule is to enable U.S. multinationals to remain competitive with companies based in countries that do not tax foreign earnings at all, for example, a territorial system.

Critical to protecting the U.S. tax base, our system of deferral is an appropriate transfer pricing policy and effective enforcement of the policy. The President’s Tax Reform Panel has pointed out that transfer pricing is even more critical under a territorial tax system.

Now, the Treasury Department has recently proposed an overhaul of cost sharing regulations and, based upon these press reports, Treasury review of this area is very timely.

So, Mr. Secretary, would you please comment on the priority given to finalizing these regulations?

Secretary Snow. Mr. Chairman, it is a clear priority for us. We share your concern, the concern you have just articulated. There is a clear danger here that there has been migration of intellectual and other intangible property offshore.

This type of migration can be accomplished through the cost sharing sort of arrangements that...
you described. We feel that the existing rules have not been effective in getting at this problem.

As a result, Treasury and the IRS undertook to overhaul, as you noted, the regulation, and proposed regulations were issued sometime back in the summer, I think it was in August. They are being commented on now. We would expect to have them made final sometime in 2006. I agree with you, this is a serious issue and we need to deal with it.

The Chairman. In order to quantify that, are you headed down the road of these regulations, bringing that $500 million that is saved by Microsoft under this back into our treasury?

Secretary Snow. Well, I think what this will do, is reduce the opportunity for abuse here, and certainly remove some of the incentives to engage in the sorts of behaviors that deny revenues to the U.S. Treasury.

The Chairman. All right.

The approach taken, in the proposed cost-sharing regulations that are referred to in the colloquy, is to assert special valuation factors that would be taken into account under the model. These special valuation factors would then be used to shoe-horn the reallocation of income resulting from such factors into a supposedly “arm’s-length” model that the revised formula will produce the same result unrelated parties would end up with were there to be any such transactions between unrelated parties. Such modifications are asserted to be consistent with the arm’s-length principle. They propose a change in the structure to require a buy-in with respect to the workforce-in-place whose costs are partly underwritten by the foreign affiliate that shares costs (and risks) under a cost-sharing agreement. Numerous commentators have asserted that leaving the party that bears the risk of unsuccessful research and development with only a financial rate of return is inconsistent with an arm’s-length model.

Although meritorious arguments have been and will be made as to how best to value special inputs by a workforce in place, it can also be said that the allocation of income based solely on financial exposure to “risk” may yield inappropriate (“bad”) results as a matter of basic tax policy. In other words, even if the income allocated to a tax haven subsidiary is equal in amount to what would have occurred in a transaction between unrelated parties, the deferral of residual U.S. tax thereon may be objectionable to some tax policy makers.

The United States has been the principal proponent of the use of the arm’s-length principle to allocate and apportion income between taxing jurisdictions. The effort has gone well beyond a mere bargaining position in treaty negotiations. The principle has been pursued as a matter of domestic law (rather than being applied only under a treaty seeking to avoid double taxation).

The arm’s-length principle does not generally require a current allocation of income to the provider of equity capital and of a payment from the company in which the investment by the equity provider has been made. This is the core consequence of the distinction made, for tax purposes, between shareholder capitalization via debt versus shareholder equity capitalization. Interest is currently taxable to the lender-investor, and the amount of interest charged by the related lender is subject to current adjustment by the IRS exercising its authority under Code Sec. 482. However, no current return on equity investment is required with respect to the investor of equity capital. The anti-deferral provisions of subpart F require inclusion of certain kinds of “tainted” income, but the required inclusion is not based on measuring the appropriate return on invested capital or the appropriate time of recognition of the return on invested capital.

Periodically, disquiet at the consequences of this distinction are expressed when the answer somehow seems inappropriate. Thus, for example, the Panel Report recognizes that the line drawn between exempt dividends from Foreign Business Income and fully taxable interest, from the same controlled foreign corporation, even from the same source of activity that generates Foreign Business Income, will require anti-abuse rules to deal with distinctions between debt and equity that might end up with “wrong” result.

The Microsoft problem undoubtedly involved a return on intangible property significantly in excess of a financial rate of return on the capital put at risk by the Irish affiliate in making cost sharing payments to the U.S. affiliated developer of the intangible property. Thus, merely imputing to the U.S. developer affiliate (or its U.S. affiliated group) a return on capital provided to the Irish Affiliate would not have eliminated the problem about which then-Chairman Grassley
was exercised. Instead, it was ownership of the high value intangible, purchased at an arm's-length rate that generated the high value (premium) returns. The “problem,” if there is one, does not need the elimination of deferral in all forms in order to be solved.

It is perhaps just a historical curiosity that the original legislative proposal that culminated in enactment of subpart F contained a provision that would have eliminated deferral with respect to income from U.S.-origin intangible property. Under the original House bill (H.R. 10650 (1962)), United States shareholders would have included in subpart F income the income derived by a controlled foreign corporation from the exploitation of U.S.-developed intangible property. Such a direct approach to the problem may be preferable to the indirect approach based on assertions about the “arm's-length” treatment of transactions that may not often occur in nature in arm's-length transactions between unrelated parties. Another direct approach would be simply to treat the return derived on the basis of “risk” assumed by a controlled foreign corporation as excluded from the arm's-length model to the extent the related U.S. parties have supplied the debt or equity capital to the foreign affiliate that “bears” the risk. The foreign affiliate bears risk by making cost sharing payments to the U.S. affiliate developer when it is not certain that the resulting intangible property will be commercially viable.

The allocation of income associated with “risk” to a foreign affiliate whose capital has been contributed by its U.S. affiliates has somewhat different results compared to income allocated to a foreign affiliate based on the same risk borne by it if its risk-bearing capital has been contributed as debt. The lender receives a current return at a financial rate of return. The shareholder receives a return only in the future. The lender has no upside interest in the successful development although there may be some upside if the lender is also an equity affiliate.

In a typical cost-sharing relationship, the non-U.S. participant will pay a portion of the costs associated with developing intangible property. To the extent of that payment, the U.S. taxpayer related-party recipient of the payment will lose the net benefit of the tax deduction it would otherwise have had for the research and development expenditure. If the capital “at risk” that is deployed by the foreign affiliate to make the cost sharing payment is funded with interest-bearing debt from the U.S. affiliates, the U.S. affiliate providing the (loan) capital will also receive current income in the form of interest. That interest income would have a present value equal to the expected normal returns on the amount of such capital. The borrowing foreign affiliate (cost-sharing payer) would then retain the benefit of the opportunity for premium return on its deployment of capital.

If, however, the foreign affiliate derives income associated with both the normal return (interest rate) and the return in excess of the normal return, the amount of income allocated to the foreign affiliate will be significantly higher. That result necessarily occurs when the foreign affiliate is funded by non-interest-bearing equity contributions. The burden on the U.S. tax base may be amplified if the risk capital invested by the U.S. related party is funded with the proceeds of money borrowed by the U.S. related party. In that case, the U.S. related-party taxpayer may be able to deduct the borrowing cost against other income that would be taxable if not reduced by such interest. The current deduction will often have a present value in excess of the present value of any projected tax on the repatriation of the income (normal plus premium) by the foreign affiliate via dividends to the U.S. taxpayer shareholder.

The IRS has responded in a limited fashion to the mismatch of interest deductions and the income the borrowed funds may generate when the borrowing is attributed to foreign invested equity. The response has been limited to reducing the numerator of the limiting fraction used to determine the amount of U.S. tax that can be offset by foreign tax. That approach has no effect on taxpayers that have insufficient foreign tax credit to be affected.

The proposed revisions to the cost sharing regulations would eliminate the inframarginal (or premium) return allocation of income to the foreign affiliate based on its assumption of developmental risk. Under those proposed regulations, the cost sharing affiliate would be limited to the normal (financial) return on the amount invested to make cost sharing payments. Taxpayers and commenters have objected to the proposal in part because ignoring “risk” borne by the cost sharing foreign affiliate is not consistent with the fundamental arm's-length assumption: unrelated parties dealing at arm's length would allocate to the cost sharing affiliate an equity-like return on investment consistent with the equity-like risk assumed. The equity-like risk is that the research and development, underwritten by the cost sharing foreign affiliate, will be commercially unsuccessful. Such a risk has occasionally materialized, and the
cost sharing payer has ended up with insufficient return to recoup its investment in the cost sharing project.\textsuperscript{313} The reasons for using the arm’s-length model in dealing with cross-border related-party trade and investment should be re-examined. One reason for using the arm’s-length model is to allocate taxing jurisdiction between the United States and other taxing jurisdictions. It would be useful to test the foreign taxing jurisdiction to confirm that it is a taxing jurisdiction. One obvious indicator that the jurisdiction is a taxing jurisdiction would be the existence of a comprehensive income tax treaty between that country and the United States.

If the foreign affiliate making the investment in a U.S. affiliate’s research and development activities is resident in a treaty country, income from the financial capital invested in generating a risk-based return on investment will ordinarily be fully taxed in the foreign affiliate’s country of residence. In that circumstance, the shareholder’s country of residence is supposed to cede primary taxing jurisdiction to the country of residence of the company generating the income. That arrangement is effected by making the initial charge for research and development to the investor corporation using an arm’s-length model. The countries in which the investor corporation is resident, or in which it derives income from exploitation of the intangible property (source countries) subject such income to whatever levels of tax are appropriate for source and residence countries. The shareholders of the investor company (the U.S. MNC) thereafter derive a return on capital and allow a credit for foreign taxes incurred by the investor foreign corporation. So long as the underlying assumptions are relevant—that the use of the arm’s-length principle is necessary to avoid double taxation of cross-border income—the arm’s-length principle should be left intact.\textsuperscript{314} The idea is embedded in all of the bilateral income tax treaties to which the United States is a party. If there is some felt need to refine the treaties’ treatment in one hypothetical or another, the Treasury should be fully up to the task of negotiating such refinements.\textsuperscript{315}

The case for keeping the arm’s-length principle intact is less compelling when used to allocate income to a tax-free (or virtually tax-free) corporate domicile. No significant exposure arises to international double taxation. Nevertheless, even with respect to nontreaty resident foreign affiliates that might invest in U.S. research and development, it is worth noting that the “Xerox problem” is also a possible outcome of risk-based cost-sharing.\textsuperscript{316}

If something needs\textsuperscript{317} to be done, there are several approaches that might be followed in excluding or minimizing the economic return of the foreign investor affiliate otherwise attributable to the risk it assumes in the development of U.S.-origin intangible property. One is, of course, the route being pursued by the IRS: trying to force a special valuation of the U.S.-based research and development workforce into the existing nomenclature for the modeling of what would occur at arm’s length. This is at best a confusing way to invoke the language of economic principles to justify the desired outcome.\textsuperscript{318}

One approach would be to limit the use of the arm’s-length principle for allocating income on the basis of “financial risk” to situations in which the U.S. agrees to do so pursuant to a bilateral or multilateral treaty. Reliance on a treaty-based retention of risk-based allocations might also coincide with plausible alternative locations to which research activity might migrate in the event tax burdens might influence such a movement of activity rather than just ownership of intangibles.\textsuperscript{319} The arm’s-length principle could be retained for other economic inputs but eliminated with respect to the return by a nontreaty country affiliate derived from its assumption of risk, when that risk is borne by equity invested in the controlled foreign corporation by the affiliated U.S. taxpayer.

An approach to the same end would be to impute income to the ultimate U.S. MNC that is the source of the capital that the foreign affiliate uses to bear the

The key point is that tax-exempt pools of U.S.-resident capital should not have U.S.–tax-based incentives to invest in foreign MNC business entities that engage in global direct investment (active business), but which are not subject to residual U.S. tax on their worldwide income, while U.S. MNCs in which such tax-exempt investors might invest would be subject to such a residual U.S. corporate income tax.
risk. Again, such an approach would only apply to transactions with affiliates that are not tax residents in a country with which the United States has a comprehensive tax treaty that prescribes use of the arm’s-length principle to determine taxing jurisdiction. The compensation to the capital provider for the use of its capital would be at a level consistent with the tax goals of the tax policy makers. One point on the spectrum might be a financial rate of return on the amount of aggregate foreign affiliate equity capital. Another might be a charge based on the aggregate equity and related-party debt capitalization of the foreign affiliate (less interest actually paid to the U.S. MNC group). The charge might be divined on the basis of the AFR or some more sophisticated measurement of enterprise cost of capital. Yet another point would be to come out somewhere near the apparent destination of the proposed cost sharing regulations: some or all premium returns on intangible property should be taxable to the U.S. MNC.

It is not clear, however, whether that tax policy destination makes sense without addressing the Xerox problem of losses absorbed after investments in speculative research and development. If presented by the U.S. tax system with a “heads I win, tails you lose” opportunity to invest in U.S.-situs research and development, and if treaties do not ameliorate the effect of this approach, it is likely that there would be a diminished interest in making the investment. Alternative investment opportunities might include foreign-situs research and development. Tax policy makers should be confident of the knock-on consequences before they indulge a fit of pique at the Microsoft problem.

Whatever point in the spectrum is chosen, the system for measuring the amount of a buy-in at some point after the commencement of research and development should be made symmetrical. There should not be an important economic incentive to change the timing of entering into joint development of an intangible in order to achieve a tax advantage. Similarly, the valuation methodology used in measuring the proper inclusion in the case of outbound transfers of intangible property potentially subject to tax-free treatment under Code Sec. 367 should be conformed to the treatment under Code Sec. 482.

If deferral was ended comprehensively, and all income of foreign affiliates was currently taxable to U.S. corporate shareholders, the consequences of the allocation of income to foreign affiliates would be greatly reduced. That would, however, be a cure with adverse collateral consequences for U.S. MNCs that participate in the global economy that would be far greater than necessary to deal with the “problem.”

Under any of the end-deferral territoriality approaches, eliminating income allocations to parties based on pure risk assumption would be more important than in a deferral system. The stakes in case of an over allocation would be greater under an exemption system than under any system contemplating eventual tax of all foreign income when distributed.

H. Competitiveness: Who Is Competing with Whom? Does It Really Matter?

There is disagreement among various participants in the tax reform debate concerning two key issues related to the competitive effect of the U.S. income tax treatment of income from cross-border business transactions (exports and imports of goods, services and intangible property) and cross-border direct investment. The first issue is whether there actually is any particular competitive effect, vis-à-vis any particular competitor or class of competitors, apart from the general notion that reduced taxes are bound to tilt the scale in favor of the U.S. MNC. Assuming that there is a cognizable competitiveness effect that actually affects competition by U.S. MNCs with real world competitors, the second issue is whether the impact on competitiveness is worth the cost of ameliorating it. The cost is a correspondingly increased tax burden on other taxpayers. The issues were summarized by Secretary Dillon in his original presentation of the Kennedy Administration’s proposal to end all deferral of income derived by controlled foreign corporations operating in developed countries:

It is sometimes contended that if U.S. firms are to compete successfully abroad they must enjoy as favorable a tax treatment as their foreign competitors. I believe that this argument is overly stressed. A difference in tax rates, I said before, should not handicap companies operating abroad although it may slow the rate of expansion. But even if this argument were fully valid, it would not be a decisive objection to our proposal…..Curtailment of foreign investment which can survive under the shelter of preferential tax treatment can only be in the U.S. interest. ... It will ... substantially increase tax receipts.
There is also a lack of consensus as to the relevant field of competition. It is not always clear in the debate whether tax competitiveness is to be favored in, for example, foreign-to-foreign business activities by U.S.-parented MNCs, while such competition is to be discouraged in competition with domestic production. In addition, even if the affected population of competitors can be agreed upon, there is significant disagreement as to the importance of the existing or any proposed tax burden placed on U.S.-parented MNCs and U.S. domestic producers in assessing their ability to compete with other business enterprises (either “global” MNCs or more locally focused business enterprises whose tax residence is within the country in which the U.S. MNC’s foreign business will compete).\footnote{324}

Assuming agreement can be reached, at least for the sake of argument, on the parameters of the competitiveness that a tax measure is supposed to affect, some participants in the debate then contend that “competitiveness” is a factor that has to be balanced against “fairness.” “Fairness” for these purposes is, as noted above, a euphemism for the societal advantages that are believed to result from placing a larger relative economic burden of maintaining society on individuals with greater wealth.\footnote{325} “Fairness” is to be advanced by a progressive income tax. The imposition of corporate income tax, in turn, is treated as \textit{per se} progressive because it is a tax on income from capital. In the international context, the implicit assumptions in such fairness arguments are that the corporate income tax on U.S. MNCs is borne by U.S. resident individuals, and then primarily by those individuals who have a greater ability to pay tax. There seems as well to be a job-related fairness argument: foreign direct investment by U.S. MNCs is a substitute for U.S. direct investment and therefore a cause of net job declines. These assumptions are part of the “unknowable” component, since we seem to be unable to deconstruct the portfolio investment capitalization of U.S.-parented MNCs among U.S. citizens and residents on the one hand and foreign residents on the other.\footnote{326}

The composition of portfolio share ownership by U.S. citizens and residents of foreign-parented MNCs with which U.S.-parented MNCs compete, is, if anything, even more unknowable. As noted above in Part III.B (“Residence-Based Taxation of “Domestic” Corporations …”), given the significant and apparently growing volume of cross-border portfolio capital flows, the vitality of the implicit fairness assumptions is less obvious than it was in 1962 or even 1992.\footnote{327} Some caution in the imposition of worldwide tax on undistributed foreign business income is warranted if the premise—that the justification is to tax U.S. well-to-do individual investors—may be at least partially incorrect.

\section*{1. Foreign Business Entity Competition with Domestic Direct Investment}

\textbf{a. Issues.} Is the relevant competitiveness that is to be fostered or protected:

\begin{itemize}
\item Between a foreign subsidiary of a U.S.-parented MNC and a domestic U.S. producer (whether or not such domestic producer is itself U.S.-owned or instead a subsidiary of a foreign-parented MNC)? Which should be favored? Why? (For example, if job creation is the reason for promoting domestic rather than foreign investment, is domestic job creation to support foreign direct investment relevant? Is the job creation discussion to be conducted on a company-by-company basis or on a net jobs created/lost basis?).
\item Foreign-to-foreign competitiveness between a foreign subsidiary of a U.S.-parented MNC and a foreign business enterprise competing in the foreign business enterprise’s country of tax residence? Is the answer informed by the intended destination of the goods or services produced? (\textit{i.e.}, is foreign production competition aimed at the U.S. market to be tested as foreign-to-foreign or as foreign-to-domestic?).
\item Foreign-to-foreign competitiveness between a foreign subsidiary of a U.S.-parented MNC and a foreign subsidiary of a foreign-parented MNC where both foreign subsidiaries are operating outside the country of tax residence of the MNC parent?
\item Foreign-to-foreign competitiveness between foreign subsidiaries of U.S.-parented MNCs?
\item Competitiveness between conglomerates of U.S.-parented MNCs and foreign-parented MNCs? What should be considered in looking at cross-border joint ventures between U.S.-parented and foreign-parented joint ventures?
\item Do income tax costs, or tax costs relative to other country tax costs, have sufficient significance to be considered to be at a level of importance comparable to other inputs, such as wage costs, skills, infrastructure (communications, transportation, energy, raw materials), \textit{etc.}? Are U.S. corporate income tax costs imposed on foreign business income of U.S.-parented MNCs suf-
ficiently important to affect competitiveness of such MNCs?
- Is the desire to reduce U.S. corporate income tax on foreign business income merely the result of a desire to reduce all tax costs, foreign or domestic without regard to the impact of such taxes on competitiveness with foreign-parented MNCs?
- What is a “U.S.” MNC whose competitiveness is properly the subject of U.S. tax policy concern?
  - A business enterprise incorporated in the United States and therefore subject to worldwide taxation?
  - A business enterprise managed and controlled in the United States and therefore subject to worldwide U.S. taxation (if the test of taxable corporate residency were to be changed)?
  - A business enterprise incorporated outside the United States but managing the direct business investment of a significant amount of portfolio capital provided by both U.S. resident and non-U.S. resident shareholder investors?
  - Some combination of these?

b. Discussion.
   i. Competition with Domestic Production. As noted above, the Kennedy Administration initially proposed to end all deferral of income derived by controlled foreign corporations. Its proposal was explained as being principally motivated by concerns about stimulating foreign direct investment in preference to domestic direct investment. Since as long ago as 1973, various subsequent Administrations, both Republican and Democrat (and the Treasury) have expressed concern about tax haven competition and tax holiday competition with domestic production. The Nixon Administration introduced legislation intended to discourage U.S. direct investment in “runaway plants” and “tax holiday” jurisdictions. The legislation was not enacted.

   More recently, Senator Byron Dorgan of North Dakota introduced similar provisions in successive Congresses. Senator John Kerry had a similar measure in his tax plan that was put forth during his Presidential campaign in 2004. Senator Edward Kennedy introduced such a measure as part of his comprehensive tax reform proposal.

   The Republican Policy Committee issued a statement in 2004 condemning (as detrimental to competitiveness) the Kerry-Edwards campaign proposals. The Treasury Department also testified against the runaway plant proposal in 1993, on a variety of grounds including complexity and departure from the ordinary focus of subpart F.

   In addition to arguments at the conceptual level, even assuming that income can be associated with destinations of goods on a completely reliable basis, concerns about competition with domestic production are amplified by concerns that related party transfer pricing may be skewed in favor of foreign production in preference to domestic production. If foreign direct investment enjoys tax benefits (deferral and cross-crediting, or territorial exemption, etc.) that domestic direct investment does not, there is a tax-based incentive to exaggerate the amount of such U.S. tax-benefited foreign income at the expense of less-favored domestic income. This, in turn, may be viewed as an amplifying tax-based effect on the location decision to establish foreign job creation or other inputs outside the United States in low-tax environments. Such skewing by transfer pricing (that generates artificially high foreign nontaxable income) would occur only with respect to foreign income that would be subject to foreign tax at an effective rate lower than the U.S. tax that would be deferred or avoided. Thus, concerns about the adverse impact on domestic economic activity are most vigorous in relation to income “diverted” to low-tax countries.

   Diversion of income to a high-tax country, to be subject there to a high effective rate of tax, is not likely to be a tax-based substitution for domestic production. If, however, a nominally high-tax country can be converted to a low-tax environment by “base erosion” transactions, the invidious effect on alternative domestic production may occur through a combination of transfer pricing to the nominally high-tax country and base erosion to reduce the effective rate of the high-tax country and to move income from that country to a low-tax country. As discussed below, at least part of the concern about the “race to the bottom” and “harmful tax competition” is based on the resulting disincentive to invest in domestic production.

   Proponents of enhanced U.S.-tax based “competitiveness” measures argue in response that these concerns are uninformed and misguided. Comparative tax costs are likely to be a factor in all taxpayer decisions, but not generally the most important factor. Indeed, most business decision makers make most of their decisions as businessmen and only secondarily make decisions as taxpayers. This is certainly true of decisions based on modest financial or economic
changes based on comparative estimated present values of future U.S. and foreign tax on projected future income.

Various empirical data tend to support the argument that most (but not all) foreign direct investment is made in high-tax countries to support access to markets. The location decisions with respect to substantial and job-intensive business activities should be distinguished from location decisions to place a purely risk-based return in a low-tax country or to place low-value-added, low-wage jobs in a low-tax low-wage country. The problem of competing with other similarly situated global MNCs should be addressed on the basis of (1) the locations in which investment occurs (predominantly high-tax countries), and (2) the treatment of competing MNC enterprises by the countries with which such “foreign” competitors have residence-based tax nexus. They further argue that the United States should not impose a more burdensome residence-based tax regime on U.S.-parented MNCs than do the principal OECD countries on their resident parents of MNCs.

To the extent the competing arguments are based on asymmetrical data, a resolution based on scientific inquiry (as distinguished from faith-based ideology) is likely to be unachievable.

The proposal to completely end deferral would respond to the assertion that domestic production (and employment) should be the dominant tax policy value and that that value could be best served by assuring an overall U.S. and foreign tax burden on U.S. MNCs at or above the U.S. income tax burden on domestic production. It is at best speculative whether completely ending deferral would affect job formation in the United States, but it might make people feel better that they had tried to do something.

The author’s preferred approach (deferring excess foreign deductions until foreign-related income equals or exceeds such expenses) would be relatively neutral or tilted against domestic production (to the extent low-tax foreign economic activity were to be subjected to a lower overall combined U.S. and foreign tax burden lower than the U.S. tax on income from domestic production). This tilt would apply only to the income in excess of the normal return on invested capital, since expenses associated with foreign-related income would be deferred (and U.S. tax increased commensurately) to the extent the expenses might offset domestic-related income.

A compete territorial exemption for foreign business income and complete disallowance of expenses associated with producing such exempt income, would favor foreign activities that produce rates of return in excess of normal financial rates of return on the disallowed expenses, while imposing a front end disincentive to invest when the eventual return might not yield a return equal to or greater than the assumed financial rate of return. If the foreign investment is unsuccessful, the disallowed expenses would never be recouped for tax purposes, unlike a similar investment in a domestic business venture.

As noted above, however, it is not at all clear how important the tax effect will be, either to stimulate or to discourage foreign or domestic investment in comparison to other (nontax) elements of location decisions. If location decisions are only marginally affected by the level of U.S. tax on foreign direct investment income, competitiveness would be at most a marginal factor in establishing the U.S. international tax regime. The intensity of the argument is not necessarily entirely commensurate with its actual importance in decisions about where to conduct business.

ii. Competition with Foreign-Owned Foreign Production to Supply Foreign Markets. A somewhat different debate attends foreign-to-foreign business activity. In this case, the relevant business competition is between U.S.-owned foreign subsidiaries and local companies to supply consumers of their output either in third countries or in the (local) country of their tax residence. Such local companies may be predominately owned by local investors or (more likely) are themselves owned by multinational corporations whose ultimate parent company is not a U.S. tax resident (i.e., a foreign-parented MNC).

U.S. MNCs have argued for at least five decades, beginning before the advent of subpart F in the Revenue Act of 1962, that their competitiveness in foreign markets has been and will be adversely affected by an overall tax burden greater than the tax burden on their local competitors. The tax burden is greater when U.S. tax on the income from foreign activity is taxed, either now or later, at a combined U.S. and foreign tax rate in excess of the rate at which the local company is taxed under only local tax law. Subpart F, in this context, merely changed the timing of the imposition of the incremental U.S. tax. The core “competitiveness” argument is not limited to avoiding current incremental U.S. tax, but also included any exposure to incremental tax, now or later.

The justification for enhancing “competitiveness” is that (1) foreign business activity by U.S. MNCs
stimulates enhanced U.S.-based productive activity (with associated gains in employment and returns on investment in domestic production), (2) nontax foreign policy benefits associated with U.S. business involvement in countries that become more prosperous as a result, and (3) the return on investment by U.S.-owned MNCs benefits their shareholders and increases tax revenues when those shareholders recognize income attributable to foreign direct investment by U.S. MNCs. The arguments against adjusting tax policy to support such “competitiveness include:

- such foreign production always includes the risk of replacing domestic investment (whether to supply foreign or domestic markets) with an associated diminution in national welfare (measured by domestic employment rather than return on investment to domestic shareholders of U.S. MNCs);
- such measures are not necessary to insure competitiveness of U.S. MNCs because they already enjoy competitive advantages by virtue of being U.S.-based that dwarf the incremental benefit of tax-based competitiveness measures; and
- other tax policy considerations are greatly more important than competitiveness, even assuming competitiveness is generally desirable and significantly affected by tax policy adjustments to the taxation of income from foreign business activity.

In addition, U.S. tax measures to enhance competitiveness of U.S.-parented MNCs may contribute to the race to the bottom and to the fiscal erosion of the welfare state.³³⁹

iii. Competitiveness: To Protect Return on Investment, Jobs or Both. The relevant variables in the competitiveness discussion are obscured by lack of agreement on whose interests are supposed to be advanced. The disputants frequently talk past each other and posit very different models of the investment decisions by business and very different criteria for success in tax policy. Advocates of capital export neutrality tend to argue that it is the welfare of employees in the United States whose interests define the success or failure of a tax policy addressing international and cross-border economic activity and the income there from.³⁴⁰ Advocates of capital import neutrality, or competitiveness as a worthy protectable interest, advocate, either explicitly or implicitly, protecting the return on investment on U.S.-origin capital deployed in foreign economic activities. For such advocates, potential U.S. employment in a putative substitute domestic manufacturing facility is not a valid measure of social utility of foreign business because the location decision to invest in foreign production is driven by other variables, and competitiveness is an issue only after the decision to establish foreign production facilities is made.

iv. Cross-Border Portfolio Capital Movement and the Competitiveness of U.S.-Parented MNCs. Very little information about the nationality or demographics of shareholders of U.S.-parented MNCs has been marshaled in the debate. None of the debate seems to be based on verifiable assumptions about who owns the U.S.-parented MNCs whose competitiveness is being discussed. Given the very large amounts of cross-border portfolio capital flows³⁴¹ across borders into corporate equities, it is probably safe to assume that U.S.-parented MNCs deploy significant amounts of foreign-origin capital and that foreign-parented MNCs deploy significant amounts of U.S.-origin portfolio capital. Given further that no one seems to know much more than this, simplifying assumptions are made. One simplifying assumption is that U.S.-parented MNCs may be safely subjected to increased tax burdens, in order to achieve a fair (acceptably progressive) tax on wealthy individual U.S. taxpayers, because U.S.-parented MNCs are probably owned by rich U.S. individual taxpayers.³⁴² To the extent this simplifying assumption turns out to discourage investment in U.S.-parented MNCs, whether by U.S. or foreign portfolio investors, some damage to the U.S. economy will occur. Various studies of the benefits associated with U.S. headquarters have been made and it is likely not disputed that some benefit accrues from U.S.-situs headquarters for global business enterprises.

v. Testing Competitiveness at the Corporation Level Only (Not “Piercing the Corporate Veil”). Another sort of fairness involves the notion of “horizontal tax equity.” This concept is applied at the level of the business taxpayer (i.e., the corporation). The corporate entity is accordingly treated as the nontransparent unit whose competitiveness is to be protected or evaluated. The U.S. or “American” status of that base unit is often based on indicia of nationality such as headquarters, place of trading of its shares, place of incorporation, nationality of its management or historical integration into the fabric of American society.³⁴³ Companies subject to worldwide U.S. federal income taxation based on present or former incorporation under the laws of the United States, one of the states or the District of
Columbia are generally viewed as “U.S.” 344 Once a corporation is viewed as “American,” the location decisions made by that corporation also seem to involve political concerns about patriotism and the burdens and benefits of citizenship. 345

In 1999, after several high profile acquisitions by foreign MNCs of U.S. MNCs, such as Daimler’s acquisition of Chrysler, British Petroleum’s acquisition of Amoco, and Vodafone’s acquisition of AirTouch, various committees of the Congress held hearings to examine whether the United States tax system encouraged or favored business activity by foreign MNCs rather than U.S. MNCs, when both were competing against each other in a “global economy.” 346 In 2002, when several U.S.-incorporated companies announced their intention to reorganize their ownership to become foreign incorporated, while retaining substantially the same ownership after the transaction as before, a different group of Congressmen expressed concern that such “inversions” were likely to erode the U.S. tax base to an unacceptable level and were, in the minds of some, unpatriotic. 347 The evaluation of the differences between takeovers by foreign MNCs of U.S. MNCs, on the one hand, and reorganization of U.S. MNCs into foreign MNCs, stopped short of examining on a look-through basis the nationality or residence of the individual shareholder investors in the “U.S.” MNCs. Instead, if the U.S. MNC was subject to worldwide taxation on the basis of being chartered by a political subdivision of the United States, it would be a U.S. MNC even if all of its shareholders were foreign resident individuals. The nationality, for political purposes, was based on its U.S. headquarters and predominant nationality or residence of its management.

The end result, or at least the current result, appears to be that many in the current Congress are concerned about competitiveness when U.S. management is exchanged for foreign management, such as the acquisition of Chrysler by Daimler, while many in the same Congress, with a somewhat different composition, are concerned about corporate patriotism when U.S. management is retained and only the place of incorporation is changed. The actual underlying composition of the shareholder investors, as U.S. residents or foreign investors, and the places where capital is deployed and the places where employed and wages are paid, appear to be below the radar of the various Congressional majorities.

2. Corporate Residency and the Assertion of U.S. Worldwide Taxing Jurisdiction

The question of competitiveness is inextricably bound up with the U.S. assertion of taxing power over worldwide income of some, but not all, multinational corporate groups of business enterprises. As discussed above at Part III.B, a U.S. MNC will be subject, now or later, to U.S. tax on its worldwide income. A foreign MNC (foreign-parented) is not subject to worldwide tax (whether currently or at some future “deferred” date) on income that is not from U.S. sources. 348 Advocates of “competitiveness” of U.S.-managed and parented corporations have argued that reorganizing out from under the reach of worldwide taxation (now or later) of all foreign income of that U.S. MNC is necessary in order for the enterprise to thrive or even survive in competition with other agglomerations of people and assets that are not subject to such tax burdens. Such positions typically conclude with the view that only exemption from U.S. tax on low-taxed foreign income will achieve the goal of competitiveness. Such an exemption can be achieved by certain kinds of territorial systems, and by the use of reorganizations of U.S.-parented MNCs into foreign-parented MNCs. Such reorganizations, where the nationality of the parent of the MNC group is changed to a foreign country, but management is continued from a U.S. headquarters, are sometimes referred to as “self-help territoriality.” 349 Such “inversions” have generated intense discussion which has generated even more heat than light.

For purposes of this analysis, however, the merits of present law as enacted in 2004 350 will not be examined. The enactment is useful as an example of the confluence of differing views as to the relevant unit (investors vs. corporation) to be looked at in evaluating “competitiveness,” the importance or unimportance of income tax in location decisions by U.S.-managed business enterprises, and, assuming the corporation is the correct unit to measure, whether the assertion of worldwide tax jurisdiction is or is not important to the “competitiveness” of multinational business enterprises and whether the inversion transaction is motivated primarily by foreign competitiveness or domestic tax minimization desires.

The JCT Options Report 351 and the Panel Report 352 each contain proposals to expand the assertion of U.S. taxing jurisdiction over worldwide income based on an expanded definition of “residency” of a corporation. Residency would continue to be entirely divorced from the composition of the investors in a
corporation as either U.S. tax residents or foreign tax residents. As under present law, a “U.S.” corporation would include any corporation chartered under the laws of the United States, any state or the District of Columbia. In addition, a “U.S.” corporation would be expanded to include any corporation chartered under foreign law but which had in the United States some quantum of its “significant” management activities of its business.

If expanded “corporate residency” is adopted in conjunction with one of the territoriality proposals, the potential adverse effects on competitiveness would be largely limited to those items or classes of foreign source income not treated as exempt under the particular territorial system. Such disfavored income would include portfolio investment income, U.S. base-erosion income and, under some circumstances, and foreign active business “Mobile Income” consisting of related party interest, rents and royalties. The competitive tilt in favor of foreign-parented MNCs would then presumably be balanced by a corresponding residence country tax burden on the foreign-parented MNC group. If the foreign country did not have comparable provisions subjecting to local tax (at least eventually) all third-country income of nontreaty residence country subsidiaries, there would be a competitive disadvantage for the U.S. MNC and its shareholders compared to shareholders in the foreign-parented MNC group.

It would be prudent to reflect upon the impact of measures that have been debated in the context of “competitiveness” and abusive “inversions,” on portfolio capital flows into and out of the United States. If shareholders in a foreign-parented foreign MNC are taxed differently than shareholders in a U.S.-parented U.S. MNC, the comparative cost of access to capital may be affected. It is at present unclear whether any such differences have been empirically examined with a view to measuring the impact of the various ideas, debated under the rubric of “competitiveness” or “fairness,” upon portfolio capital flows. Any such examination, if even possible, would need to compare investors with distinct taxpayer profiles, including U.S. tax-exempt investors (e.g., tax-exempt charitable organizations, university endowments, retirement plans, etc.), foreign tax-exempt investors, foreign individuals protected by treaties on income from U.S. corporate debt or equity investment, U.S. taxable investors protected by treaties on income from foreign MNC debt and equity investment, and other investor subgroups, with respect to alternative investment opportunities each might have in deciding how to participate in a global economy. It will also be necessary then to determine separately for each investment capital pool the extent to which the managers thereof, are or are not sensitive to tax effects (i.e., whether they purport to measure their performance on the basis of before-tax or after-tax returns).

3. Does It Really Make Any Difference?

The significance of the impact (on domestic welfare or global welfare, and on flows of portfolio and direct investment capital) of taxing currently, deferring or even exempting foreign business income from U.S. corporate income tax is subject to substantial disagreement. As noted above, the Treasury has itself, within the last decade, reached different conclusions about the significance of any anti-competitive effects of the current system of worldwide taxation, coupled with a foreign tax credit, but which limits deferral of tax on U.S. shareholders with respect to undistributed subpart F income.

Business groups have marshaled data in support of their assertion that U.S. taxation of worldwide income does in fact hamper competitiveness. The relative impact of tax on different kinds of foreign business income compared to other location costs, has not been presented with great particularity. Economic data, at least as referred to in the Panel Report, tend to be provided at a macroeconomic level that does not seem to be based on direct observation but instead on statistical inferences that do not differentiate between categories of taxpayers such as heavy industry, software production, etc.

With these caveats, it appears that comparative tax costs are sufficiently significant in affecting the competitiveness of U.S. MNCs that they should be taken into account. It is also likely that the intensity of view about importance of the comparative tax burden (i.e., with and without U.S. corporate income tax on foreign business income) is sometimes exaggerated to a level that may not give adequate weight to other factors.

Whatever the actual effect on enterprise or investor competitiveness, the debate surrounding “inversions” suggests that the intensity of political vehemence surrounding any proposal to exempt, or to include, on a broad basis, foreign source income will be very high. Advocates of territoriality as a means to enhance competitiveness will focus on foreign market competition; advocates for ending deferral altogether will focus on domestic tax “equity.”
I. Tax Competition Between Countries and the Race to the Bottom: What Role Should U.S. Tax Play in Backstopping the Tax Systems of Foreign Countries?

1. Issues

Some argue that tax “competition” between developed countries to attract direct investment capital will erode the fiscal base necessary to maintain the necessary level of government functions in the modern welfare state. There are two prongs to this argument:

1. The United States competes for capital investment that will result from location decisions to be made by business enterprises on the basis of economic advantages that are supported by significant social infrastructure “investments” that are funded by the corporate income tax. The principal competitors are other developed (welfare) states that make comparable corporate-income-tax-funded “investments” in infrastructure.

2. A reduction in foreign country corporate income tax in a normally high-tax welfare state will make that state temporarily more attractive as a location for business investment. In the long run, the foreign state “tax competitor” will suffer a diminution in its capacity to maintain its comparative advantage because it will not be able to continue appropriate levels of corporate-income tax-funded investment in the government services that make it competitive (apart from tax incentives).

The United States and each other developed country with which the “tax competitor” state is competing via incentives, are then exposed to the temptation to reduce their own corporate income tax burden on domestic business income (thus joining the “race” to achieve the lowest corporate income tax burden). Second, the United States can move unilaterally to deprive U.S. MNCs of some or all of any net tax benefit, by subjecting to residual U.S. corporate income tax the base eroding income that has been moved to a low-tax country. Third, the United States could move in concert with other countries that share the concern about erosion of the fiscal base of the modern welfare state.

The issues resolve (1) whether there is a U.S. tax problem; (2) if there is a U.S. tax problem, whether the United States should move unilaterally to deal with it; or (3) whether the United States should instead move only in concert with multilateral action that would not single out U.S.-owned MNCs for a higher overall burden of tax in their foreign operations than the foreign-parented MNCs with which they compete.

2. Subpart F Not Aimed at Race to the Bottom

Anti-deferral regimes have been used to serve multiple purposes. The original design of subpart F as enacted was to reach targeted “abuses,” but, once in place, the machinery has been used to pursue other purposes such as “capital export neutrality.” Harmful tax competition and the race to the bottom did not until quite recently make the list of possible problems to be solved by ending deferral of income derived from foreign-to-foreign base erosion transactions.

The longest serving anti-deferral regime dealt with “incorporated pocketbooks.” Such “incorporated pocketbooks” were entities not directly taxed by the United States at the entity level (i.e., foreign corporations not doing business in the United States). In 1937, the core architecture was changed to tax individual U.S. shareholders in closely held foreign
corporations on the undistributed “foreign personal holding company income” of such corporations, provided that a prescribed minimum percentage of the corporation’s income was from “pocketbook” items such as dividends and interest.361 For purposes of this discussion, it is useful to note that the remedy selected was targeted at a particular “abuse.” That abuse had nothing to do with foreign-country-level tax competition that might affect direct investment location decisions by business enterprises. Active business income was not, and was not intended to be, caught by the definition of “foreign personal holding company income.”

In 1962, Congress enlisted and expanded the anti-deferral system to impose the same sort of tax on certain undistributed income of certain closely held foreign subsidiaries of U.S. corporations.362 Initially, the Kennedy Administration proposed to tax United States corporate shareholders on all undistributed income of all foreign subsidiaries.363 The Kennedy Administration identified two broad sets of concerns: (1) tax haven abuses and (2) capital export neutrality.

The Kennedy Administration’s comprehensive end-deferral proposal (capital export neutrality) was rejected, on the basis of a perception that it might have had an excessively adverse impact on competitiveness of U.S.-parented MNCs. Instead, only the anti-abuse (tax haven) measures were adopted.364 First, deferral was ended for corporate U.S. shareholders in controlled foreign corporations that derived “foreign personal holding company income.” Second, deferral was ended for income from certain related-party transactions that eroded either the U.S. tax base (export sales income) or foreign country tax base (foreign-to-foreign multi-country sales and services income).

In selecting the kinds of undistributed income subject to current U.S. corporate income tax (“subpart F income”), Congress applied various criteria that are still useful to consider. First, Congress included in subpart F income (with certain minor modifications) “foreign personal holding company income” of the sort that had previously been taxable to individual shareholders of closely held foreign incorporated pocketbooks. The concern about a “race to the bottom” and erosion of the fiscal foundation of the modern welfare state did not make the list.

The tainted “foreign personal holding company income” also included related-party active-business interest, rents, dividends and royalties that, like base company sales and services income, could be used to erode the tax base of manufacturing country affiliates. Such related-party items were described from the outset of the Kennedy Administration legislative initiative as examples of base erosion strategies to be targeted.365 Second, Congress moved to tax currently income that could be relatively easily allocated to “base countries” (a euphemism for tax haven that appears to have originated in a publication366 sponsored by Harvard Law School’s International Program in Taxation in 1957 when Professor Stanley Surrey367 was its Director).

The base country income concept was aimed at an “abuse,” but the explanations of that abuse did not include “tax competition” among countries. The articulated abuse was limited to the risk that foreign base erosion would encourage U.S. companies to substitute foreign investment for alternative domestic investment. In addition, there also seemed to be an objection to the ability of some companies to avoid U.S. tax on income that might have been taxed by the United States if repatriated by dividends.

However, to the extent that business operations are conducted in countries with lower tax rates, there is considerable leeway for deferring U.S. tax. With a foreign tax rate of 28-1/2 percent, for example, a company can defer U.S. tax payments equal to 23-1/2 percent of total pretax profits. These statutory rates, however, do not give adequate weight to the variety of arrangements that have been made by American firms in their foreign operations which may bring down substantially the rates of tax imposed on income from their foreign operations. Thus, an American company operating in West Germany through a German subsidiary will be subject to tax there at the West German income tax rate of 51 percent, and hence it cannot benefit significantly from U.S. tax deferral. However, to the extent that the profits of the German subsidiary can be diverted from the sweep of the German tax system, a lower tax on profits can be obtained. And this is precisely what is achieved through a proliferation of corporate entities in tax haven countries like Switzerland.368

The Dillon statement went on to describe related party licensing of intellectual property, selling activities and services that could deflect income from its proper home in a high-tax country.

The statement specifically indicated that the problem was exacerbated by U.S. companies “frequently
attribut[ing] a disproportionate share of profits” to [the tax haven subsidiaries]-a practice that is extremely difficult if not impossible for the Internal Revenue Service to police effectively."369 Secretary Dillon’s reference to transfer pricing did not include a concern that the base-eroded country might encounter difficulty in enforcing whatever restrictions it might have had on related party transfer pricing. Instead, the focus was entirely on the potential erosion of the U.S. tax base and the impact on domestic versus foreign direct investment location decisions.

The need to combat “harmful tax competition” or to do something about a “race to the bottom” was thus not an inherent feature of the anti-deferral regime as originally enacted.

a. “International Tax Norms”: OECD “Harmful Tax Competition.” Some encouragement to pursue harmful tax competition might be provided by current views of an “international tax norm.”370 Such a norm might conceivably be found in the Organisation For Economic Co-operation and Development (OECD), “Harmful Tax Competition” project.

In 1996, ministers representing the public finance agencies of the OECD member states called upon the OECD to “develop measures to curb the distorting effects of harmful tax competition on investment and financing decisions and the consequences for national tax bases, and report back in 1998.” The OECD Committee on Fiscal Affairs then launched the project on harmful tax competition. In 1998, the Committee on Fiscal Affairs adopted the report entitled “Harmful Tax Competition, an Emerging Global Issue.”371 The OECD Report noted the unilateral, residence country CFC rules, while developed for a variety of purposes in each member state, could be adapted to be an effective tool to deal with harmful tax practices.372 Generally, however, the OECD Report recommendation with respect to unilateral residence country CFC taxation was limited to relatively vague exhortations to do good and avoid evil: “Accordingly, Member countries are urged, with the continued co-ordination by the OECD, to try for congruence of results of their respective CFC or equivalent legislation in a manner consistent with the objectives of this Report.”373 In pertinent part, the OECD Report summarized the function of “tax havens”:

Tax havens serve three main purposes: they provide a location for holding passive investments (“money boxes”); they provide a location where “paper” profits can be booked; and they enable the affairs of the taxpayers, particularly their bank accounts, to be effectively shielded from scrutiny by tax authorities of other countries.374

The OECD Report further focused on tax competition involving:

... geographically mobile activities, such as financial and other service activities, including the provision of intangibles. Tax incentives designed to attract investment in plant, building and equipment have been excluded at this stage, although it is recognized that the distinction between regimes directed at financial and other services on the one hand and at manufacturing and similar activities on the other hand is not always easy to apply.375

Harmful tax competition, whether effected via “tax haven” or by direct tax incentives by countries not normally viewed as “tax havens” was asserted to have a number of negative consequences:

Globalisation has, however, also had the negative effects of opening up new way by which companies and individuals can minimize and avoid taxes and in which countries can exploit these new opportunities by developing tax policies aimed primarily at diverting financial and geographically mobile capital. These actions induce potential distortions in the patterns of trade and investment and reduce global welfare.

... these schemes can erode national tax bases of other countries, may alter the structures of taxation (by shifting part of the tax burden from income to relatively immobile factors and from income to consumption) and may hamper the application of progressive tax rates and the achievement of redistributive goals. Pressure of this sort can result in changes in tax structures in which all countries may be forced by spillover effects to modify their tax bases, even though a more desirable result could have been achieved by intensifying international co-operation.376

The OECD Report represented a collective recital that the race to the bottom was a bad idea, and that it was bad because of potential prejudice to progressive taxation and effective wealth redistribution. That said, the OECD Report proceeded immediately to reaffirm:
The Committee recognizes that there are no particular reasons why any two countries should have the same level and structure of taxation. Although differences in tax levels and structures may have implications for other countries, these are essentially political decisions for national governments. Countries should remain free to design their own tax systems so long as they abide by internationally accepted standards in doing so.

Having thus enunciated a very amorphous notion of permissible national sovereignty in conjunction with undesirable tax reduction, the OECD Report then focused on bad-actor “tax havens” rather than on bad-actor residence countries or bad-actor source countries. Nothing in the ensuing history of the OECD project seems to supply anything like established international norms for residence-country CFC rules to combat “harmful tax competition.” Indeed, it is noteworthy in this regard that no OECD attention seems to have been given to the effect of the disregarded entity provisions that erode in various respects the U.S. CFC rules that the OECD Report probably had in mind when it referred to existing “CFC rules.”

Moreover, whatever role the OECD Report might have had in describing some sort of “international norms” that the United States might want to respect or pursue in setting its own tax policy was effectively rejected in 2001. On May 10, 2001, then Secretary of the Treasury Paul M. O’Neill issued a public “Statement on OECD Tax Havens.” In that statement he indicated that the OECD Harmful Tax Competition Project was not “in line with this Administration’s tax and economic priorities.” He stated that the project needed to be:

refocused on the core element that is our common goal: the need for countries to be able to obtain specific information from other countries upon request in order to prevent the illegal evasion of their tax laws by the dishonest few. (Emphasis added.)

The statement strongly suggests that the policy is limited to each country pursuing separate tax policies but acting in concert with respect to reciprocal information exchange to enable the taxing country to enforce that country’s separate and independent requirements against the taxpayers subject to its taxing jurisdiction. The statement effectively rejects, as a goal of U.S. tax policy, tax rate or tax base harmonization and the idea that the United States would help other countries who might want to avoid a “race to the bottom.” The relevant “international norms” for this purpose include information exchange; they do not include the United States joining in an OECD project aimed at stamping out tax haven competition where the United States would backstop the efforts of another country worried about its own place in the race to the bottom.

The new Administration may take a different view. The prior Administration did.

3. Other Reasons to Backstop Tax Collection by Foreign Countries

If the United States is not required by explicit or implicit international agreements to backstop some sort of international tax system, why would it matter if U.S. MNCs effectively reduce the rate of tax on foreign income from foreign activities? Why would the United States want to encourage the payment of corporate income tax to another country when doing so effectively erodes the U.S. fiscal base because taxes paid to another country will eventually reduce the amount of tax payable to the federal fisc?

The answer by the Kennedy Administration and by the successive proponents of capital export neutrality since the Revenue Act of 1962, is that increased foreign taxes diminish the impact of tax-based comparisons between the after-tax return on capital invested in U.S. domestic business (fully taxable at the U.S. effective rate) and the after-tax return on alternative foreign direct investment. That answer was refreshed in Notice 98-11 when the Treasury asserted that the Revenue Act of 1962 really had enacted “capital export neutrality” even though Congress in 1962 spoke as if it had not. Notice 98-11 was subsequently withdrawn in response to 1998 Congressional objections, although such objections were at least as focused on the procedural deficiencies (lack of hearings on regulations proposed to be retroactive before the regulations were even issued in proposed form). From the turmoil, it is possible to infer that, at least under current thinking, the need to backstop collection by foreign countries of their taxes is not an independent truth about which there is universal agreement.

Various commentators have argued that “international tax arbitrage” is not a U.S. problem except to the extent of a U.S. agreed-upon “problem.” Such
problems could include (1) collateral damage to the U.S. fisc from such diminished foreign tax collections (by foreign countries) (that might inspire the U.S. to race to the bottom in order to prevent capital flight), or (2) actual changes in location decisions by U.S. MNCs to invest in low-tax foreign countries rather than in the United States (as distinguished from a location decision to invest in one foreign country rather than another foreign country). On the other hand, articles by prominent public finance economists, at least by the titles of the articles and some of the terminology used in them to describe the “problem,” seem to be premised on the assumption that foreign tax reduction by foreign base erosion is in and of itself bad because it is part of a “race to the bottom” and “aggressive tax planning.” \(^{387}\)

As noted above, however, the use of disregarded entities to engage in disregarded transactions is not “aggressive” by any stretch of imagination. \(^{388}\) Such use of disregarded transactions is based on extraordinarily simple elections laid out in Treasury regulations with the apparent intent that even non-aggressive taxpayers should make them. From a foreign law standpoint, they are the most commonplace of transactions (loans and intangible property licenses) established on arm’s-length terms. From a foreign tax law standpoint, there is nothing unusual to think about. They are just “plain vanilla” related party transactions.

Further, there is no “race to the bottom” in this scenario. The source country is likely to be allowing deductions to the same extent it would allow such deductions for any cross-border loan or license from any party, related or unrelated. Only from the United States’ perspective is there a “problem” in the reduction of source country tax resulting from the payment of interest or royalties to a recipient in another country, and then only if some other bad thing results from the base erosion. The problem is entirely internal to the U.S. tax conversation about location decisions and the effect of U.S. tax on those decisions.

We are left then with the same reason for objecting to foreign base erosion as asserted by Secretary Dillon in 1961: the risk that U.S. direct investment in domestic business will be supplanted by U.S.-tax-favored direct investment in foreign business. Various economists have challenged that assertion based on their perception that empirical data do not confirm the theory. \(^{389}\) Such economists argue that empirical data indicate that most direct investment occurs in high-tax jurisdictions, so that location decisions appear to be based on other more important factors.

In the end, foreign base erosion appears to be inappropriate for unilateral U.S. tax measures to attack. So long as other countries do not share a commitment to prevent base erosion that results in effective foreign tax rates below the U.S. effective rate, unilateral U.S. tax measures to impose higher taxes on foreign-related income are likely only to undermine competitiveness of U.S. MNCs without obtaining any useful increase in U.S. domestic direct investment. The impact on such competitiveness is also rather nebulous and difficult to measure, but it seems pointlessly ideological to erect an elaborate anti-base erosion regime when no one is able to demonstrate what difference it actually makes in location decisions against U.S. domestic direct investment.

### J. Financial Services and Passive Income

The Panel Report indicates that special attention must be given to financial services businesses, such as banks, securities dealers and insurance companies. Such businesses derive income that would, absent special treatment, constitute “tainted” Mobile Income. The special treatment is to treat as exempt “Foreign Business Income” such items derived by financial services businesses “to the extent such income is earned through active business operations abroad.” \(^{390}\) The Panel Report further indicated that “anti-abuse rules would be needed to prevent passive investment income from being treated as Foreign Business Income.” The Panel Report provides no guidance, however, as to what principles might be used to distinguish “passive investment income” from income derived from “active business operations.”

The confusing language may be clarified by a brief review of the treatment under present law of “foreign personal holding company income” derived by certain financial services businesses. From 1962 (the inception of subpart F) until 1986, dividends, interest and gains from the sale or exchange of stock or securities derived in the conduct of a banking, financing or similar business, or derived from the investments made by an insurance company (if and to the extent received from a person other than a related person) were excluded from amounts includible in income of a United States shareholder. \(^{391}\) In 1986, Congress determined that such items of income should be currently taxable to United States shareholders, even if derived by a controlled foreign corporation engaged in the conduct of a banking, financing or similar business, or derived from investments made by an
insurance company. Congress’ stated reason for this change suggested some concern about mobility of income from investments, whether or not such investments were part of the ordinary trade or business of the controlled foreign corporation:

Congress believed that these exceptions [under former I.R.C. section 954(c)(3)(B) and (C)] often provided excessive opportunities for taxpayers to route income through foreign countries to maximize U.S. tax benefits. The lending of money is an activity that can often be located in any convenient jurisdiction, simply by incorporating an entity in that jurisdiction and booking loans through that entity, even if the source of funds, the use of funds, and substantial activities connected with the loans are located elsewhere.392

In 1996, Congress was persuaded that certain banking, financing and insurance business activities should be entitled to exclude what might otherwise be foreign personal holding company income.393 The exclusion was initially temporary but has been regularly extended (most recently through the end of 2009394). The constraints under “temporary” Code Sec. 954(h) are focused on minimizing allocation of income to tax haven booking offices (the essential complaint about the more general exclusion from foreign personal holding company income in place from 1952 until the 1986 Act amendments). The current constraints thus appear to be intended to emulate the treatment of foreign base company sales income, and the facility with which such income can be moved from its “true” home to a tax haven in which little “real” activity occurs.

This may be what the Panel Report is attempting to say even though it couches the description of the “abuse” as based on a taxpayer trying to characterize income from “passive investments” as if it were business income. Such a distinction is hard to apply when a financial services business deploys assets of which it is the “owner” to generate interest from loans and gains from securities involving interest in an issuer which are, under conventional norms, at or below the ordinary percentage for distinguishing portfolio from direct investment.

In any event, it seems to make sense to establish parity between the treatment of active business income of financial services businesses and non-financial services businesses. If active foreign business income of a unified non-financial services business is to be deconstructed into different components (e.g., foreign base company sales income versus in-country (of incorporation) sales income) based on the likelihood that some of the income might otherwise escape source country taxation while other income is unlikely to escape source country taxation, a similar test should be applied to financial services income.395

If deconstruction into separate components, based on base erosion predilection, is not used to determine U.S. taxability of active foreign business income of industrial companies, it should not be applied to interest and securities gains derived by financial services income. Main Street should not be treated more or less favorably than Wall Street.

Once a business is determined to be engaged in an active banking, financing or similar business, income derived in the course of that business should be treated under a single set of rules rather than being deconstructed into “business” and “investment” income. Portfolio investment of a non-financial services business can be identified without reliance on “anti-abuse” rules, based on the ownership percentage held by the non-financial services business in the issuer of the income-producing stock or debt. A financial services business will derive its business income from loans to, or transactions in the securities of, entities in which it has only a portfolio level of ownership. Thus, instead of an ownership threshold to distinguish active from portfolio income, it will be appropriate to define the eligible financial business on an activity basis, and then to treat all income that arises from that activity as Foreign Business Income.

Diversified U.S. MNCs frequently have within the group of affiliated companies a foreign finance affiliate. Such an affiliate may derive substantial amounts of interest and gains or losses on unrelated party instruments (and on obligations to or financial contracts with) such unrelated parties. Such finance affiliates are commonly engaged in managing affiliated group exposure to interest rate and currency risk. Such finance affiliates should be treated under the same rules as financial services businesses. Concerns about using such finance affiliates to deploy excess assets in investment portfolios should be addressed by limiting the benefits of the active business income classification to income derived by a business with a debt to equity ratio comparable to regulated banks in the United States.
K. The Disregarded Entity Rules and Electivity Under Subpart F

Subpart F was enacted in 1962. The “core” architecture assumed that, with one limited exception, the relevant “subpart F income” would be income from investments, or transactions entered into, by the “controlled foreign corporation” in or with other persons. Such other “persons” could include other corporations, individuals, partnerships and trusts. A branch was not, however, a “person” distinct from the rest of the corporation.

The limited exception, for “certain branch income,” was adopted because of a last-minute awareness in Congress that, by virtue of certain features of foreign territorial tax systems, the base erosion or “income deflection” transactions intended to be reached by subpart F might not be covered in certain branch transactions.

For such branch transactions, a special rule was crafted in order to reach transactions that might otherwise be disregarded under the general U.S. tax axiom that a taxpayer realizes neither gain nor loss on “transactions” with itself. Such transactions are simply ignored as non-transactions.

The “certain branch income” provisions apply, by their terms, only to various transactions that would give rise to foreign base company sales income. In the limited circumstance of testing for foreign base company sales income, certain activities can give rise to foreign base company sales income if a sales branch sells on behalf of a manufacturing presence within the same legal entity (the controlled foreign corporation) or if a manufacturing presence is operating outside the country of incorporation of the controlled foreign corporation.

Intracompany (branch to branch) services, interest, dividends, rents and royalties are all “non-transactions” and there is no statutory provision that applies, either generally or on the basis of “anti-abuse,” to them. This rule has occasionally penalized taxpayers, such as was the case when foreign financial institutions with U.S. taxable branches were not able to reduce U.S. taxable income by losses “incurred” by the branch on hedging “transactions” entered into between the branch and the home office. The rule is also somewhat in tension with tax treaty provisions that contemplate determining income attributable to a permanent establishment (e.g., a branch), arising from transactions between the permanent establishment and the rest of the treaty resident enterprise, as if the permanent establishment were a separate corporation dealing at arm’s length with the rest of the treaty-resident enterprise. Nevertheless, except when otherwise compelled to do so by treaty, the basic rule is that intra-taxpayer “transactions” are simply ignored because no transaction occurs.

From the inception of subpart F in 1962, therefore, there has been a dichotomy in treatment of potential base erosion transactions among constituent components of a U.S.-parented MNC. Notional (from a U.S. tax standpoint) intracompany loans and license agreements would not give rise to foreign personal holding company income, while “actual” (from a U.S. tax standpoint) intercompany loans and license agreements could give rise to such income. It is also likely that foreign tax law generally coincided with U.S. tax law during this time, with the exception of income attributed under certain foreign law territorial income systems to foreign sales branches. Intracompany interbranch loans and license agreements did not, typically at least, support foreign host country deductions for payments of interest or royalties to foreign branches of the same legal entity.

In 1996, the Treasury and the IRS promulgated the so-called “check-the-box” regulations. A key feature thereof was (and remains) the treatment of certain single member entities as “disregarded” extensions of the single member. Prior to the promulgation of these regulations, there was scant authority for treating any business legal entity as “disregarded.” In anticipation of the issuance of the disregarded entity provisions in the check-the-box regulations, several experienced practitioners specifically warned representatives of the Treasury in public forum that adopting “disregarded entity” rules, with the corresponding opportunity to ignore related party interest and royalties, would make subpart F substantially elective with respect to ordinary base erosion transactions of the type referred to in the legislative history of subpart F. Such electivity, it was asserted, would lead inevitably either to repeal of the provisions that treat intercompany related-party dividends, interest, rents and royalties as foreign personal holding company income currently taxable to United States shareholders under subpart F, or to withdrawal of the disregarded entity provisions in the foreign context. The Treasury indicated in response that it intended to watch closely the international consequences of the new regulatory regime, and to make appropriate changes if and to the extent necessary.
Similar concerns were likely shared by international personnel within the IRS and the Treasury. Any such concerns, if expressed, were subordinated to the overriding Treasury interest in implementing the fundamental tax policy improvement: taxpayer electivity in entity classification. Almost immediately after the disregarded entity provisions became final, U.S.-parented MNCs proceeded to examine systematically the potential application of the notion that an entity could be disregarded solely for U.S. tax purposes while continuing to enjoy its traditional separate existence under the laws of the country in which it was established, the country in which resident (if different than place of establishment) and, most importantly, the country of tax residence of the related entity to which deduction-bearing loans or licenses might be provided. The unsurprising result was that a controlled foreign corporation could be incorporated in a low-tax foreign country, hold interests in one or more operating subsidiaries in high-tax countries, and make tax-efficient base eroding loans or intangible property licenses to high-tax operating subsidiaries. The loans and licenses would, of course, have to survive examination under source country restrictions on intercompany debt or licenses, including both arm’s length rules and direct restrictions on permissible ratios of shareholder debt to shareholder equity. Within those constraints, however, base erosion would be permitted, and subpart F would not “backstop” foreign tax law. If the source country was comfortable with continuing to apply its general rules to cross-border related party transactions, the United States would not end deferral of the income attributable to the related party “non-transactions” that “deflected” income from a high tax operating country to a low-tax base country.

Within a year or so, the Treasury moved to limit the reach of the international “non-transaction” implications. It did so by taking an indirect approach rather than by simply seeking to limit the disregarded entity classification rules to domestic business entities. The indirect approach taken instead was to create, by administrative fiat, a new, additional, kind of foreign personal holding company income. Under this approach, certain branch base erosion transactions would be deemed to create foreign personal holding company income. While the IRS and the Treasury were presumably acting within their governmental (Executive Branch) powers to apply subpart F (or not to apply subpart F) as a consequence of exercising the power to decide what was or was not a separately
cognizable legal “person” under Code Sec. 7701(a) (1), they were not conceded to have the power to create “certain branch” foreign personal holding company income once the determination had been made that the relevant business entity was not a separate “person.”

By retaining the “disregarded” status of the foreign single member business entity, the Treasury and the IRS had assumed the challenging task of overriding the general rule that transactions by a taxpayer with itself are disregarded unless a statute directs otherwise. The existence of the “certain branch income” rules in the subpart F regime for foreign base company sales income, to other subcategories of foreign base company income and foreign personal holding company income raised significant issues as to the Treasury’s authority.

Ultimately, the Treasury agreed not to proceed with the proposed regime for treating certain income from non-transactions as foreign personal holding company income. In doing so, the Treasury stated that it was doing so in order to permit Congress to study the policy premises underlying continued reliance on subpart F as then in effect. The 2000 Treasury Subpart F Study was undertaken thereafter, in part to assist Congress in its study of the continued suitability of one or another of the features of subpart F, including in particular the desirability of continuing to include as “foreign personal holding company income” items of related party dividends, interest, rents and royalties (i.e., items of otherwise passive investment income derived from direct investment in active foreign business activities and facilities).

Although the Treasury has continued to remind the tax community that there is nothing “sacred” about the check the box rules, the JCT Options Report approached the problems posed by the disregarded entity regime as the proper subject of legislative rather than solely administrative remedies. The importance of the disregarded entity rules has been reduced somewhat, at least temporarily, by the enactment of a “temporary” exclusion from subpart F foreign personal holding company income of related party dividends, interest, rents and royalties attributable to income of the payer that is itself not otherwise subpart F income (e.g., foreign base company sales income).

L. International Joint Ventures

The Panel Report states that “Further rules would be needed to address the taxation of Foreign Business Income earned by a U.S. multinational that owns at
least 10 percent of the stock of a foreign corporation that is not controlled by U.S. shareholders (so-called “10/50 companies”). The perceived need for “further rules” in dealing with income that would not be exempt if earned by a controlled foreign corporation is not elaborated upon.

Two features distinguish a “non-controlled” foreign corporation from a controlled foreign corporation. First, the lack of control makes it difficult (and in some cases perhaps even impossible) to obtain information that conforms to U.S. tax concepts with respect to the income and activities of the foreign corporation and its related parties. Those activities will affect the time, character and source of the income and accumulated earnings of the foreign corporation for U.S. tax purposes. It may be difficult, for example, to convince the management of a non-U.S. shareholders of a non-controlled foreign corporation to calculate the amounts of “income” associated with imputed royalties on transfers of intangible property that may occur only by operation of U.S. tax fictions. Such imputed royalties would, under the Panel Report proposal, be excluded from exempt “Foreign Business Income” and would instead be taxed as “Mobile Income.” Such fabrication or imputation of income, solely for U.S. tax purposes, would be extraneous to the normal accounting, whether residence-country tax accounting or financial accounting, of the foreign corporation.

Second, the lack of U.S. shareholder control makes it difficult for noncontrolling U.S. shareholders to compel distributions of amounts corresponding to the undistributed income included in the U.S. tax base of the U.S. shareholder/joint venturer. Such lack of control by the United States can result in increased costs for the U.S. shareholder (if it is required to fund the U.S. tax on undistributed earnings of the non-controlled foreign corporation) or for the foreign shareholder/joint venturer (if it is required to make distributions from the joint venture that it would not otherwise make, but for the U.S. tax problem of the U.S. shareholder/joint venturer).

The JCT Options Report proposed to deal with the problems of a U.S. shareholder in a noncontrolled foreign corporation by excluding dividends from such entities from exempt foreign business income. Under this approach, the U.S. shareholder would not be taxable until actual distribution, and the income taken into account on distribution would not be “looked through” to its constituent components as active or passive investment income, related party mobile business income, (“Mobile Income” in the Panel Report), etc. Alternatively, such an U.S. shareholder investor could elect to treat the foreign joint venture as if it were a controlled foreign corporation, with full look through to determine exempt and taxable income, etc.

Under present law, an investor in a passthrough entity faces the same problems resulting from lack of control: it will be taxed on its aliquot share of the venture’s income, calculated under U.S. tax principles, whether or not such investor can secure the information necessary to determine its liability or force the distribution of income corresponding to the amounts included in U.S. taxable income. Further, such income will generally flow through for purposes of determining time, character and source of income that will be included in the U.S. investor’s U.S. tax base substantially as if earned directly by the U.S. investor.

Foreign direct investment (as distinguished from passive portfolio investment) in joint ventures can ordinarily be structured to overcome the control problems associated with noncontrolled foreign corporations. At least for prospective joint venture agreements, the non-controlling U.S. shareholders can require the determination of items of income affecting such shareholders’ U.S. tax base in accordance with U.S. tax accounting and U.S. substantive rules governing related party transactions, time of recognition, character (capital vs. ordinary) and source. Similarly, such prospective shareholder agreements can also stipulate that distributions will (or will not) be made in the event and to the extent associated with income of the joint venture taxed on an undistributed basis to the U.S. shareholder investor.

On a prospective basis, therefore, nothing in the core architecture of any of the proposed reform alternatives really compels the exclusion of non-controlled foreign corporate joint ventures from the basic regime applicable to foreign active business conducted under the control of U.S. direct investor shareholders.

The reason given by Congress in 1986 for segregating operations of 10/50 companies from the rest of the global enterprise was that joint ventures were not really part of the worldwide business enterprise.

In the case of foreign corporations that are not controlled foreign corporations, however, Congress did not believe that there is sufficient identity of interest with U.S. shareholders to treat nonmajority ownership positions as units of a worldwide business.
Congress also seemed to think it would be relatively easy to tote up the income and associated foreign tax credits on an entity-by-entity basis, and that there would be some simplification gains associated with a per company limitation on foreign tax credits. However, in making that determination Congress may not have given adequate thought (or any thought) to the iterative complexity involved in allocating and apportioning various kinds of shareholder-level fungible expenses (interest and general and administrative costs, primarily) to a potentially large number of such noncontrolled foreign companies whose ordinary accounting would be impervious to such shareholder costs and expenses.

Taxpayers challenged the separate per company limitation for more than a decade. Eventually, Congress reversed the position it had taken in the 1986 Act. In 1997, the 10/50 basket was eliminated prospectively (from 2002), and in its place a look-through regime was established. In discarding the 1986 Act approach, Congress explained itself as follows:

The Congress found that the prior law rule that subjects the dividends received from each so-called 10/50 company to a separate foreign tax credit limitation imposes substantial record-keeping burden on companies and has the additional negative effect of discouraging minority-position joint ventures abroad. Indeed the Congress was aware that recent academic research suggests that the present-law requirements may distort the form and amount of overseas investment undertaken by U.S.-base enterprises. . . . “Aggregate data indicate that U.S. participation in international joint ventures fell sharply after [enactment of prior law] in 1986.” (citing Mihir A. Desai and James R. Hines, Jr., “Basket Cases: International Joint Ventures After the Tax Reform Act of 1986,” National Bureau of Economic Research, Working Paper #5755, September 1996).

The Congress believed that the joint venture can be an effective way for American business to exploit its know-how and technology in foreign markets. If the prior-law limitation was discouraging, such joint ventures or altering the structure of new ventures, the ability of American business to succeed abroad could be diminished. . . .

The Panel Report may intend to reject, at least implicitly, the 1997 legislative determination that joint venture direct investments are “units” in a global business or that differentiating them from other units impair “competitiveness” or both. If so, that policy should not be supported.

Whatever the merits of competitiveness as opposed to other goals of tax policy, it is likely to be better tax policy to treat foreign direct investment in non-controlled foreign businesses to the extent possible in the same manner that foreign direct investment in controlled foreign businesses is treated. Both are routinely selected for nontax reasons (business exigencies) and introducing tax distinctions into business decisions in which only tax consequences depend on the choice of vehicle is likely to lead to unsatisfactory gaming of the system either by the taxpayers or by the tax administrators.

The burden of having to pay current U.S. tax on undistributed earnings, over which the U.S. shareholder has insufficient control to force distribution, has been compared by some to the burden placed on U.S.-resident portfolio investors in passive foreign investment corporations (PFICs). The burden placed on a portfolio investor of either paying U.S. tax currently, or paying U.S. tax later with an interest charge, has been thought to be reasonable, perhaps in order to achieve other tax goals, such as horizontal equity with portfolio investment in U.S.-resident mutual funds. Under the PFIC regime, shareholders may well have no access to the information necessary to calculate the current tax. In such a case, the Internal Revenue Code constructs a surrogate for actual taxable income in hypothesized based on deemed income attributable to amounts distributed or proceeds of sales of interests in the PFIC. The adequacy of an analogy to PFICs is subject to two basic objections. First, the PFIC regime is basically intended to deal with foreign investment by U.S. resident portfolio investors when the investment that is either undesirable or at least not to be encouraged by tax measures. Second, to the extent the PFIC regime is not restricted to undesirable situations, it is unclear whether there has been sufficient taxpayer compliance to know whether the apparatus actually works. It is not really clear whether taxpayers have generally reported PFIC investments and income there from and whether they have demonstrated the practical feasibility of making the surrogate income calculations. It is difficult under such circumstances to extrapolate the impact of incremental tax costs on such a limited pool to the broader class of foreign direct investment in business joint ventures.
The best approach under a regime that includes either partial or complete territoriality-based exemption for Foreign Business Income would be to apply the exemption to income of a 10/50 company in the same categories as would qualify for exemption in a controlled foreign corporation. A separate tax policy decision would be whether to subject the nonexempt undistributed Mobile Income to current tax in the hands of the U.S. shareholder. In the case of a continued deferral-based system, the best approach would be to allocate expenses to foreign-related income that includes anticipated income from the joint venture entity. This would be economically comparable to eliminating expenses associated with this activity from deductions against income from domestic business activity that is not foreign related.

**M. Tax-Exempt Investors**

The Panel Report proposes a form of integration of corporate income tax and shareholder income tax. Under the proposed regime, corporate income tax would be imposed on the corporation’s income, and distributions from such previously taxed income would be nontaxable to the shareholder. Foreign business income (other than foreign business income that is Mobile Income) would be exempt from corporate income tax under the dividend-exemption system also proposed by the Panel Report. Distributions to shareholders attributable to such exempt income would be taxable to shareholders (thus assuring at least one level of income tax on all income from whatever source derived).

Tax-exempt investors would, however, appear to be entitled to the same exemption for dividends received that they currently enjoy, without regard to whether paid out of income that was taxable or nontaxable to the corporation. If tax-exempt investors could calibrate investment strategy to capture the preference thus created for exempt foreign business income, there would be a potential distortion in investment incentives. Tax-exempt investors would enjoy a lower tax burden on dividend income that originates in low-tax, or no-tax, foreign business activities of a U.S. MNC than on dividends from income generated in such U.S. MNC’s as domestic business activities. In the context of the Panel Report recommendations, this is probably just the result of oversight or indifference (because the effect of the incentive on actual investment decisions by tax-exempt investors may have been thought to be too conjectural to worry about).

The anomaly does, however, point to a broader aspect of the asymmetry in investment income derived by U.S. tax-exempt investors from equity investment in U.S. MNCs compared to tax exempt equity investors income equity investment in foreign MNCs. The current “classic” system, under which corporate income is taxed once to the corporation, and again, upon distribution to the shareholder, ordinarily involves at least one level of U.S. income tax (at the corporate level). Under that “classic” system, dividends are not taxable to tax-exempt investors, so that such tax-exempt investors derive income that has borne only one of the two levels of tax ordinarily imposed on income from the deployment of portfolio equity investment in a business enterprise. This ordinary result is also symmetrical with the division of tax burden into a tax on the business activity income (source-based taxation) and a tax on capital income (residence-based taxation of income from capital).

If a tax-exempt investor holds shares of a foreign MNC, the dividends it receives are tax exempt (just as would dividends from a U.S. MNC). Unlike dividends from a U.S. MNC, however, such capital income will not be distributed out of amounts that have already borne a U.S. corporate-level tax on business activity income.

Under present law, tax-exempt investors who lend at interest to business corporations have similar tax-exempt treatment for their interest income. Interest is deductible from corporate taxable income, is taxed only as income from capital, and thus avoids tax at the business activity level. Under present law, a tax-exempt investor in a foreign corporation is exempt from all U.S. corporate income tax on foreign source income that is not “effectively connected” with a U.S. trade or business. Under present law, a tax-exempt investor thus has a U.S. tax incentive to invest in the equity of a foreign MNC rather than in the equity of a domestic corporation (if the underlying business income of the foreign corporation is not otherwise subject to federal income tax on the basis of having a source in the United States). It may be that most such investments have been made in vehicles that are themselves subject to substantial foreign income taxes (e.g., investments in foreign MNCs resident and/or doing business in high-tax countries, or in investment funds that reinvest in operating companies subject to high levels of foreign income tax).

The existing exemption for tax-exempt investors is based on the good works that tax-exempt investors do. The limitations on that exemption are basically
aimed at two “problems.” First, tax-exempt investors are taxable (the tax on unrelated business taxable income, or UBTI) on income derived from active business conducted in competition with taxable business enterprises.\textsuperscript{429} Second, the size of the exemption is also limited so as to exclude debt-financed income.\textsuperscript{429}

The first limitation (intended to avoid a tax subsidy for competition with taxable enterprises) does not treat investment in foreign MNC equity as an undesirable tax-favored competitive advantage.\textsuperscript{430} Portfolio investments by a tax-exempt U.S. resident investor in a foreign MNC may thus generate income never subject to U.S. tax on business enterprise income. Such differentiation may artificially encourage investment by such U.S. resident tax-exempt entities in equity of foreign MNCs rather than in equity of U.S. MNCs. The same amount of capital invested in a U.S. MNC may bear a higher overall tax burden\textsuperscript{431} than the same amount invested in a foreign MNC.\textsuperscript{432} That situation could arise if a foreign corporation were to conduct active foreign business in a low-tax jurisdiction or to employ some or all of the common base erosion measures in general use that reduce the effective rate of tax on business conducted in nominally high tax jurisdictions.\textsuperscript{431}

The problem would not be significant if the tax-exempt investor’s investment location decision with respect to income derived from investment in foreign MNCs that are subject to an overall effective rate of foreign tax comparable to the effective rate of similar situated U.S. MNCs. Foreign portfolio investment by U.S. tax-exempt investors may have been assumed to be made primarily in foreign equities issued by residents of generally high-tax jurisdictions. Such assumption may not be valid in the long term if fund managers of tax-exempt capital pools begin to track after-tax differences, with particular focus on U.S. and foreign MNCs that participate in the global economy.

If tax-exempt investors were to be subjected to “UBTI” treatment with respect to all income from equity investments in foreign MNCs, there might be a risk of imposing an excessive U.S. tax burden on otherwise desirable cross-border portfolio investment and of imposing too great a burden on their ability to do the good works for which they are given a tax exemption. This problem corresponds to the exposure to double taxation of cross-border \emph{direct} investment income that is relieved by residence-country foreign tax credits or residence country exemption of foreign direct investment income. Such relief is not available, however, for cross-border \emph{portfolio} investment by taxable residents (other than for withholding taxes that are determined without having to examine the underlying tax base of the dividend payer).

Unlike generally taxable U.S. residents, who are subject to “double” tax on portfolio dividend income, whether from domestic or foreign sources, tax-exempt investors are only supposed to be taxed once on income attributable to capital invested in equity of an active business enterprise. To preserve that structure, it might be possible to adapt from the regime for cross-border foreign direct investment something akin to the foreign tax credit for tax-exempt investors to offset a UBIT charge intended to eliminate the incentive for tax favored pools of U.S. investment capital to move to non-U.S. MNCs.

Introducing a foreign tax credit into the taxation of generally tax-exempt investors is a step to be taken very cautiously. Portfolio investors are usually unable to obtain sufficient data to support a foreign tax credit calculation with respect to corporate tax paid by investee corporations in which they hold only portfolio investments (less than 10 percent). Nevertheless, the risk of U.S.-taxed based stimulation of foreign investment by U.S.-resident tax-exempt investors, in preference to otherwise identical portfolio investment by such U.S. resident tax-exempt investors, is likely to become increasingly serious.

A better approach to relief from excess taxation of a tax-exempt investor might be achieved by providing a targeted exemption from UBIT for dividends from foreign MNCs that are qualified residents of a country with which the United States has a comprehensive tax treaty. The key point is that tax-exempt pools of U.S.-resident capital should not have U.S.–tax-based incentives to invest in foreign MNC business entities that engage in global direct investment (active business), but which are not subject to residual U.S. tax on their worldwide income, while U.S. MNCs in which such tax exempt investors might invest would be subject to such a residual U.S. corporate income tax.

\textbf{III. Recommendations}

The discussion of issues leads to the question, “Well, what would you do about all this?” The following suggestions are the points on the line of choices where the author would strike the balance. There is more than one wrong answer and it is important to keep the importance of all this in perspective. The tax burden on global business activities is an important social and economic choice to be made. It is likely that a
plethora of other factors will likely matter more in deciding where jobs will go and in determining the role of U.S. MNCs in managing available investment capital in conducting global business, but U.S. tax policy will matter as well.

A. Retain Existing Core Architecture

The United States should tax all business income, domestic or foreign, derived by businesses with a prescribed minimum nexus to the United States, and should allow a foreign tax credit. Business income would consist of items realized by a U.S. taxpayer under general U.S. tax accrual principles.

U.S. tax should not be imposed on a U.S. shareholder’s unrealized income consisting of undistributed foreign business income of foreign corporations. U.S. tax should be imposed on a U.S. shareholder when it receives a distribution of such income. A U.S. shareholder is a U.S. tax resident with 10-percent-or-greater-equity interest (as under present law).

a. The United States should tax U.S. shareholders on their pro rata share of undistributed foreign personal holding company income to the extent attributable to portfolio investment made by controlled foreign corporation. A PFIC-type interest charge should be applied to passive income (undistributed foreign personal holding company income) attributable to U.S. shareholder’s interest in a non-controlled foreign corporation (10/50 company), when the income is included upon distribution to such U.S. shareholder.

b. The United States should not extend a territorial exemption to any U.S. shareholder’s interest in any income of a foreign corporation. All return on capital investment should eventually be taxable in the hands of the U.S. taxpayer investor, no later than upon actual or constructive receipt determined on general U.S. tax principles.

B. Eliminate Separate Regimes for Foreign Business Conducted via Foreign Corporations vs. Branches and Other Passthrough Entities

The United States should treat all foreign business activities, in which a U.S. corporation has a greater-than-10-percent voting equity interest, as a separate entity (corporation) rather than variously as a corporation, branch or other passthrough entity based on the legal form of the business vehicle. This will eliminate electivity of tax regime for foreign business activities of U.S. MNCs, particularly loss pass through and disregarded transactions between a legal entity and its branch.

C. Match Foreign-Related Expenses and Foreign-Related Income

Existing law should be modified to apply a matching principle for deductible expenses incurred to produce foreign-related income. All “foreign-related” income should pay for itself and expenses in excess of aggregate foreign income should not offset otherwise taxable domestic source income.

1. Extend the present law approach to matching of expenses, used for purposes of limiting the maximum foreign tax credit, to include not only taxpayers which are affected by the foreign tax credit limitation but also to include taxpayers which do not have foreign tax credits in any particular year sufficient to have an economic effect equivalent to matching.

2. Without such matching, expenses incurred to produce foreign-related income can offset U.S. corporate tax on the corporation’s purely domestic income (if any).

3. The expenses to be deferred would be calculated under principles developed under present law that are used to allocate expenses to foreign source income for purposes of calculating the foreign tax credit limitation.

   ■ The principal items affected would be interest expense, general and administrative expense and research and experimentation expense. Allocable interest expense should be calculated by taking into account controlled foreign corporation indebtedness.

   ■ The class of income to which such expenses are to be allocated should be drafted broadly.

4. A broadly drafted class would consist of all foreign-related income attributable to cross-border business activities, including undistributed direct investment income, direct investment dividends, and related party interest, rents and royalties from direct investment foreign affiliates, active business royalties from third parties and export sales income (but see resourcing proposal for export sales and intangible property royalties).

5. Under the system using a broadly drafted class, deferrable expenses incurred for the production of a broad class of deferred income would be initially larger, but would be more readily restored to
deductibility if the class includes items normally remitted currently such as related party interest and royalties, as well as other foreign-related items taken into account on a current basis such as export sales income and royalties for U.S.-origin intangible property. Interest and royalties received from foreign-related business would restore deductions for expenses that might have been incurred to generate earnings to be derived by dividends not yet taken into income.

6. Any deferred expenses not restored as deductions would be added to basis in the U.S. shareholder’s investment in assets intended to produce foreign-related income. If that investment is disposed of, or abandoned, the tax benefit of deferred deductions would be available subject to any limits on loss deductions generally.

7. It is likely that no other country applies comparable matching of otherwise deductible expense to foreign-related income, even broadly defined. To this extent, the proposal may decrease “competitiveness” of U.S. MNCs with similarly situated foreign MNCs.

D. Repeal Foreign Base Company Sales Income and Foreign Base Company Services Income Provisions Now in Subpart F

As enacted in 1962, Subpart F was intended to reach targeted base erosion activities that would permit an enterprise in a high-tax jurisdiction (e.g., Germany) to lower its effective rate compared to a domestic enterprise in, say, Tennessee. In the more recent past, Subpart F’s base erosion provisions have been characterized as a tool to limit harmful tax competition and the resulting race to the bottom and as a means to achieve desirable progressivity in the burden of federal income tax. As discussed at various points in Part II, Subpart F has not discouraged the migration of active business activities, for the simple reason that taxes are only relevant to investment location decisions after the prospect of profitable (taxable) business has been optimized. The present value of future U.S. residence-country residual tax on potential income is unlikely to be of much importance to a decision-maker compared to labor cost, customer location, raw materials, supplies, etc., that are likely to have much greater impact on realization of any income at all. It is equally unlikely that Subpart F has or will do much to diminish tax competition (See Part II. H (“Competitiveness: Who is Competing with Whom? Does It Really Matter?”)) or enhance progressivity of tax on wealthy Americans (See Part I. C (“ABA Task Force on International Tax Reform (2006)” and Part II. H. at Note 327).

Subpart F in general, and the foreign base company sales and services provisions in particular, assume a “normal” business model that is usually not used. As a result, they can induce pointless tax costs on normal business activity, or pointless aberrations in normal business behavior to minimize those costs.

It can be argued, of course, that the combination of the IRS’ “check-the-box” rules (and particularly the “disregarded entity” portion thereof) and taxpayer ingenuity in dealing with base erosion arrangements make this repeal proposal only a simplification rather than a substantive change. While that may be true in the short run, in the long run we should, and probably will, decide the deferral issue based on business activities rather than such notions as “tax nothings.” See Part III. B (“Eliminate Separate Regimes for Foreign Business Conducted via Foreign Corporations and Other Passthrough Entities”).

The purpose of this proposal is to achieve at least four goals:

1. Accommodate the normal business model of participants in the global economy. That model is business conducted across national borders rather than in hermetically sealed national bubbles.

2. Accommodate the emergence of regional trade areas such as the European Union or the North American Free Trade Area in which goods manufactured in one country are supposed to move efficiently to other countries throughout the free trade area.

3. Facilitate U.S. MNC participation in joint ventures with non-U.S. MNCs. Joint ventures are made more difficult if one party is subject to residence-country tax pressure to withdraw capital (distribute dividends) while the other is not. premium returns.

4. Simplify the compliance burden imposed on taxpayers in keeping track of previously taxed undistributed earnings, with the concomitant need to make continuing adjustments for currency fluctuation, future losses, hedging gains or losses associated with inventories and anticipated inventories, etc.

The core premise, that existing U.S. tax policy embedded in deferral provides an incentive to invest
abroad rather than in the United States, is an appealing explanation for why jobs have been lost. U.S. tax policy is something we can control.

The assertion need not be correct in order to resonate with people worried about loss of jobs. Deferral has not in fact had much to do with why companies invest in the United States or in another country. If we take action to penalize the business sector for participating in the global economy, and the jobs do not come home, we will be worse off. Venting will not put bread on the table, while a strong global economy has done so in the past and will do so in the future.

Whatever conceptual risk exists that there is a tax subsidy for foreign investment can be adequately addressed by the expense matching recommendation in Part III. C (“Match Foreign-Related Expenses with Foreign-Related Income”).

E. Retain Related-Party Look-Through Rule That Excludes from Subpart F Income Related-Party Interest, Rents and Royalties Paid by Foreign Affiliates to Other Foreign Affiliates

Foreign personal holding company income is overly broad and should be carved back to accommodate the normal financial functions of any business, domestic or foreign.

The related party look-through rules under Code Sec. 954(c)(6) has been in place for about three years and are scheduled to expire this Year (2009). Code Sec. 954(c)(6) should be enacted permanently. It allows a U.S. MNC group to manage its intragroup working capital and long term investment capital in a normal way.

In addition, reasonable exceptions from even portfolio foreign personal holding company income (generally taxable currently to the U.S. shareholder) should be provided to accommodate hedging currency, interest rate and commodity risk, and to exclude interest derived on short term deposits of working capital.

The real world needs of non-financial corporations to manage their financial assets, financial liabilities, interest rate risk and currency risk are both real and necessary. Surely we do not think that U.S. MNCs should not have interest bearing assets or assets with exposure to currency gains or losses. That view of U.S. MNCs (unencumbered by financial assets and liabilities), if ever correct, is out of touch with running a normal business in the global economy.

If deductions for U.S. expenses incurred to carry the U.S. MNCs investment in producing foreign-related income are no greater than the associated income that is taken into the U.S. tax base, there is no significant subsidy left—the financial rate of return on the financial assets should be equal to the implied cost of carrying the nondeductible expense. The financial asset will have an incremental deferral benefit only to the extent it is attributable to equity invested in the foreign subsidiary plus any retained earnings of the foreign subsidiary. This is simply not a large enough tax “subsidy” to warrant penalizing the normal management of group financial assets on a multi-jurisdictional basis.

F. Transfer Pricing: Exclude Risk Based Allocations of Income to CFCs Except by Treaty

Code Sec. 482 should be amended to exclude allocation of income away from a U.S. affiliate to a foreign affiliate based on the risk borne by that foreign affiliate’s capital. Such risk-based allocations should be retained under bilateral tax treaties. The affiliate’s capital that bears the risk represents the related shareholder’s “risk” as the provider of the capital that bears the risk. This proposal would require adjustment to accommodate any significant cross-border trade and investment by U.S. MNCs in countries with which the United States does not have treaties, such as Argentina, Brazil, Hong Kong, Singapore, Taiwan and the Persian Gulf states. Such countries could be identified by an appropriate euphemism for non-tax-havens.

G. Eliminate Repatriation Tax on Arm’s-Length Transactions Between a CFC and U.S. Affiliates

If the so-called “repatriation tax” is a real problem, it can be solved without completely repealing deferral and without completely exempting a piece of such income (“Foreign Business Income”). The more measured solution would be to repeal Code Sec. 956 (Investment in United States Property).

If Code Sec. 956 were to be repealed, the kind of taxable deemed distribution that would end deferral, would be limited to transactions on non-arm’s length terms that would be treated as constructive dividends under general tax principles. CFC acquisition of related party stock should be treated as dividend, or
not a dividend, under generally applicable tax rules rather than pursuant to a special rule for controlled foreign corporations only.

H. Retain Crediting of Foreign Taxes Against U.S. Tax on Export Sales Income (Foreign-Related Income)

Code Sec. 863(b) (deemed foreign source rule with respect to export sales) should be retained. Such income is foreign-related without regard to the passage of title, and foreign income taxes on some parts of the overall pool of foreign-related income should be allowed as a credit against U.S. corporate income tax on the overall pool.

I. Make Intangible Property Royalty Sourcing Symmetrical with Income From Export Sale of Inventory Property, Except to the Extent Otherwise Provided by Treaty

All things being equal, there should be no distinction in treatment as “foreign-related income” between income derived from an intangible when licensed and income derived from an intangible embedded in exported tangible property. If a careful examination (in which MNC decision makers are involved) confirms that research and development activities will not be likely to migrate as a result of such a change, symmetry with export property sourcing would be a desirable result. Such examination should consider the extent to which alternative locations for research and development are, or are not, parties to tax treaties with the United States. If migration of the research and development activity is a serious risk, the existing system should be retained. U.S.-situs research and development is worth more than symmetry with export sales.

J. Interest from Related Parties Should Continue to Be Foreign Source Income Eligible for Cross-Crediting

All interest from foreign enterprises in which the interest recipient (or any person that controls, is controlled by, or under common control with the recipient) is a greater-than-10-percent shareholder would be foreign source income. U.S. tax on the income could be reduced with excess foreign tax credits from other foreign direct business investment. All foreign source income should also be foreign-related income.

K. Dividends, Interest, Rents and Royalties from Portfolio Investment Should Be Ineligible for Cross Crediting Any Foreign Income Tax Imposed on Foreign Direct Investment Income

Portfolio income should also be segregated from business income for purposes of the expense matching proposal. Expenses related to foreign-related business income would not be eligible to offset foreign-related portfolio income.

L. Contributions of Appreciated Property to Foreign Affiliates

This recommendation is prompted by two distinct considerations. First, the treatment of valuation in the case of outbound transfers of income-producing property in exchange for stock should be symmetrical in economic consequences with similar transactions when the consideration is money or other property. Second, simplification gains would be desirable if available without doing violence to the first consideration.

Income-producing property will often have been purchased or developed with tax deductible expenditures. If such property is shifted to a foreign affiliate without recovering the deductions, there would be an asymmetry between the recommendations that current expenses allocable to foreign-related income be deferred to the extent they exceed foreign-related income. At present, the basic approach is to capture the fair market value when and if an exit tax is due. Although the present system may be appropriate for some items of property, the search for fair market value of items that are not normally disposed of in a market is a difficult undertaking. Simplification gains could be achieved by seeking to recapture only prior unrecovered deductions.

In the case of high-value intangible property, expense recapture may be simpler but it may also be asymmetrical with the valuation approach suggested for cost sharing in the development of high value intangible property. In addition, tracking and allocating costs of developing successful high-value intangible property, and determining how much of the costs of developing unsuccessful intangible property should be borne by the successful intangible property, is likely to erode any simplification gains otherwise available when dealing with property that is unlikely to generate premium returns.
If, notwithstanding the undesirable complexity inherent in expense recapture, a regime requiring current recapture of previously deducted costs is adopted, and if it is also important that there be symmetry between the treatment of inframarginal (premium returns) on transferred intangible property transferred for stock and the treatment of such returns by means of a cost sharing arrangement (with buy-in payments when applicable), the transfer of intangibles for stock should trigger a recovery of previous deductions of expense incurred in the development, plus a current return for the cost of capital previously incurred to develop the property. The treatment of the value (if any) in excess of the development-cost recovery could then be treated in a manner consistent with the approach that would apply in a cost-sharing arrangement. The premium return could be realized by the U.S. MNC (capital provider) when it realizes a return on capital investment (dividends) from the transferee controlled foreign corporation. Alternatively, the premium return could be realized over the life of the intangible by relying on a deemed running royalty that is commensurate with income (i.e., comparable to the current law treatment under Code Sec. 367(d)).

As with the ongoing discussion of cost sharing, tax policy makers should be very cautious in moving to a regime in which U.S.-situs research and development is treated less favorably than foreign situs research and development. The relevant comparison will include foreign situs research and development by the U.S. MNC as well as foreign or U.S. situs research and development by a "foreign" MNC. If the same intangible will have a higher value when owned by a foreign MNC than by a U.S. MNC, there is always the risk that portfolio investment capital will follow such a comparative advantage. It is something tax policy makers might want to look into.

Code Sec. 367 should be amended to require income inclusion by a U.S. taxpayer transferor of tangible and intangible property (including stock) to a foreign affiliate. The includible amount should equal the sum of all prior deductions allocable to the transferred property, including amortization and depreciation. If intellectual property is thought to be a special case, and that simplification should yield to a more important concern about high value intangibles, the existing framework of Code Sec. 367(d) could be retained (running royalty commensurate with income). In the interest of simplicity, no interest charge would be applied to increase the income inclusion by the amount of the present value of the prior tax deduction. The recaptured amount would be added to basis and amortized against future income from the foreign income producing asset. Undistributed earnings of foreign affiliates whose stock is transferred would not be recaptured (i.e., the Code Sec. 1248 amount), but would be included as foreign-related income for purposes of making expense allocations.

M. Joint Ventures (10/50 Companies)

The guiding principle should be to treat direct investment in controlled foreign corporations the same as direct investment in noncontrolled foreign direct investment (i.e., 10/50 companies). Certain modifications must be made with respect to portfolio investment income of a 10/50 company.

1. Matching

Expenses incurred by a U.S. corporate taxpayer attributable to direct investments (greater than 10 percent) in noncontrolled foreign corporations should be nondeductible unless and until foreign related income is included in income by the U.S. shareholder. Any deferred expense attributable to the joint venture investment would, in effect, be capitalized and added to basis of the U.S. shareholder's investment.

The amount of allocable interest expense would be the amount of deferrable interest incurred by the U.S. shareholder allocable to the joint venture investment. If and to the extent the U.S. shareholder could provide information to support an adequate measurement of foreign affiliate interest expense, the amount of U.S. shareholder allocable interest expense could be reduced in the same manner that U.S. shareholder interest is reduced by interest expense of a controlled foreign corporation. The excess or net allocable interests in any year would then be added to the pool of potentially deductible expenses associated with all foreign-related income.

2. Foreign Tax Credit

All foreign taxes on foreign source business income would be taken into account and allowed to offset all U.S. tax otherwise due with respect to foreign source business income. As with controlled foreign corporations, deferred expenses, when restored and deductible, would be subject to limitations comparable to present law that would prevent offsetting foreign income tax on foreign income against U.S.
3. Foreign Personal Holding Company Income

U.S. shareholders would not be taxed on undistributed foreign personal holding company income of a noncontrolled foreign corporation. Deferred expenses associated with the investment in the 10/50 company would be available as a deduction taxable if and to the extent of foreign-related income. Deferred expenses would not be “grossed up” (from time incurred and deferred until restored) by the foregone financial rate of return on disallowed deductions. The PFIC regime should be retained. If a 10/50 company derives certain minimum proportions of portfolio investment income, it would be a “PFIC” and shareholders would be subject to an interest-like charge on the tax then imposed upon receipt of a distribution. Relief from the interest-charge regime would be available to shareholders able to make an effective “qualified electing fund” (QEF) election to be taxed currently or undistributed income. Absent PFIC treatment, there would be no special treatment of income derived in respect of a direct investment in a 10/50 company: all income received by a U.S. shareholder should be taken into account and taxed when actually or constructively received under general U.S. tax principles.

4. Foreign Base Company Sales Income

No special treatment would be necessary with respect to related party sales and services income. The repeal generally of foreign base company sales income and foreign base company services income represents a policy decision that is equally applicable to 10/50 companies.

5. Foreign Personal Holding Company Exclusion: Look-Through Rules Should Apply to Interest, Rents and Royalties

No special rules would be necessary, except to distinguish related party interest, rents and royalties from portfolio asset income. Such rules would be relevant with respect to PFIC treatment of a 10/50 company.

Any such items of income received by a foreign corporation from a payer in which the recipient (or any person that controls, is controlled by, or under common control with the recipient), holds more than a 10-percent equity interest, would not be treated as portfolio income.

N. Foreign Direct Investment in the United States Should Continue to Be Taxed on Effectively Connected Income

1. Branch Rules Should Be Replaced by Separate Entity Rule treating all domestic branches as separate corporations.

2. Interbranch Transactions Should Be Treated as Intercompany Transactions.


4. Dividends and Interest from Domestic Corporations Should Remain U.S. Source to the Same Extent as Present Law and subject to U.S. withholding tax except to the extent otherwise provided by treaty.

This is present law and should not change under the logic of this proposal.

O. Foreign Portfolio Investment in U.S. Business Entities

Present law should be retained. Dividends, interest, rents and royalties should be taxable based on gross income at appropriate withholding tax rate, subject to treaty relief.

Portfolio interest taxation should eventually be made symmetrical with taxation of portfolio dividends paid to nonresident aliens and foreign corporations. The present regime favors foreign portfolio debt investment over foreign portfolio equity investment in domestic business enterprises.

P. Financial Institutions

1. Domestic: Present Law Temporary Exclusion from Subpart F Should Be Made Permanent.

U.S.-parented MNCs engaged in the active conduct of a banking, financing or similar business should be excluded from the regime taxing U.S. shareholders currently on undistributed foreign personal holding company income (income that is not otherwise excluded from foreign personal holding income on the basis of a related-party payer). However, any income deferred from tax would result in a corresponding deferral of deductions for interest, general and administrative expense and other expenses incurred.
to produce such deferred foreign financing business income. Simplifying conventions should be applied to accommodate differences in currencies and other terms (maturities, interest rate basis) applicable to borrowing by such financial institutions and lending by such institutions.

Branches and subsidiaries would be treated as separate entities (corporations) for this purpose. Interbranch transactions should therefore be treated as cognizable intercompany transactions.

2. Foreign Parent Financial Institutions: Domestic Branches Should Be Treated As Separate Corporations

Foreign-parented MNCs engaged in the active conduct of a banking, financing or similar business that generates income, effectively connected with a U.S. trade or business (or permanent establishment under an applicable tax treaty) should be subject to corporate tax on net income. Branches should be treated as separate corporations. Interbranch transactions should be treated as transactions with tax effect. The Branch Profits Tax should be repealed because a branch would be treated as a separate corporation.

Q. Tax-Exempt Investors

Distributions from foreign MNCs should be made a class of UBTI (subject to a contrary provision in a U.S. tax treaty with the country from which a tax-exempt investor receives a dividend). All income from investments in domestic and foreign corporations should be taxed once to the extent attributable to a U.S. tax-exempt investor’s interest therein.

Their paper eschews ambitious schemes for corporate-shareholder integration and partnership simulation: “U.S. shareholders have the opportunity for enjoying these lower foreign rates by investing directly in foreign companies. In this article, we do not explore ambitious integration schemes such as full partnership taxation with the current inclusion of all corporate income at the individual shareholder level. This would achieve the goals of the corporate level schemes for cross-border income we do study. But, for one thing this would require the look through to the ultimate earnings of the foreign corporations owned by U.S. shareholders, which would be very impracticable. It also raises the question of how to tax foreign owners of U.S. corporate income. Nevertheless, it appears better to move toward integration by lowering taxes at the corporate level because that brings the cross-border benefits.”

21 Letter from Senator Max Baucus, Ranking Member, and Charles E. Grassley, Chairman, United States Senate Committee on Finance, to George K. Yin, Chief of Staff, Joint Committee on Taxation (Feb. 26, 2004), reproduced in the JCT Options Report, at 3. The letter states, in pertinent part: “We request the staff of the Joint Committee on Taxation issue periodic reports to the Congress containing proposals to reduce the size of the tax gap. These reports should include proposals to curtail tax shelters, close unintended loopholes, and address other areas of noncompliance in present law. In addition, we would appreciate receiving recommendations to reform tax expenditures that the Joint Committee staff believes the Congress should review from a policy standpoint.” The invitation to explore reform of tax expenditures may have been understood by the JCT staff as an invitation to reform the U.S. international corporate income tax system as a policy matter.

22 JCT Options Report, at 186–97. The JCT Options Report refers to its end-deferral/partial territoriality approach at various points as a “dividend exemption system.”

23 JCT Options Report, at 189. This seems to be completely inaccurate in suggesting that the dividend exemption system would move in a direction consistent with the Congressional reforms in the AJCA. See summary discussion at Part I.G.4. (“1997–2006 Congressional Tax Reforms”).


25 The ABA Report indicated that “Individual members of the Task Force do not agree with certain of the alternatives discussed and do not agree with all the observations made in the Report.” 59 TAX LAWYER at 653, note 2.

26 59 TAX LAWYER at 732 (“In most cases, a 25% U.S. shareholder group would be adequate to cause U.S. tax issues to be taken into account by a company.”). In most cases, it is more likely that the U.S. shareholder will either have to work out disproportionately voting on distributions or find another business opportunity.

27 59 TAX LAWYER at 679 (“As is well understood, taxes are borne by individuals, as consumers and shareholders, not corporations; fairness to corporations is not relevant in applying fairness criteria.”). As noted below at Part I.I (“Worldwide Tax; Corporations As Separate Taxpayers”), note 107, Professor Seligman asserted in the 1923 Report to the League of Nations that residence-country taxation in lieu of source country taxation was necessary to preserve the progressivity of the income tax, because only the residence country could take into account the aggregate ability to pay of any particular taxpayer. AJCA, Sec. 401. The flow of portfolio capital across national boundaries has increased substantially since 1923, and the residence of portfolio capital investors may be hard to establish with the confidence expressed by the ABA Report. See note 30.

28 59 TAX LAWYER at 679 (“Only U.S. citizens and residents should be taken into account in applying the ability to pay fairness criterion.”).

29 59 TAX LAWYER at 670 (“Moreover, in the vast preponderance of cases, the place of incorporation effectively represents the place where either most of the corporation’s shareholders reside or most of the corporation’s operations are carried on.”). The ABA Report has a chapter that discusses in some depth alternatives to the place of incorporation, such as the residence of the shareholders, place of management, etc. The Executive Summary concludes that none of these alternative bases would be practical to administer.

30 Donald J. Marples, Congressional Research Service Report for the Congress, U.S. Taxation of Overseas Investment and Income, (May 21, 2008), at 1 (“... if trade has increased substantially, investment has grown dramatically. Rough estimates indicate that in 1976, the stock of U.S. private assets abroad was 6.7% of the total U.S. privately owned capital stock; by year end 2006, assets abroad were 38.4% of the total U.S. private capital stock. In 1976, the stock of foreign private assets in the United States was 3.7% of the U.S. capital stock; at year end 2006 it was 38.8% of private U.S. capital.”)

31 59 TAX LAWYER at 660.

32 This may be another way of stating that killing the goose that lays the golden egg is not necessarily a good idea.


34 The Treasury hosted a July 26, 2007, conference on “Global Competitive Advantage and Business Tax Reform.” The conference participants included various business leaders, academics and practitioners with an interest in tax policy.

35 Department of the Treasury, Office of Tax Policy, Approaches to Improve the Competitiveness of the U.S. Business Tax System for the 21st Century (Dec. 20, 2007) (herein sometimes referred to as the “Treasury Approaches Report.”)

36 Treasury Approaches Report, at ii.

37 Treasury Approaches Report, at iii.


39 Rangel Bill, sec. 3203 would eliminate Code Sec. 864(b) (worldwide allocation of interest expense which would allow offset for interest expense incurred by foreign subsidiaries in calculating how much to reduce the foreign tax credit limiting fraction by U.S. interest expense of the shareholder that must be allocated to foreign source income). This proposal appears to be based on revenue goals.

40 Agreed by a working majority of the relevant Congressional committees and by the Administration in place when the issue is considered. Nothing cosmic.

41 This article does not address possible adoption of the proposals with respect to the “Growth and Investment Tax” as proposed...
by the Advisory Panel, nor modifications thereof. Such an examination is better addressed in a separate paper that can give due attention to the international treaty and trade agreement implications of such a tax regime, particularly under the rules of the World Trade Organization. The Advisory Panel identified the need to give further attention to such implications as part of the evaluation of the Growth and Investment Tax proposals. One key feature requiring such special consideration is the subtraction of wage inputs from the taxable base of the putative “consumption tax,” a feature which may support a characterization of the Growth and Investment Tax as a tax which is not sufficiently “pure” to qualify for the benefits of the WTO accommodation of consumption taxes under the various provisions intended to prevent export subsidies. The “border adjustment” features that would be permissible in a “pure” consumption tax may be at greater risk of challenge by WTO members if incorporated into an income tax. See, e.g., Philip D. Morrison, Why the Tax Reform Panel’s “GIFT” Proposal Will Soon Be Gone, BNA DAILY TAX REPORT (Feb. 16, 2006).

This article also does not discuss the implications of adding a national “value added tax” (VAT) to supplement the corporate and individual income taxes. Many countries rely on a combination of income taxes (to adjust progressivity of the tax burden) and value added taxes (to provide necessary revenue from a broad population base). The Advisory Panel specifically declined to propose an add-on value added tax to operate in tandem with an income tax. Nevertheless, several members of the Advisory Panel have subsequently proposed adding a value added tax to the U.S. national tax regime. Although such an approach may be unlikely to attract support from tax policymakers in the near to mid-term foreseeable future, in the long run it appears likely that the United States will find it necessary to add a VAT. A useful discussion of one way to incorporate a VAT in the overall tax-funding system can be found in MICHAEL J. GRAETZ, 100 Million Unnecessary Returns (2008). In the event such an approach were to be proposed, the income tax issues discussed in this paper would remain pertinent to any such system as a qualitative matter, although with potentially reduced quantitative importance (for example, if any such additional VAT were to be accompanied by a reduction100 in individual and corporate income taxes). See also Reuven-Avi-Yonah, Risk, Rents, and Regressivity: Why the United States Needs Both an Income Tax and a VAT, 105 TAX NOTES 1651 (Dec. 20, 2004).

See H. David Rosenblum, From the Bottom Up: Taxing the Income of Foreign Controlled Corporations, 26 BROOKLYN J. INT’L L. 1525, at 1530-31 (2001) (“[W]e are not speaking of a constitution but a set of tax laws, a quite different proposition. Tax laws (not subpart F in particular, thank goodness) are probably the most important laws in the United States as a practical matter, but there is no obvious reason why, in revising them, we should be saddled today with the “intention of the framers.” Anything is possible and worthy of consideration. It would be foolish to operate on the assumption that what may or may not have been right in the early 1960s should have substantial force in the new century. Lengthy reports are not needed to demonstrate that the world has changed since 1962.”).

44 See Revenue Act of 1918, Ch. 18, 222(a) (1), 238(a), 240(c). 40 Stat. 1057, 1073, 1080-82 (1919).


49 See note 47.

50 Base erosion here refers to eroding a foreign country tax base rather than the U.S. corporate income tax base.


52 Notice 2008-91, IRB 2008-43 (Oct. 6, 2008) is a limited exception to the practice of trying to preclude repatriation. That Notice, allowing a CFC to exclude from the definition of U.S. property an obligation collected within 60 days of the time incurred. The Notice was issued to ameliorate the impact of a freeze in commercial paper markets, and was not prompted by a desire to change permanently the anti-repatriation policy embedded in Code Sec. 956. See also Notice 2009-10, IRB 2009-5 (January 14, 2009), which extended the relaxed standards.

53 Robert J. Peroni, J. Clifton Fleming, Jr., Stephen E. Shay, Getting Serious about Curtailing Deferral of U.S. Tax on Foreign Source Income, 52 SMU L. REV. 455, 458 (1999) (describing the present system of worldwide taxation with deferral as “anachronistic” and proposing a complete end to deferral); NATIONAL FOREIGN TRADE COUNCIL, THE NFTC FOREIGN INCOME PROJECT: INTERNATIONAL TAX POLICY FOR THE 21ST CENTURY, Vol. 1, iii Preface (“The foreign competition faced by American companies has intensified as the globalization of business has accelerated. At the same time, American multinationals increasingly voice their conviction that the Internal Revenue Code places them at a competitive disadvantage in relation to multinationals based in other countries.”).

54 Office of Tax Policy, Treas. Dept. Report,
The Deferral of Income Earned Through U.S. Controlled Foreign Corporations, A Policy Study (Dec. 2000) (hereinafter sometimes referred to as the “2000 Treasury Subpart F Study”), at vii; Pamela Olson, Assistant Secretary of the Treasury for Tax Policy, Testimony before the Senate Committee on Finance on International Tax Policy and Competitiveness (July 15, 2003); Treasury Approaches Report (Dec. 20, 2007). 57 Supra note 46. 58 Alan Murray & Jeffrey Birnbaum, Showdown at Gucci Gulch (June 1987). The account of adopting legislation based on personalities rather than well understood principles is a bit disquieting. 59 See note 12. 60 Panel Report, Ch. 2, at 16. 61 1986 Act Blue Book at 868. 62 Willis D. Gradison, R-OH. 63 Dan Rostenkowski, D-Ill, was then Chair of the House Committee on Ways and Means. 64 “Foreign Income Tax Rationalization and Simplification Act of 1992,” 102d Cong., 2d Sess. (May 27, 1992). See Staff of the Joint Committee on Taxation, Explanation of H.R. 5270 (Foreign Income Tax Rationalization and Simplification Act of 1992). JCS-11-92 (hereinafter “JCT Gradison-Rostenkowski Explanation”). 65 The 1986 Act had limited utilization of prior-year deficits to reduce current year inclusions under subpart F. H.R. 5270 did not amend the deficit carryover and chain deficit rules as they emerged under the 1986 Act. 66 Paul W. Oosterhuis and Roseann M. Cutrone, The Cost of Deferral’s Repeal: If Done Properly, It Loses Billions, Tax Notes, Feb. 8, 1993. 67 See discussion below at Part I.I (Worldwide Tax; Corporations as Separate Taxpayers) and II.K. (The Disregarded Entity Rules and Electivity Under Subpart F). 68 Part II.F.6. (Illustration of Cross-Crediting and Expense Allocation). 69 AJCA section 401. See note 23 in Table 1. It has not yet become effective, and was postponed until 2011 by the Housing Assistance Tax Act of 2008 (P.L. 110-289). 70 Taxpayer Relief Act of 1997, P.L. 105-34 (Aug. 5, 1997); Tax and Trade Relief Extension Act of 1998, P.L. 105-277 (Oct. 21, 1998); American Jobs Creation Act, P.L. 108-357 (Oct. 22, 2004) (hereinafter the “AJCA”); Tax Increase Prevention and Reconciliation Act of 2005, P.L. 109-222 (May 17, 2006) (hereinafter, “TIPRA”). 71 See discussion at text accompanying notes 12 and 263. 72 Statement of Hon. Douglas Dillon, Secretary of the Treasury, before Committee on Ways and Means of the House of Representatives, May 3, 1961, reproduced at Legislative History of the Revenue Act of 1962, at 170 (“[Ending deferral] will help domestic growth, strengthen our balance-of-payments position and (a matter in which I am not entirely disinterested) substantially increase tax receipts”). The passing reference to tax receipts appears to be the entire tax revenue reference in the description of the proposal at this stage of explaining the point of it all. 73 Panel Report, at 104–05, 132–35. 74 Panel Report, at 240. 75 Panel Report, at 103 (“Similarly, to prevent tax avoidance and to maintain government revenues, countries with predominantly territorial systems typically do not exempt certain foreign earnings of foreign subsidiaries, including earnings generated from holding mobile financial assets from home-country taxation.”). 76 Panel Report, at 241. 77 J. Clifton Fleming and Robert J. Peroni, Exploring the Contours Of A Proposed U.S. Exemption (Territorial) Tax System, 109 Tax Notes 1557 (Dec. 19, 2005), at note 5 (“Since 1996, the already anemic restraints on deferral have been further weakened through a series of poorly advised legislative enactments, culminating in the American Jobs Creation Act of 2004 (Jobs Act, P.L. 108-357, which would be more appropriately named the No Lobbyist Left Behind Act of 2004.”). 78 The NFTC is an association of about 550 U.S.-based MNCs, and NFTC Council members include most of the largest U.S. manufacturing companies and banks, which together account for 70 percent of U.S. foreign direct investment. 79 National Foreign Trade Council, The NFTC Foreign Income Project: International Tax Policy for the 21st Century, Part One: A Reconsideration of Subpart F (Washington, D.C. Mar. 1999) (herein sometimes referred to as the “NFTC Study Part One-1999”). 80 National Foreign Trade Council, The NFTC Foreign Income Project: International Tax Policy for the 21st Century, Part Two: Relief of International Double Taxation (Washington, D.C. Dec. 2001). 81 Supra note 14 and infra note 263. 82 Infra note 263. 83 See for example, Michael J. McIntyre, Statement before Senate Finance Committee: Collecting Tax from American Resident Individuals and U.S.-Based Multinationals on Income Earned Through Foreign Entities (July 21, 1995). 84 This table was included as an attachment to the author’s written testimony submitted at the hearing of the Senate Finance Committee, The Foundation of International Tax Reform: Worldwide, Territorial, and Something in Between, (June 26, 2008). 85 T.D. 8697, 1997-1 CB 215, 61 FR 66,584 (Dec. 27, 1996), establishing the so-called “check-the-box” regime under Reg. §§301.7701-1 through 301.7701-4, inclusive, and further establishing the “disregarded entity” status for certain single-member business entities. 86 In response to several tax practitioner comments about the consequences of introducing a electivity under subpart F, at 1995 and 1996 meetings of the Tax Section of the American Bar Association, representatives of the Treasury indicated that they intended to monitor the international implications and to take appropriate action to deal with any problems that might be identified. The obvious “electivity” provided to taxpayers (to decide to be or not to be subject to subpart F with respect to common items of foreign personal holding company income and foreign base company sales income) was evidently not then perceived by the government architects of the check-the-box rules to be a per se reason to limit the disregarded entity rules to domestic business entities. The issues were flagged as well by Reuven S. Avi-Yonah in To End Deferral as We Know It: Simplification Potential of Check-the-Box, 74 TAX NOTES 219 (Jan. 13, 1997). 87 The selection of a wholly owned foreign corporation, rather than a domestic corporation, to conduct foreign business activities, is elective and the consequences of that election will be deferral of recognition of income or loss, and credits for foreign taxes. See H. David Rosenbloom, From the Bottom Up: Taxing the Income of Foreign Controlled Corporations, 26 BROOKLYN J. INT’L L. 1525, 1536 (2001) (“A foreign corporation represents an election by controlling shareholders in the residence country not to recognize income and loss, or credits, currently.”). Once that permissible election has been made, however, the continued deferral or current taxation of United States shareholders with respect to subpart F income and investments in United States property is not supposed to be elective. 88 1998-1 CB 433. 89 See, e.g., Reg. §1.446-3(c) (“An agreement between a taxpayer and a qualified business unit (as defined in section 989(a)) of the taxpayer, ... is not a notional principal contract because a taxpayer cannot enter into a contract with itself.”) (Emphasis added.) 90 Notice 98-35, 1998-2 CB 34 (July 6, 1998). See, e.g., S. Rep. 105-174, 105th Cong., 2d Sess., reprinted in 1998-3 CB 537, at 646. The Senate Report states: The subpart F provisions of the Code reflect a balancing of various policy objectives. Any modification or refinement of that balance should be the subject of serious and thoughtful debate. It is the Committee’s view that any significant policy developments with respect to subpart F provisions, such as those addressed by Notice 98-11 and the regulations issued
thereunder, should be considered by the Congress as part of the normal legislative process.” 1998-3 CB at 649–50. Several bills were introduced to preclude implementation of regulations proposed in conjunction with the issuance of Notice 98-35, including S.572, 105th Cong. 2d Sess. (Mar. 10, 1998) which was co-sponsored by Senators Mack and Breaux. After leaving the Senate, Messrs. Mack and Breaux served as co-chairs of the Advisory Panel. The Advisory Panel Report effectively proposed eliminating the disregarded entity rules, but it does not appear that this was intended by Senators Mack and Breaux to inform the debate invited by them in Senate Report 105-174.

91 REG-113909-98. 64 FR 37,727-01 (July 13, 1999).

92 H. REPT. NO. 105-825 (Oct. 19, 1998) (“Nothing in this provision is intended to alter the Treasury Department’s agreement, as reflected in Notice 98-35, not to finalize regulations regarding so-called hybrid entities prior to January 1, 2000, in order to allow Congress the opportunity to fully consider the tax policy issues involved ... The Conference agreement follows the House bill.”).

93 Edward D. Kleinbard, The Business Enterprise Income Tax: A Prospectus, TAX NOTES 97 (Jan. 3, 2005); Rehabilitating the Business Income Tax, Brookings Institution The Hamilton Project, (June 2007). Mr. Kleinbard’s “cost of capital allowance” or “COCA” system would apply to equity capital invested in business entity capital a system similar to the original issue discount regime for debt capital. One advantage would be to eliminate possibly undesirable distinctions in the tax consequences of income and deductions attributable to debt versus the return on equity; one disadvantage might be to assume overoptimistically that the business using the capital is likely to be successful. While business is, on average, successful, a particular business may not be, in particular. It may be that risk capital investment would be discouraged by adding a current tax cost on the basis of assumed future returns. The traditional distinction between debt and equity has relied heavily on the distinction between equity that seeks a return on investment that is more versus less dependent on the success of a business venture than a debt investment that has a realistic expectation of repayment of a sum certain and compensation for the use the invested amount. See generally, William T. Plumb, Jr., The Federal Income Tax Significance of Corporate Debt: A Critical Analysis and a Proposal, 26 TAX L. REV. 369 (1971). That distinction may not be purely tax driven in its origins.

94 See, e.g., H. David Rosenbloom, From the Bottom Up: Taxing the Income of Foreign Controlled Corporations, 26 BROOKLYN J.

95 INT’L. L. REV. 369 (1971). That distinction may not generally, generate the opportunity for the use the invested amount.


97 Id., 1550 (“Income earned by foreign corporations in a non-controlled situation—either the corporation is not controlled by any one shareholder or controlling group of shareholders or the residence country taxpayer is not part of the control group—presents a different question. The proposal relating to control situations does not indicate how best to deal with the problem of international double taxation when control is lacking. ...”).

98 See discussion at Part II.E. (Matching of Expenses and Foreign-Related Income to Which the Expenses Relate).

99 A 2006 seminar in which various possible changes were discussed had a title that neatly summarizes the problem: James A. Baker III Institute for Public Policy Conference, Is It Time for Fundamental Tax Reform?: The Known, Unknown and Unknowable, Houston, Texas, April 27–28, 2006.

100 See note 40.


104 See, for example, the musings of the Treasury on protecting the source-country tax base (for the United States as source country) in Treasury Integration Report at 78–80.

105 Congressional Research Service Report for the Congress, U.S. Taxation of Overseas Investment and Income, note 30 above (“... if trade has increased substantially, investment has grown dramatically. Rough estimates indicate that in 1976, the stock of U.S. private assets abroad was 6.7% of the total U.S. privately owned capital stock; by year end 2006, assets abroad were 38.4% of the total U.S. private capital stock. In 1976, the stock of foreign private assets in the United States was 3.7% of the U.S. capital stock; at year end 2006 it was 38.8% of private U.S. capital.”).

106 Moline Properties, SCI, 43-1 USDTC ¶9464, 319 US 436, 63 SCI 1132 (1943).

107 See note 10 in Table 1.

108 This is, in effect, the assertion of portfolio shareholder-residence-country (capital exporting country) tax jurisdiction priority over foreign- business-activity country (source country) tax policy goals. 59 TAX L. REV. at 679 (“As is well understood, taxes are borne by individuals, as consumers and shareholders, not corporations; fairness to corporations is not relevant in applying fairness criteria.”) It is less clear now than it may have been in the 1920s that taxing resident corporations is likely to achieve progressivity at the portfolio shareholder residence level. Unlike the probable situation in 1923, when Professor Seligman advocated residence country priority in order to enhance progressivity of the income tax in a report to the League of Nations, Report on Double Taxation Submitted to the Financial Committee by Professors Bruins, Einaudi, Seligman and Sir Josiah Stamp, League of Nations, Part II Section I A (The Basis of Taxation The Principle of Ability to Pay), Doc. E.F.S. 73F 19 (the “1923 Report”), there is a much greater divergence in 2008 between the country of residence of corporations and the country of residence of their portfolio investor shareholders. See note 30.

109 See note 13 and accompanying text.

110 Senator Kerry had proposed similar legislation in previous Congresses.


112 The 2008 Democratic National Platform, Renewing America’s Promise, as approved by the Democratic National Conventions, August 25, 2008, at p. 21, “We will invest in American jobs and finally end the tax breaks that ship jobs overseas.” (emphasis added). The term “finally” may be a reference to President Kennedy’s 1961 original proposal to end deferral. See notes 55 and 83 and accompanying text.

113 Code Sec. 7701(a)(4) and (5).

114 The JCT Options Report built on the similar concept in the 2004 protocol to the U.S.-Netherlands tax treaty. The parameters of such residency have not yet been staked out in IRS guidance or in litigation. The Netherlands treaty protocol was designed to identify corporations that had too little nexus to make a corporation incorporated in one of the Contracting States be respected as a corporate resident of the state of incorpora-
tation. The same test may be hard to apply to determine where the true residence is outside the state of incorporation.

The JCT Options Report explained the intended scope as follows:
Under the proposal, a company's residence is based on the location of its primary place of management and control. A corporation's primary place of management and control is where the executive officers and senior management of the corporation exercise day-to-day responsibility for the strategic, financial and operational policy decision making for the company (including direct and indirect subsidiaries).

In determining which individuals are considered executive officers and senior management employees, the decision-making activities of all executive officers and senior management employees are taken into account. Under a centralized management structure, these employees would generally be those individuals who have executive officer positions and report to the corporate headquarters office. However, some companies may operate under a more decentralized management structure, where many strategic policy decisions are delegated to individuals who are directors of subsidiary companies. In this situation, individuals who are not executive officers and senior management employees of the corporate headquarters may be carrying on the strategic, financial and operational policy decisions for the company. The decision-making activities of these individuals are taken into consideration in determining the company's residence. [JCT Options Report, at 180.]

114 If expanded corporate residency is subject to the common “tie-breaker” provision in a bilateral U.S. income tax treaty, as it likely would be when the dust settles and Congressional road rage over inversions subsides, the putative U.S. resident (foreign incorporated) would remain a foreign treaty-resident corporation unless it failed to be sufficiently a resident of its country of incorporation under the “limitation of benefits” provisions included in the bilateral income tax treaty with that country. See, e.g., Model Income Tax Convention of November 15, 2006 (hereinafter sometimes referred to as the “2006 U.S. Model Treaty”), Articles 4.4 (“Where by reason of the provisions of paragraph 1 a company is a resident of both Contracting States, then if it is created or organized under the laws of one of the Contracting States or a political subdivision thereof, but not under the laws of the other Contracting State or a political subdivision thereof, such company shall be deemed to be a resident of the first-mentioned Contracting State.”) The likely end result in the long run would be that the expanded assertion of U.S. taxing jurisdiction would apply to (1) foreign MNCs parented in jurisdictions that are not parties to a comprehensive income tax treaty with the United States (e.g., Bermuda), or (2) foreign parented MNCs established under the laws of a “treaty country” but which are not, by operation of the “limitation of benefits” provisions in the applicable comprehensive income tax treaty, treaty residents because of limited nexus to the treaty country other than mere incorporation. While the provisions of Code Sec. 7874(f) purport to put expanded corporate residency determinations safely beyond the reach of the Treasury in its treaty-making process, it is likely that such provisions will eventually yield to a more moderate accommodation of the positions of treaty partners with whom we have to share the global economy.

117 See note 30 and materials referred to therein.
118 See note 27 and note 107.
119 Then-Chairman Dan Rostenkowski, “Don’t tax you. Don’t tax me. Tax the companies across the sea.” See note 14.
120 ABA Task Force Report, 59 Tax Lawyer 649, 670. See note 29.
121 “Residual” tax is the net U.S. tax (generally residence-based) due after allowance for foreign tax credits associated with the undistributed (deferred) taxable income. As discussed at infra note 129, the 2000 TREATY SUBPART F STUDY took this approach.
122 Such “marking to market” has also been the subject of some concern in connection with the financial crisis of 2008.
123 NFTC Study Part One-1999, note 79 above, at 33.
124 Generally accepted accounting principles in the United States.
125 Panel Report, at 133 (“If the U.S. multinational redeploys earnings abroad by reinvesting the [after-tax foreign earnings] in an active business, for example, it may avoid the U.S. tax on the earnings. To do so, the U.S. company may forego more attractive investments in the United States or may have to fund investments at home through costly borrowing that would be avoided if there were no repatriation tax on the earnings.”) The 2007 Treasury Approaches Report makes similar assumptions. See e.g., p.54 (“Moreover, the current U.S. tax system provides a tax disincentive to the repatriation of foreign earnings, which may cause U.S. multinational corporations to forgo U.S. investment.”)
127 Note 56.
128 2000 TREATY SUBPART F STUDY at p. 1 ix. (Emphasis added) See note 56. The Study described “deferral” in terms that appear to be premised on the Cary Brown model, although no mention of the model is made by name.
129 Particularly the failure to apply a similar “time value of money” effect to measure the deferral consequences that may underrate the value of previously paid foreign taxes when they are taken into account upon actual distribution without being grossed up to a future value that would increase the amount by then same discount rate used to discount the future U.S. tax to assumed “present value” in the original year when the earliest accretion to wealth might occur.
131 Stated more elegantly, Professor James Eustice is reported to have observed that “While there is a time value of money, there is also a money value of time.” Quote ascribed to Professor Eustice in Christopher H. Hanna, Comparative Income Tax Deferral: The United States and Japan, at 2 (2000). It has also been observed by Professor Hanna in his book that “...much of the complexity of the United States tax system can be linked to the ... provisions designed to prevent the benefits of tax deferral.”
133 The economics of economists such as Cary Brown.
134 As pointed out above in note 131, another view is that the deferred tax is really more akin to an equity investment by the government in the enterprise that utilizes the working capital provided by the deferred tax. For purposes of this discussion we will make
comparisons based on various interest rates to measure the cost to the government, or the benefit to the taxpayer, of replacing the deferred tax amount with borrowed money.

121 As Dr. Franklin observed, death and taxes are certain. However, GAAP accounting takes a different view. There’s the rub. See Part II.C.2. (U.S. GAAP Accounting for Undistributed Foreign Affiliate Income and Deferred Tax on the Income).

122 The 35-percent tax the government will collect on the premium over the risk-free rate, and all of the tax on all of the income generated on the undistributed “after tax” amount (the amount in excess of the deferred tax), should not be taken into account in testing the cost of tax deferral because the corporate income tax on that amount is an amount the government would be entitled to in any event, whether or not tax is deferred. Future increased tax on such additional income would only be properly offset against the tax “cost” to the government of deferral if one assumes that collecting the tax (otherwise deferred) at the outset would kill the goose that lays the golden egg.

123 See Act of 11 November 1647, supra note 133.

124 Code Sec. 1272–1275.

125 Code Sec. 453A.

126 Code Sec. 475.

127 Code Sec. 1256(a), (b).

128 Code Sec. 1256(a), (b)(2), (g)(2).

129 The theoretically correct result is a tax system in which tax collections now or tax collections later have the same present value. The theoretically correct result is also one that does not kill the goose, since the present value of zero is also its future value.

130 Notwithstanding the arguments about whether or not tax deferral is akin to an equity investment by the government, there is little doubt that the government insists on cash rather than shares in order to satisfy the tax on estimated accrued wealth.

131 Code Sec. 1272.

132 Code Sec. 453A.


134 Cities Service Company, CA-2, 75-1 ustc ¶9107, 522 F2d 1281; Gulf, Mobile and Ohio Railroad Company, CA-5, 78-2 ustc ¶9686, 579 F2d 892.

135 Reg. §1.1273-2(b)(1) and 2(c)(1).

136 See, e.g., DAVID C. GARLOCK, FEDERAL INCOME TAXATION OF DEBT INSTRUMENTS, APPENDIX A (5th ed. 2005), a leading treatise on the taxation of original issue discount into financial calculations.

137 Reg. §1.1273-2(b)(1) and 2(c)(1) use about 100 words. Recently proposed regulations under Code Sec. 959 and 961 take up almost 50 typed pages. Proposed Reg. §§1.959-1 to 1.959-4, inclusive, and 1.961-1 to 1.961-4, inclusive, REG-121509-00, 71 FR 51155-51179 (Aug. 29, 2006). They would replace existing regulations that should be required reading for public finance enthusiasts for ending deferral.


141 The lack of correlation between financial statement balance sheet net worth and actual market value of foreign affiliate stock has been described by the Tax Court when it was trying to deal with currency translation exposure for a U.S. dollar functional currency parent with respect to subsidiaries operating in a different functional currency. See, e.g., Hoover Co., 72 TC 206, 239, Dec. 36,032 (1979) ("Although financial reporting rules require a parent corporation to reduce consolidated earnings by exchange losses (experienced by its subsidiaries) on its consolidated income statement, the exchange losses are neither recognized nor realized for tax purposes. These losses merely represent the worst possible financial picture if the parent corporation were to liquidate its subsidiaries on the day following a devaluation ... In the final analysis, we are not convinced that a real risk of economic loss, either ordinary or capital in nature, is present under these circumstances"). A somewhat different view of the intersection between value of foreign affiliate stock and undistributed earnings is evident in the colloquy between Senators Dole and Moynihan discussing the intended scope of the hedging exception to the Code Sec. 1256 provisions then under debate. 127 Cong. Rec. 17852-3 (July 28, 1981). Sorting out the permutations provides a good living for many who might otherwise be forced into rocket science or bus driving.

142 As discussed above in Part II.C.2. (U.S. GAAP Accounting for Undistributed Foreign Affiliate Income and Deferred Tax on the Income), the interest free loan effect, as distinguished from the provisioning effect in U.S. GAAP financials for residual U.S. tax on undistributed foreign earnings, probably has only a modest effect on any such location decisions.

143 See Part II.C.2.a. ("International Tax Norms": OECD” Harmful Tax Competition”)

144 Excerpts from this section of the article were included as an attachment to the author’s written testimony submitted at the hearing of the Senate Finance Committee, “The Foundation of International Tax Reform: Worldwide, Territorial, and Something in Between” (June 26, 2008). The topic was also mentioned in the ABA Task Force Report, 59 Tax Lawyer 649, 670. In addition, Professor Christopher Hanna has prepared an interesting article on the issue that will be published in the Spring 2009 issue of
ENDNOTES


177 FAS 109, supra note 172.
178 FAS 109, Para. 16.
179 FAS 109, Para. 177.
180 FAS 94, supra note 171.
181 APB Op. 23, Para. 10 (emphasis added).
184 FAS 109, Para 171-172 (emphasis added).
185 FAS 109, Para. 173.
186 FAS 109, Para. 169.
188 Panel Report, at 133.
189 JCT Options Report, at 188-89.
191 FAS 94.
192 APB Opinion No. 23; FAS 109.
193 Stated differently, such later accruals of income tax with respect to prior income accruals are not treated as a mere adjustment to balance sheet retained earnings (which would have no effect on earnings per share).
195 FAS 94.
196 It would remain a matter of art rather than science to predict the future U.S. effective tax rate in the year of eventual repatriation, since the future history of the U.S. members of the group can only be very roughly guessed at. A convenient surrogate could be the effective tax rate (U.S. and foreign) in effect in the year the income is included in the consolidated financial statements.
197 The incongruity of language sounding in dividend equivalence and the actual focus in the consolidated financial statements.
198 FAS 109, supra note 172.
199 See, e.g.,LTR 833-4003 (May 5, 1983) dealing with the presence of a ship temporarily in U.S. waters for repairs that was unable to steam out beyond the shore defenses before the last day of 1978 and whether it was an investment in U.S. property. The IRS applied a home-grown version of economic substance to determine whether the ship had really left or had merely left for the impermissible reason of avoiding a tax trap for the unwary.
201 There is also a balance of payments deficit at the present time.
202 The triggering threshold was set at 25-percent common ownership between the investing controlled foreign corporation and the investee United States person.
204 Id. (emphasis added).
206 T.D. 7604, 1964-1 CB Part I 284 (Feb. 19, 1964), added Reg. §1.956-2(d)(2)(ii), which defined an “obligation” of a United States obligor to exclude any indebtedness which is collected within one year from the time it is incurred.
207 1988-2 CB 174 (June 14, 1988).
208 Id.
211 Id.
212 Panel Report, at 133.
213 See also, Jonathan Swift, A Modest Proposal: For Preventing the Children of Poor People in Ireland from Being a Burden to Their Parents or Country, and for Making Them Beneficial to the Publick (London 1729) (“These mothers, instead of being able to work for their honest livelihood, are forced to employ all their time in strolling to beg sustenance for their helpless infants: who as they grow up either turn thieves for want of work, or leave their dear native country to fight for the Pretender in Spain, or sell themselves to the Barbadoes.”). The Panel Report authors may have a similar concern about the risk of holding company income.
proliferation of U.S.-parented foreign entities that may be encouraged by deferral to sell themselves to the Barbados (a tax haven).

234 Constructive dividends under general tax jurisprudence would also be treated as dividends for such purposes.

235 The "repatriation tax" discussion sometime seems to assume that "repatriation" is a dividend or other withdrawal of investment by a U.S. shareholder in a foreign corporation. See for example, the discussion in ABA 2006 Task Force Report, at 711 ("...the additional U.S. tax on a dividend distribution sometimes referred to as a repatriation tax.").

236 If general U.S. tax principles are insufficient to reach withdrawals of shareholder's equity under certain circumstances, a slightly more targeted approach might be to follow the approach of Notice 2006-85, IRB 2006-41, 677 (Sept. 22, 2006).

237 Code Secs. 951(a)(1)(B) and 956.

238 This appears to be the approach in all other countries.

239 Notice 2008-91, IRB 2008-43, 1001 (Oct. 6, 2008) recognizes this affirmative use of Code Sec. 956 by taxpayers, allowing an election between the "30/660" and the "60/180" rule, so as not to disturb such tax planning. See also Notice 2009-10, IRB 2009-5 (Jan. 14, 2009), which extended the relief in Notice 2008-91.

239 Code Sec. 78.

240 Note 14 above.

241 It is in large measure identical to the dividend exemption system in the JCT Options Report. The expense matching in the JCT Options Report was asymmetrical with its intellectual premise and was effectively corrected in the version propounded in the Panel Report.


243 Expenses that are definitely allocable to discrete income producing assets or activities.

244 An alternative approach might be devised that would not require asset-by-asset basis adjustments, but instead rely on an adjustment to aggregate bases of all assets in a pool. In the event of a sale, exchange or other disposition of a particular asset, the then-remaining aggregate pool might be apportioned to the asset to be disposed of to the extent of any gain (measured with respect to basis and amount realized determined without regard to disallowed expenses). While this would be simpler, and would avoid the need to make specific basis allocations that might not ever be used to determine tax liability, its averaging effect would probably be an insurmountable obstacle to its acceptance.

245 In addition, any such adjustment would also reflect prior additions for disallowed deductions, as well as reductions to reflect, in the case of deferral, restoration of a deduction in a future year.

246 See discussion above at Part II.E.6. (Illustrative Calculation of Tax Effect of Deferring orDisallowing Expenses Matched to Foreign Income).

247 Such shareholder-level expenses may be allowed as a deduction against lower-tier affiliate income under a consolidated return regime. Such regimes do not generally contemplate consolidated returns that include foreign shareholders that are not themselves taxable on a worldwide residence basis.

248 See, e.g., Paul W. Oosterhuis, The Evolution of International Tax Policy: What Would Larry Say? 2006 TNT 128-19 (June 19, 2006). See also, remarks by Philip D. Morrison, then International Tax Counsel, Department of the Treasury, to the Tax Foundation, November 30, 1989, reported at 89 TNT 241-3 (Dec. 1, 1989) in which Mr. Morrison discussed the significance of ensuring that all expenses would be deductible somewhere, provided that all income was also taxable somewhere under a principle of tax harmonization. Such a principle would not, in all likelihood, have combined concern about an expense deductible nowhere with indifference to the incidence of tax on the income attributable to the deductible expense.

249 Code Sec. 263(g).

250 Code Sec. 265(a)(2).


252 Note 129 above. Intangible property ownership in low-tax jurisdictions is likely to be responsive to the GAAP benefits of permanent reinvestment of subsidiary earnings as much as, or more than, to the time value of money associated with deferral of residual residence-based tax. See discussion at Part II.C.2 (U.S. GAAP Accounting for Undistributed Foreign Affiliate Income and Deferred Tax on the Income).

253 The foreign tax credit limitation on these facts would not reduce the tax credit from 12.5 to a lesser amount of credit as a result of allocating 30 units of USCO interest expense against 100 units of "foreign source" income from For-Sub (Dividend: 88.5; Sec. 78 "gross up" 12.5 = 100). Total USCO income: Domestic: 70; Foreign 100 = 170; 170 times 35% = 59.5 maximum amount of U.S. tax against which credit is allowed: 59.5 times 70/170 = 24.5.

254 If For-Sub deploys 35 units at, say, five percent (the assumed governmental risk-free borrowing rate), an inclusion in Year 2 of five percent of 35 would not, at a 35-percent tax rate, recover 100 percent of the government's cost of borrowing 35 at a five-percent rate. In order to make the government whole, from the standpoint of its cost of borrowing to replace the deferred tax, the USCO For-Sub inclusion would have to increase from 1.75 (35 x 5%) to 5.0, so that 35% tax thereon would cover the entire 1.75 borrowing cost. In order to generate five units of taxable income in year 2 on 35 units of capital provided by the delayed or foregone year 1 tax of 35, For-Sub would have to earn at the rate of 14.28% (5/35), an amount in excess of both the government's assumed risk-free borrowing rate (five percent) and USCO's enterprise risk borrowing rate (six percent). Any such excess would be attributable to some form of premium income producing capacity or assets such as intangible property or a better business model. Treating the tax on such premium income as a way to make the government whole on the initial tax deferral is incorrect. The government will always be entitled to the tax on the future premium income whether the tax is collected currently or deferred. The taxpayer can be fairly assumed always to borrow at six percent to generate a profit corresponding to the premium return.

255 This latter approach was proposed by H. David Rosenbloom in 2000. From the Bottom Up: Taxing the Income of Foreign Controlled Corporations, 26 B. (2001).

256 And from any deferral because all deferral would be ended.

257 ABA 2006 Task Force Report, note 19 above, at 665 ("An exemption proposal that provides greater relief from U.S. tax than is required to relieve double taxation is difficult to justify under any fairness analysis."). This may assume that the exempt income will eventually make its way to the wealthy residents of Beacon Hill rather than to the benefit of foreign investors, U.S. charitable organizations, exempt employee retirement plans, etc. Such an assumption needs to be examined and verified empirically before acting on it without regard to potential collateral damage.

258 The Organisation for Economic Co-operation and Development or OECD is comprised of 30 member countries who together comprise the most economically developed countries participating in the global economy. China, India and Russia are not members.

259 Grubert and Alshuler, Corporate Taxes in the World Economy, supra note 20.


261 Present law foreign base company sales income and foreign base company services income. See Code Sec. 954(d) and 954(e).
Present law related-party interest, rents and royalties included in “foreign personal holding company income” by Code Sec. 954(c). This treatment of such base erosion income does not reflect the provisions of TIPRA that added new Code Sec. 954(c)(6). See discussion above at text accompanying note 9 in Table 1.

See, e.g., Pamela Olson, Assistant Secretary of the Treasury for Tax Policy, testimony before the Senate Committee on Finance on International Tax Policy and Competitiveness (July 15, 2003) (“Under subpart F, a U.S. parent company is subject to current U.S. tax on income earned by a foreign subsidiary from certain sales transactions. Accordingly, a U.S. company that uses a centralized foreign distribution company to handle sales of its products in foreign markets is subject to current U.S. tax on the income earned abroad by that foreign distribution subsidiary … [A] foreign competitor that similarly uses a centralized distribution company with sales into the same markets … generally will be subject only to tax imposed by the local country … [T]his rule has the effect of imposing current U.S. tax on income from active marketing operations abroad. U.S. companies that centralize their foreign distribution facilities therefore face a tax penalty not imposed on their foreign competitors.”).

Code Secs. 863(b), 865(b). Present law related-party interest, rents and royalties included in “foreign personal holding company income” by Code Sec. 954(c). This treatment of such base erosion income does not reflect the provisions of TIPRA that added new Code Sec. 954(c)(6). See discussion above at text accompanying note 9 in Table 1.

Revenue Act of 1921, ch. 136, 222(a)(5), 238(a), 42 Stat. 227, 249, 258. This remains true under present law. It was also necessary that the other income be not less than zero. The aggregate amount of credit was limited to a portion of U.S. tax otherwise due on worldwide income. Domestic losses could reduce U.S. tax otherwise due and thus reduce the amount of allowable foreign tax credit in any year.

The pertinent history is summarized in Michael J. Graetz and Michael M. O’Hear, The Original Intent Of U.S. International Taxation, 46 Duke L. J. 1021, note 141 (Mar. 1997).


The reason appears to be a concern about Code Secs. 863(b), 865(b). Proponents of this mechanism typically prefer the alternative euphemism, “foreign tax averaging.” Either term is accurate enough. We use the “cross-crediting” euphemism, notwithstanding its pejorative connotation, because that is the term used in the Panel Report.

“Adopt a dividend exemption system for their foreign competitors.”

This treatment of such base erosion income does not reflect the provisions of TIPRA that added new Code Sec. 954(c)(6). See discussion above at text accompanying note 9 in Table 1.

The example is provided to illustrate the destination (“source”) country tax is also reinforced by tax treaties between the United States and each such country. Sales income would be business income taxable only if attributable to a local “permanent establishment.” Treaties ordinarily exclude from constituting a “permanent establishment” the mere delivery of tangible property (e.g., passage of title to a buyer in the destination country).

Reg. §§301.7701-2, -3

The exemption from destination (“source”) country tax is also reinforced by tax treaties between the United States and each such country. Sales income would be business income taxable only if attributable to a local “permanent establishment.” Treaties ordinarily exclude from constituting a “permanent establishment” the mere delivery of tangible property (e.g., passage of title to a buyer in the destination country).

U.S. tax on income from active marketing operations abroad. U.S. companies that centralize their foreign distribution facilities therefore face a tax penalty not imposed on their foreign competitors.”

This treatment of such base erosion income does not reflect the provisions of TIPRA that added new Code Sec. 954(c)(6). See discussion above at text accompanying note 9 in Table 1.

The example is provided to illustrate the concepts involved. “Inappropriate” separation of foreign taxes and the foreign tax base on which the foreign taxes are imposed has been a topic of great concern to the IRS and
that concern has led to a number of regulatory responses to disfavored transactions. A review of the regulatory and administrative guidance provided as part of the IRS response is beyond the scope of this article.

The synthetic denial of the economic benefit of a deduction if, at the margin an allocated expense, results in loss of credit against the U.S. tax otherwise due at the effective rate of U.S. corporate income tax.

As discussed above, the result is achieved by applying quantitative limits. The foreign tax is eligible for credit whether or not imposed on foreign source income, so long as it is imposed under an income tax law of the foreign country.

Code Sec. 865(a). Personal property is all property other than real property. Income from real property is sourced in the country where situated.


The manufacturing profit, if any, is of course not subject to destination country taxation. Such axioms depend upon the effective attribution of income to manufacturing and sales. In an integrated business, such attribution is often more art than science.

The United States Model Income Tax Convention of November 15, 2006, contains an example of such a provision in its Article 5. The various incidents of taxable nexus do not include sporadic or even continuous transfer of legal ownership (“title”) and risk of loss.


1986 Act Blue Book, at 918.

1986 Act Blue Book, at 918. The United States has reported “substantial trade deficits” every year since 1986. Economists frequently explain that such deficits are compensated for by reduced imports and currency exchange rate adjustments. Such theories may be true in the fullness of time but have proven to be difficult to confirm in the short to medium term.

“Congress was concerned with the tax policy implications of prior law, however, and directed the Treasury Department to study the source rules for sales of inventory property taking into account not only the tax policy implications of the rule but also Congress’ concerns regarding the impact of this rule on U.S. trade.” 1986 Act Blue Book, at 918.


280 Temporary Reg. §1.482-7T, TD 9441 (Jan. 5, 2009); Proposed Reg. §1.482-7, REG. 144615-02 (Jan. 5, 2009).


283 Id., at 28–29.


285 Id., at 62 (in the context of adopting a dividend-exemption system along the lines suggested by the ICT Options Report or the Report).

286 Id., note 296.

Now it is conceivable that globalization in the internet are changing the assumptions about substitutability among various margins. For example, it may be that R&D and other intangible development is becoming more mobile. If it is taxed highly in the United States, it might move to Ireland or some other low-tax location. But at this stage, the most recent National Science Foundation data do not seem to support this possibility. The share of their worldwide R&D performed abroad by U.S. companies was about the same in 1990 as it was in 2001, the last year for which data was available. n100 Investment in intangibles seems less mobile than other types of investment. Furthermore, the concern about the location of R&D depends on the assumption that it provides externalities in the location where it is undertaken and that the current tax benefits to R&D such as the research credit do not adequately reflect these externalities.

Nevertheless, it may be that in the future, creators of intangible assets will become highly mobile themselves. For example, if authors are highly taxed in the United States, they may choose to expatriate to Monaco or some other low-tax location. If they do in fact become highly mobile, then the analysis above on trade and tariffs would apply. One could think of creators of specific intangibles as a

ENDNOTES
specific “unique” type of labor or human capital, which the end products embody very intensively in the same way that insurance depends heavily on financial capital. But at this stage, this is entirely speculative and a tax on such intangible imports would be very difficult to implement. It also would of course violate WTO obligations.


Foreign corporations are subject to U.S. federal income tax only on income “effectively connected” with a U.S. trade or business or on U.S.-source “fixed or determinable, annual or periodical” income. The “otherwise taxable” income we refer to is that attributable to an increased value of foreign activity and foreign assets, and is accordingly neither U.S.-source “FDAP” nor effectively connected with a U.S. trade or business.


See also Charles E. McLure, Jr., “Federal Use of Formula Apportionment to Tax Income from Intangibles,” 97 TNT 66-65 (Apr. 7, 1997). He points out that a formulary approach would inevitably be subject to difficulties comparable to the arm’s-length model because of difficulty in assigning a “situs” to an intangible.

See note 40.


See Senate Committee on Finance, *Hearing on the President’s Proposed Fiscal 2007 Budget*, Feb. 7, 2006 (unofficial transcript reported in TAX NOTES TODAY, Feb. 15, 2006). 2006 TNT 31-15, at 24–25. Neither Senator Grassley nor Secretary Snow mentioned the experiences of Xerox Corporation when it applied the same tax technology as Microsoft. Xerox Corporation was reported to have suffered large (and tax-inefficient) losses in its Irish subsidiary when the technology whose development costs Xerox was underwriting did not achieve profitable commercial levels. The problem might have been less urgently in need of a solution if that additional information had been kept in mind at the hearing.

See Proposed Reg. §1.482-7, 25, 2005, Temporary Reg. §1.482-7, TD 9441, was adopted January 5, 2009. The temporary and proposed regulations issued in January, 2009 are not materially different in support of the issues involved in the response to the so-called “Microsoft problem.”


Section 103(b) TIPRA, supra note 9 Table 1.

Panel Report, at 240.


Proposed Reg. §1.482-7(g)(2), supra note 307. Temporary Reg. §1.482-7T, TD 9441, was adopted January 5, 2009.


For example, cost sharing with risk-based allocations to subsidiaries or affiliates in Ireland or Switzerland would be subject to a treaty-based arm’s-length principle, while cost sharing with subsidiaries and affiliates in the Cayman Islands, Liechtenstein, et al., would be subject to the alternative regime. Special considerations, if applicable, would have to be addressed legislatively with respect to U.S. possessions and associated territories such as Puerto Rico the Virgin Islands, and the Northern Marianas.

It is probably appropriate to note that occasionally the United States has been uncomfortable with the arm’s-length principle in the treaties it has entered into. The saga of NatWest Bank in dealing with the application of Reg. §1.882-5 under a treaty (or the others) (July 15, 2003) (“Both the increase in foreign taxable income eventually to be realized as capital income by the U.S. MNC in respect of the capital invested (i.e., the premium return) should keep the government largely whole. Other considerations, such as investment location decisions, might be addressed by a careful examination of why businesses decide to invest, and should consider both tax and nontax factors.

The impetus for going to this point may be a lack of confidence that deferral with respect to income from high value intangibles is only temporary. The opportunity for some sort of eventual amnesty from residual residence-country corporate income tax may encourage such lack of confidence. For example, the “Temporary dividends received deduction” under Code Sec. 965, as added by the AJCA, may have suggested to some commentators that the provision might be proposed as a recurring response to the emergency of the moment rather than a one-time-only event. See, e.g., George K. Yin, *Reforming the Taxation of Foreign Direct Investment by U.S. Taxpayers*, 88 TAX NOTES 173, 175 (2008).


The differing perceptions are reflected in fairly recent Treasury pronouncements. See TREAT. DEPT., OFFICE OF TAX POLICY, THE DEFERRAL OF INCOME EARNED THROUGH U.S. CONTROLLED FOREIGN CORPORATIONS, A POLICY STUDY, at 57 (Dec. 2000) (“Indeed, the available data simply do not provide a reliable basis for evaluating whether subpart F has affected multinational competitiveness to any significant effect.”). Pamela Olson, Assistant Secretary of the Treasury for Tax Policy, testimony before the Senate Committee on Finance on International Tax Policy and Competitiveness (July 15, 2003) (“Both the increase in foreign acquisitions of U.S. multinationals and the corporate inversion activity of the past few years evidence the potential competitive disadvantage created by our international tax rules.”). The National Foreign Trade Council produced its extended report between 1999 and 2002, THE NFTC FOREIGN INCOME PROJECT: INTERNATIONAL TAX POLICY FOR THE 21ST CENTURY.
In Volume II (Dec. 15, 2001), at 3–4, the report concludes that there is an important competitive effect: “The breadth of subpart F exceeds the international norms for such rules, adversely affecting the competitiveness of U.S.-based companies by subjecting their cross-border operations to a heavier tax burden than that borne by their principal foreign-based competitors.” The commentators’ response to those disparate conclusions has been equally varied.

Cross data is available with respect to aggregate cross-border portfolio capital flows to U.S. domestic equities or foreign equities, but such data seem not to be readily segregated among manufacturing, high technology, Fortune 100, Fortune 500, or other permutations of the U.S. and foreign MNC population that might have distinct levels of sensitivity to different levels of corporate income tax.

The notion that the wealthy capitalist residents of Beacon Hill are living off the sweat of the brow of the laborers in Lowell may be out of date. See Lee Sheppard, Treasury’s Dilworth Addresses International Tax Reform Issues, 2006 TNT 178–8 (Sept. 14, 2006) (“Fighting the last war ... Kim Blanchard of Weil Gotshal & Manges, the current chair of the New York State Bar Association Tax Section, told Dilworth he was fighting the last war in trying to tax returns for U.S.-owned capital on a residence basis. “There is no such thing as outbound investment of U.S. capital,” Blanchard said. Capital comes from all over the world into funds that deploy it all over the world, she explained, alluding to hedge funds but also other large international institutional investors. “It isn’t the 1960s anymore.”)


The Kerry-Edwards Pro-Jobs Tax Reform Plan. See also, a 2006 article by James Kvaal, a senior advisor to Senator John Edwards in the latter’s 2004 campaign to become Vice President, Removing Tax Subsidies for Foreign Investment, 111 Tax Notes 1299 (June 12, 2006).


The simplest and most certain form of tax minimization is to avoid altogether engaging in a profit seeking business, but most business enterprises are not willing to go to this length to achieve a reduced tax burden.

A report by the Government Accountability Office, Offshoring of Services, An Overview of the Issues, GAO-06-5 (Nov. 28, 2005), at 10, and the authorities cited therein, tend to indicate that foreign investment location decisions are affected by wage costs in cases of low wage jobs and by other infrastructure factors in other cases. A very substantial majority of foreign direct investment by U.S. MNCs flows into high tax jurisdictions.

E.B. Barlow & Ira T. Wender, Foreign Investment and Taxation, at 247 (1955) (“Exemption has been advocated by many companies and by such important groups as the National Foreign Trade Council and the United States Council of the International Chamber of Commerce.”). The book was published under the auspices of the Harvard Law School International Program in Taxation of which Professor Stanley Surrey was then the Director.

Professor Surrey measured the comparative tax burden on the basis of discounted cash flows that take into account the difference between payment of tax now rather than later. A tax that is deferred “costs” the taxpayer less, and costs the government more, than a tax that is paid currently. As sensible as this approach to measure tax incentives may be, it does not appear to be the manner in which many U.S.-parented MNCs generally measure the impact on their provision for income taxes. GAAP does not use or permit discounting to reflect the difference between additions to the tax provision in the current year for current or deferred tax. To the extent U.S.-parented MNC behavior is informed by relative competitiveness, it will more likely be informed by GAAP and earnings per share than the measures used by Professor Surrey and his successors.


As of November 2008, they may now only be affluent.


Code Sec. 269B is an exception. While the deemed domestic corporation is subject to worldwide federal income tax because it is domestic, it is excluded from the privilege of joining in filing a consolidated federal income tax return because it is treated as foreign for purposes of Code Sec. 1504(b) (3). Notice 89-94, 1989-2 CB 416.

Rep. Rosa DeLauro (D-CT), press release, June 1, 2004 (“These companies enjoy all the benefits of corporate citizenship in America—they look like U.S. companies, the principle (sic) market their stock is traded in is the United States, and their physical assets are protected by our armed forces. They just refuse to pay for the benefits—as every other U.S. citizen and company does.”).


The foreign MNC may, however, be subject indirectly to worldwide tax on the non-U.S. source income of U.S.-parented foreign subsidiaries that are in the foreign MNC group. Thus, Amoco’s historical subsidiaries operating in foreign countries will generate income subject to U.S. worldwide income tax, even when operating in the same jurisdictions as other non-U.S. subsidiaries of British Petroleum. Such exposure may then be the impetus for considering post-merger “restructuring” when a U.S. MNC is acquired by a foreign MNC.


Code Sec. 7874.

JCT Options Report, at 178–81.

Panel Report, at 135.

Either the JCT Options Report or Panel Report.

See note 327 above.
Individuals were also subjected to the same thresholds of passive income at the foreign Revenue Act of 1937, P.L. 377, 75th Cong. Such investments are sometimes described very inclusively to include not only such obvious matters as education to produce a capable workforce but also more generally less tangible elements of state-sponsored welfare that may contribute to a contented population. See discussion of various “runaway plant” tax proposals since the Nixon Administration at Part II.H.1.b.i. (Competition with Domestic Production).

Revenue Act of 1937, P.L. 377, 75th Cong. 1st Sess. ch. 815, 50 Stat. 813 (1937). The AJCA, supra note 12 in Table 1 repealed the standalone provisions dealing with Foreign Personal Holding Companies, but the substance is effectively continued in the provisions of subpart F dealing with “foreign personal holding company income.”

Thresholds of passive income at the foreign corporation level were required in order to subject shareholders to tax on undistributed income. The threshold confirms an intention to reach the abuse of an incorporated pocketbook rather than a more general desire to revisit the treatment of corporations as separate taxable entities. See, e.g., P.Y. Eder, CA-2, 138 F2d 37 (1942) (“We do not agree with taxpayers’ argument that inability to expend income in the United States, or to use any portion of it in payment of income taxes, necessarily precludes taxability. In a variety of circumstances it has been held that the fact that the distribution of income is prevented by operation of law, or by agreement among private parties, is no bar to its taxability. See, e.g., Heiner v. Mellon, 38-2 USTC 9311, 304 US 271, 281, 58 SCt 926; Helvering v. Enright’s Estate, 41-1 USTC 9356, 312 US 636, 641, 61 SCt 777; cf. Helvering v. Braun, 40-1 USTC 9337, 309 US 461, 60 SCt 631. That the result under the statute here before us may be harsh is no answer to the government’s position; the purpose of Congress was to deal harshly with ‘incorporated pocketbooks’ and the motive of a particular taxpayer who has such a ‘pocketbook’ we have held to be irrelevant.”

Individuals were also subjected to the same regime to maintain symmetry. The resulting overlap with the older regime for Foreign Personal Holding Companies continued until cleared out as deadwood in the AJCA.
financial services income from the disfavored “Mobile Income” category, while treating as tainted Mobile Income the fruits of multi-jurisdictional sale of goods and services.

See, e.g., Reg. §1.446-3(c)(1)(i), dealing with notional principal contracts. (“An agreement between a taxpayer and a qualified business unit…of the taxpayer … is not a notional principal contract because a taxpayer cannot enter into a contract with itself.”) (emphasis added).


See, e.g., 2006 U.S. MODEL TREATY, Article 7.2 (“Subject to the provisions of paragraph 3, where an enterprise of a Contracting State carries on business in the other Contracting State through a permanent establishment situated therein, there shall in each Contracting State be attributed to that permanent establishment the profits that it might be expected to make if it were a distinct and independent enterprise engaged in the same or similar activities under the same or similar conditions. For this purpose, the profits to be attributed to the permanent establishment shall include only the profits derived from the assets used, risks assumed and activities performed by the permanent establishment.”).

The United Kingdom referred to such rules as “thin capitalization” rules. The U.S. counterpart for addressing earnings stripping by means of excessive related party debt is found in Code Sec. 163(j).

Notice 98-11, 1998-1 CB 433 (Feb. 9, 1998) (“Treasury and the Service believe it is appropriate to prevent taxpayers from using these types of hybrid branch arrangements to reduce foreign tax while avoiding the corresponding creation of subpart F income.”) (emphasis added).

Admitting error, on the other hand, would have raised no such issues.


Notice 98-35, Id.

Hon. Donald C. Lubick, Assistant Secretary of the Treasury for Tax Policy, Remarks before the GWU/IRS Annual Institute on Current Issues in International Taxation, Dec. 11, 1998. (“Following events of the past year, including the controversies over Notice 98-11, the active financing exception to subpart F, and other matters, we have decided to undertake a re-examination of our deferral rules. We hope this reexamination will be useful to the tax writing committees in their deliberation of international tax issues next year”).

Remarks attributed to Hal Hicks, International Tax Counsel, by Lee Sheppard, News Analysis: Check the Box Rules Not Sacred, Says Hicks, TAX NOTES TODAY, June 5, 2006.

JCT OPTIONS REPORT, Modify Entity Classification Rules to Reduce Opportunities for Tax Avoidance, pp 182–85.


Panel Report, at 240.

See, e.g., Code Secs. 367(d), 482.

Panel Report, at 240 (“Income of foreign branches would be treated like income of foreign affiliates … These rules would be needed to place branches and foreign affiliates on an equal footing. For example, a rule would be needed to impute royalties to foreign branches.”

JCT Options Report, at 191.


Id.

Code Sec. 904(d)(2)(E), as added by the 1986 Act.

Staff of the Joint Committee on Taxation, General EXPLANATION OF TAX LEGISLATION EN-ACTED IN 1997, at 301–302, JCS 23-96 (Dec. 17, 1997).

The JCT Options Report took the position that the choice between portfolio treatment (with concomitant loss of the foreign tax credit) or controlled foreign corporation treatment, with current residual U.S. residence-based tax on undistributed income, was the proper “extent possible.” The third alternative, present law, was, not so viewed by the Staff of the JCT.


Panel Report, at 134.


Exempt foreign business income would be wholly exempt from U.S. income tax (without regard to the level of foreign tax if any) on any such exempt foreign business income.

See discussion at Part II. (Worldwide Tax; Corporations as Separate Taxpayers). .

Code Sec. 501(a). Dividends or interest from a foreign corporation would not normally constitute “unrelated business taxable income” under Code Sec. 511 that would be taxable to a tax-exempt entity. A foreign corporation is subject to U.S. corporate income tax on certain U.S.-source investment income and on “effectively connected” business income. Code Secs. 881, 882.

See discussion of the use by tax exempt investors of foreign “blocker corporations” organized in low tax or no tax jurisdictions at infra note 430.

Code Sec. 501.

See note 40.

Code Secs. 511–512

Code Sec. 514.

In 2007, the Staff of the Joint Committee prepared a report on selected international issues, including, inter alia, certain issues involving tax-exempt investors and their investments in offshore “blocker” corporations to structure investments in certain investment funds, Present Law and Analysis Relating to Selected International Tax Issues, JCX-85-07 (Sept. 24, 2007). The Report did not examine the potential application of the same or similar tax incentives for investment by tax-exempt investors in foreign MNCs, but the reasoning contained in the Report as to such incentives for investment in portfolio management investment funds would appear to apply equally to investments by tax exempt investors in foreign MNC equity securities. For example, the Report at page 69 recites “Others argue that the ability to block UBIT by investing through blocker corporations established in tax haven jurisdictions results in the investment of capital offshore rather than domestically, and that this is undesirable. However, others argue that the use of offshore UBIT blockers does not have this result, because the underlying investment assets frequently are located in the United States.” The possible sensitivity to tax incentives described in the Report, that led tax-exempt investors to use of foreign “blockers,” may migrate to the comparison of the overall tax burden on investments by tax-exempt investors in foreign MNCs compared to similarly situated U.S. MNCs that may be distinguished by a difference in residual residence country tax on business income.

Combined corporate (business activity) income tax and shareholder (residence based capital income) tax.

If the foreign MNC conducts business outside the United States at an effective rate lower than the combined U.S. and foreign effective rate on a U.S. MNC conducting the same foreign business.

Supra note 430.

See Part III.F. (Transfer Pricing: Exclude Risk Based Allocations of Income to CFCs Except by Treaty).

See note 40.

ENDNOTES