[COMMITTEE PRINT]

U.S. TAXATION OF FOREIGN SOURCE INCOME—DEFERRAL AND THE FOREIGN TAX CREDIT

PREPARED FOR THE USE OF THE

COMMITTEE ON WAYS AND MEANS

BY THE STAFF OF THE

JOINT COMMITTEE ON INTERNAL REVENUE TAXATION

SEPTEMBER 27, 1975

U.S. GOVERNMENT PRINTING OFFICE

59-015 O WASHINGTON : 1975 JCS-39-75

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I. INTRODUCTION

There are two generally recognized bases for any country's jurisdiction to tax income: (1) jurisdiction over the recipient of the income, and (2) jurisdiction over the activity which produces the income (i.e., the source of the income). Thus, a country may tax the worldwide income of persons subject to its jurisdiction or it may tax income earned within its borders, or it may tax both.

Tax jurisdiction over an individual may be obtained, as in the United States, by the residency or citizenship of an individual. Tax jurisdiction over a corporation is determined by place of residency, which in the United States is the place of corporate organization.

In addition, most countries' tax laws and regulations contain rules (called source rules) for determining whether, and the extent to which, income is earned from activities conducted within that country or within some other country.

Since most sovereign nations apply the above principles in taxing their residents and in taxing income from sources within their borders, two nations often claim the right to tax the same income. Most nations have developed principles to accommodate these competing claims and thus avoid what could be called a double taxation of income. One principle is that the country of the source of income, particularly in the case of business profits earned through an office in the source country, has the primary jurisdictional right to tax that income. The country of residence retains a residual right to tax that income. Since a double tax on this income would tend to discourage capital and individuals from crossing borders and thus inhibit international commerce, most countries which exercise the residual right to tax their residents and corporations on a worldwide basis allow a tax credit for income taxes paid to the source country.

II. U.S. TAXATION OF FOREIGN INCOME—AN OVERVIEW

Under present law, the United States imposes its income tax upon the worldwide income of any corporation organized under the laws of any of the States or the District of Columbia, whether this income is derived from sources within or from without the United States.[1] A tax credit (subject to limits) is allowed for foreign taxes imposed on their foreign source income.

Foreign corporations generally are taxed by the United States only to the extent they are engaged in business in the United States (and to some extent on other income derived here). As a result, the United States generally does not impose a tax on a foreign corporation even though it is owned or controlled by a U.S. corporation or group of U.S.

[1] Exceptions to this general rule are provided for corporations who primarily operate in the possessions and for DISCs. Also, a reduced rate of tax (34 percent) is provided for Western Hemisphere trade corporations.

corporations (or by U.S. citizens or residents). Such a corporation is subject to tax, if any, by the foreign country or countries in which it operates. Generally, the foreign source income of a foreign corporation only will be subject to U.S. income taxes when it is actually remitted to the U.S. corporate or individual shareholders as a dividend. The tax in this case is imposed on the U.S. shareholder and not the foreign corporation. The fact that no U.S. tax is imposed in this case until (and unless) the income is distributed to the U.S. shareholders (usually corporations) is what is generally referred to as tax deferral.

There are, however, exceptions to the general rules set out above where income of a controlled foreign corporation is taxed to the U.S. shareholders, usually a corporate shareholder, before they actually receive the income in the form of a dividend. The procedures (subpart F of the code) set forth in present law treat certain income as if it were remitted as a dividend. Under these provisions income from so-called tax haven activities conducted by corporations controlled by U.S. shareholders is deemed to be distributed to the U.S. shareholders and currently taxed to them. The rules generally apply in the case of foreign corporations more than fifty percent of whose shares are owned by U.S. persons, each with a 10 percent or more ownership interest.

Under present law, a U.S. taxpayer who pays foreign income taxes on his income from foreign sources is allowed a foreign tax credit against his U.S. tax on his foreign source income. The credit is provided only for amounts paid as income, war profits or excess profits taxes paid or accrued during the taxable year to any foreign country or to a possession of the United States. This foreign tax credit system is based on the principle that the country in which business activity is conducted has the primary right to tax the income from that activity and the home country of the individual or corporation has a residual right to tax that income, but only so long as double taxation does not result. While some countries, such as France and the Netherlands, avoid international double taxation by exempting all income from foreign operations, most of the other industrial nations—including the United States, Great Britain, Germany, Canada and Japan—use the credit system to avoid double taxation of income.

Present law permits taxpayers subject to U.S. tax on foreign income to take a foreign tax credit for the amount of foreign taxes paid on income from sources outside of the United States. The credit is provided only for amounts paid as income, war profits or excess profits taxes paid or accrued during the taxable year to any foreign country or to a possession of the United States.

The foreign tax credit is allowed not only for taxes paid on income derived from operations in a specific country, but it is also allowed for dividends received from foreign corporations operating in foreign countries and paying foreign taxes. This latter credit, called the deemed-paid credit, is provided for dividends paid by foreign corporations to U.S. corporations which own at least 10 percent of the voting stock of the foreign corporation. Dividends to these U.S. corporations are considered as carrying with them a proportionate amount of the foreign taxes paid by the foreign corporation. The computation of the amount of the foreign taxes allowed as a deemed-paid credit in the case of a dividend distribution differs depending upon whether or not the payor of the dividend is a less developed country corporation.

In order to prevent a taxpayer from using foreign tax credits to reduce U.S. tax liability on income from sources within the United States, two alternative limitations on the amount of foreign tax credits which can be claimed are provided by present law. Under the overall limitation, a taxpayer aggregates his income and taxes from all foreign countries. A taxpayer may credit taxes from any foreign country as long as the total amount of foreign taxes applied as credits in each year does not exceed the amount of tax which the United States would impose on the taxpayer's income from all sources outside of the United States.

The alternative to the overall limitation is the per-country limitation. Under this limitation, the same calculation made under the overall limitation is made on a country-by-country basis. A taxpayer's credits from any country are limited to the U.S. tax on the amount of income from that country. Taxpayers are required to use the per-country limitation unless they elect the overall limitation. Once the overall limitation is elected, it cannot be revoked except with the consent of the Secretary or his delegate.

In cases where the applicable limitation on foreign tax credits reduces the number of tax credits which can be used by the taxpayer to offset the U.S. tax liability in any one year, present law provides that the excess credits not used may be carried back for two years or carried forward for five years.

The significance of the present overseas operation of U.S. firms is indicated by the fact that the sales of U.S. multinational foreign affiliates were $292 billion in 1973. The U.S. share of the book value of U.S. overseas affiliates in 1973 stood at $107.3 billion—an increase of $12.9 billion over 1972—of which $4.9 billion represented net capital outlays from the United States and $8.1 billion represented reinvested earnings of these affiliates. Data on U.S. direct investment since 1966 are shown in table 1.

TABLE 1.—U.S. DIRECT INVESTMENT ABROAD BY SELECTED INDUSTRY GROUP, 1966–73

[In millions of dollars]

	Book value at yearend	Net capital outflows	Reinvested earnings [1]	Earnings	Balance-of-payments income [2]
All industries:					
1966	54,790	3,661	1,739	5,364	3,707
1967	59,491	3,137	1,598	5,650	4,133
1968	64,983	3,209	2,175	6,538	4,489
1969	71,033	3,271	2,604	7,544	5,074
1970	78,178	4,410	2,948	8,118	5,330
1971	86,198	4,943	3,157	9,389	6,385
1972	94,337	3,517	4,715	11,485	6,925
1973 [3]	107,268	4,872	8,124	17,495	9,415
Mining and smelting:					
1966	4,365	305	129	659	524
1967	4,876	330	135	746	596
1968	5,435	440	134	795	644
1969	5,676	93	167	782	664
1970	6,168	393	111	675	553
1971	6,685	510	23	499	482
1972	7,110	382	41	419	395
1973 [3]	7,483	201	143	675	548

TABLE A-1.—U.S. DIRECT INVESTMENT ABROAD BY SELECTED INDUSTRY GROUP, 1966-73—Continued

[In millions of dollars]

	Book value at yearend	Net capital outflows	Reinvested earnings [1]	Earnings	Balance-of-payments income [2]
Petroleum:					
1966	16, 222	885	106	1, 530	1, 443
1967	17, 399	1, 069	175	1, 736	1, 604
1968	18, 887	1, 231	239	1, 965	1, 787
1969	19, 882	919	−59	1, 868	2, 054
1970	21, 714	1, 460	425	2, 264	1, 937
1971	24, 152	1, 950	500	2, 946	2, 532
1972	26, 263	1, 603	563	3, 311	2, 826
1973 [3]	29, 567	1, 417	1, 927	6, 183	4, 325
Manufacturing:					
1966	22, 078	1, 752	983	2, 104	1, 116
1967	24, 172	1, 234	847	2, 055	1, 193
1968	26, 414	945	1, 261	2, 519	1, 265
1969	29, 527	1, 160	1, 939	3, 287	1, 337
1970	32, 261	1, 295	1, 534	3, 416	1, 859
1971	35, 632	1, 556	1, 854	3, 834	1, 950
1972	39, 716	1, 100	2, 991	5, 172	2, 144
1973 [3]	45, 791	1, 820	4, 408	7, 286	2, 757
Other:					
1966	12, 134	718	520	1, 071	624
1967	13, 044	504	442	1, 112	740
1968	14, 248	592	541	1, 259	793
1969	15, 948	1, 099	557	1, 606	1, 020
1970	18, 035	1, 262	877	1, 764	981
1971	19, 728	927	780	2, 111	1, 422
1972	21, 249	433	1, 118	2, 583	1, 560
1973 [3]	24, 427	1, 434	1, 645	3, 351	1, 785

[1] Represents a U.S. reporter's share in the reinvested earnings of its foreign-incorporated affiliates.
[2] Includes interest, dividends, and branch earnings.
[3] Preliminary.

Source: U.S. Department of Commerce, "Survey of Current Business," pt. II, August 1974, pp. 16, 17.

The earnings, after foreign income taxes, of these foreign investments were $17.5 billion, $4.1 billion of which represented earnings of U.S. branches. Of the $13.4 billion of earnings of foreign affiliates, $5.3 billion or 39 percent was distributed as dividends to the U.S. shareholders. The net amount received by shareholders, after foreign withholding taxes, was $4.6 billion. An additional $3.6 billion was received as interest, fees, and royalties. The composition of foreign source earnings is shown in table 2 and the dividend payout ratios in table 3.

TABLE 2.—EARNINGS, RELATED ITEMS AND MEASURES OF RETURN: DERIVATION AND RELATIONSHIP

[Millions of dollars]

	1973 amount and source
1. Net earnings of foreign-incorporated affiliates	13,407 reported.
2. Net earnings of foreign branches	4,088 reported.
3. Earnings	17,495=1+2.
4. Gross dividends (on common stock)	5,283=5+6.
5. Foreign withholding tax (on common stock dividends)	690 reported.
6. Dividends (on common stock)	4,593 reported.
7. Preferred dividends	17 reported.
8. Interest	717 reported.
9. Fees and royalties	2,838 reported.
10. Adjusted earnings	17,539=3−5+7+8.
11. Reinvested earnings	8,124=1−4 or 3−2−4.
12. Balance of payments income	9,415=2+6+7+8 or 10−11.
13. Balance of payments receipts	12,254=9+12.
14. Direct investor's ownership benefits	20,377=9+10.

Note. Figures are preliminary estimates derived from sample data. Estimates may not add to totals because of rounding

Source: U.S. Department of Commerce, "Survey of Current Business," pt. II, August 1974, p. 40.

TABLE 4.—DIVIDEND PAYOUT RATIO OF FOREIGN-INCORPORATED AFFILIATES

[Millions of dollars, or ratios]

Item and industry	All areas 1971	All areas 1972 [2]	All areas 1973 [3]	Developed countries 1971	Developed countries 1972 [2]	Developed countries 1973 [3]	Other areas [1] 1971	Other areas [1] 1972 [2]	Other areas [1] 1973 [3]
All industries:									
Earnings	7,178	9,109	13,407	4,941	6,449	9,669	2,238	2,660	3,738
Gross dividends	4,022	4,394	5,283	2,504	2,739	3,522	1,518	1,655	1,761
Ratio, gross dividends to earnings	.56	.48	.39	.51	.43	.36	.68	.62	.47
Petroleum:									
Earnings	1,554	1,811	3,239	470	616	1,507	1,085	1,196	1,733
Gross dividends	1,054	1,248	1,312	219	192	340	836	1,056	972
Ratio, gross dividends to earnings	.68	.69	.40	.47	.31	.23	.77	.88	.56
Manufacturing:									
Earnings	3,736	5,074	7,156	3,149	4,302	6,110	588	772	1,046
Gross dividends	1,882	2,083	2,748	1,584	1,765	2,369	299	318	379
Ratio, gross dividends to earnings	.50	.41	.38	.50	.41	.39	.51	.41	.36
Other:									
Earnings	1,888	2,223	3,011	1,322	1,531	2,052	566	693	959
Gross dividends	1,085	1,063	1,223	700	782	812	384	281	410
Ratio, gross dividends to earnings	.57	.48	.41	.53	.51	.40	.68	.41	.43

[1] Includes developing countries, international and unallocated.
[2] Revised.
[3] Preliminary.

Note.—Details may not add to totals because of rounding. Reported earnings are also equal to the sum of dividends, foreign withholding taxes, and reinvested earnings. Estimates are drawn from table 12. Gross dividends exclude preferred dividends, but include foreign withholding taxes.

Source: U.S. Department of Commerce, "Survey of Current Business," pt. II, August 1974, p. 12.

From the point of view of the U.S. investors, the return on this investment in 1973 was $20.4 billion (including interest, royalties, and fees), an increase of $6.3 billion over 1972. This represents a rate of return of 21.6 percent on the book value of the investment as of the beginning of 1973.

Of the $20.4 billion of earnings in 1973, $12.3 billion represents a balance-of-payments inflow (receipts of income on U.S. direct investment), while $8.1 billion is reinvested earnings. This $12.3 billion inflow represents a rate of return of 13 percent on the book value of investment at the end of 1972. Of the $12.3 billion inflow, $4.1 billion is earnings of U.S. branches and $8.2 billion is dividends, interest, royalties, and fees paid by U.S. subsidiaries to their parent corporations. Dividends account for $4.6 billion of the $8.2 billion, royalties and fees account for $2.8 billion, and interest accounts for $0.7 billion. Table 4 shows the balance-of-payments flows related to direct investment abroad for developed and under developed countries for the years 1971 through 1973.

TABLE 4.—IDENTIFIABLE U.S. CORPORATE TRANSACTIONS WITH FOREIGNERS [1]

[Millions of dollars, balance of payments signs: debits (—), credits (+)]

Line	Item	All areas 1971 [3]	All areas 1972 [3]	All areas 1973 [4]	Developed countries 1971 [3]	Developed countries 1972 [3]	Developed countries 1973 [4]	Other areas [2] 1971 [3]	Other areas [2] 1972 [3]	Other areas [2] 1973 [4]	Change, 1972–73 All areas	Change, 1972–73 Developed countries	Change, 1972–73 Other areas
1	Net flow [5]	3,994	7,607	7,092	2,266	5,125	2,930	1,728	2,482	4,162	−515	−2,195	1,680
2	Change in corporate claims on foreigners	−9,037	−9,765	−15,649	−6,036	−6,640	−11,540	−3,001	−3,126	−4,109	−5,884	−4,900	−983
3	Addition to direct investment position	−8,020	−8,140	−12,930	−5,427	−5,676	−9,726	−2,593	−2,465	−3,204	−4,790	−4,050	−739
4	Net capital outflows	−4,943	−3,517	−4,872	−2,988	−1,988	−3,631	−1,955	−1,529	−1,241	−1,355	−1,643	288
5	Reinvested earnings	−3,157	−4,715	−8,124	−2,437	−3,710	−6,147	−720	−1,005	−1,977	−3,409	−2,437	−972
6	Valuation adjustment [6]	80	92	66	−1	23	52	81	69	14	−26	29	−55
7	Change in other corporate claims	−1,017	−1,625	−2,719	−609	−964	−1,814	−408	−661	−905	−1,094	−850	−244
8	Long-term	−168	−253	−464	−98	−156	−276	−70	−97	−188	−211	−120	−91
	Short-term:												
9	Liquid	−531	−505	−841	−404	−277	−565	−127	−228	−276	−336	−288	−48
10	Nonliquid [7]	−496	−214	−1,413	−266	−172	−972	−230	−42	−441	−1,199	−800	−399
11	Adjustments [6]	178	−653	−1	159	−359	−1	19	−294		652	358	294
12	Change in corporate liabilities to foreigners	1,846	3,580	2,207	1.564	3,224	1,671	282	356	536	−1,373	−1,553	180
13	New issues of securities sold abroad by U.S. corporations [8]	1,181	2,002	1,222	1,181	2,002	1,222				−780	−780	
14	Change in corporate liabilities other than new issues	665	1,578	985	383	1,222	449	282	356	536	−593	−773	180
15	Long-term	384	594	264	289	561	118	95	33	146	−330	−443	113
16	Short-term [7]	22	160	943	−162	10	553	184	150	390	783	543	240
17	Adjustments [6]	259	824	−222	256	651	−222	3	173		−1,046	−873	−173
18	Direct investors' ownership benefits	11,702	14,055	20,377	7,152	8,856	12,628	4,550	5,200	7,749	6,322	3,772	2,549
19	Receipts on U.S. direct investments	8,545	9,340	12,253	4,715	5,146	6,481	3,830	4,195	5,772	2,913	1,335	1,577
20	Royalties and fees	2,160	2,415	2,838	1,594	1,816	2,182	566	600	656	423	366	56
21	Dividends and interest	4,174	4,548	5,327	2,648	2,899	3,637	1,526	1,649	1,690	779	738	41
22	Branch earnings [9]	2,211	2,377	4,088	473	431	662	1,738	1,946	3,426	1,711	231	1,480
23	Reinvested earnings	3,157	4,715	8,124	2,437	3,710	6,147	720	1,005	1,977	3,409	2,437	972
24	Offset to adjustments [6]	−517	−263	157	−414	−315	171	−103	52	−14	420	486	−66

[1] Some balance of payments flows associated with U.S. corporate transactions are not separately identified in the U.S. balance of payments data and therefore are not reflected in the estimates given in this table. See text for further explanation. Claims and liabilities of U.S. banking and brokerage institutions are excluded.

[2] Includes developing countries, international and unallocated.

[3] Revised.

[4] Preliminary.

[5] Sum of lines 2 plus 12 plus 18 plus 24.

[6] These adjustments plus balance of payments flows are equal to the changes in the international investment position. Such adjustments do not enter the balance of payments flow figures. Line 24 is the sum of lines 6, 11, and 17, with sign reversed.

[7] Excludes brokerage claims and liabilities.

[8] Excludes funds obtained abroad by U.S. corporations through bank loans and other credits and also excludes securities issued by subsidiaries incorporated abroad. However, securities issued by finance subsidiaries incorporated in the Netherlands Antilles are treated as if they had been issued by U.S. corporations to the extent that the proceeds of such issues are transferred to U.S. parent companies.

[9] Petroleum branch earnings have been revised as described in the Technical Notes.

Note: Details may not add to totals because of rounding.

Source: U.S. Department of Commerce, "Survey of Current Business," pt. II, August, 1974, p. 11.

A somewhat different perspective on the foreign and U.S. tax position of U.S. controlled foreign corporations is provided by data derived from tax returns for 1972 (the latest year available). The data show that the earnings and profits for 1972 before tax were $14.5 billion, foreign taxes paid were $6.7 billion, the amount distributed to U.S. parent corporations was $3.9 billion, the after-tax payout ratio was 46.6 percent, and the foreign effective tax rate was 46.3 percent.[2]

III. DEFERRAL

Present Law

Generally, the foreign source income of a foreign corporation is subject to U.S. income taxes only when it is actually remitted to the U.S. corporate or individual shareholders as a dividend. The tax in this case is imposed on the U.S. shareholder and not the foreign corporation. The fact that no U.S. tax is imposed until (and unless) the income is distributed to the U.S. shareholders (usually corporations) is what is generally referred to as tax deferral.[3]

Present law, however, provides for an exception to the general rule of deferral under the so-called subpart F provisions of the code. Under these provisions income from so-called tax haven activities conducted by corporations controlled by U.S. shareholders is deemed to be distributed to the U.S. shareholders and currently taxed to them before they actually receive the income in the form of a dividend.

The rules generally apply to U.S. persons owning 10 percent or more of the voting power of a foreign corporation, if more than 50 percent of the voting power in the corporation is owned by U.S. persons owning 10 percent interests.

Prior to the Tax Reduction Act of 1975 the categories of income subject to current taxation as tax haven income were foreign personal holding company income; sales income from property purchased from, or sold to, a related person if the property is manufactured and sold for use, consumption, or disposition outside the country of the corporation's incorporation; and service income from services also performed outside the country of the corporation's incorporation for or on behalf of any related persons. The statute refers to these types of income as "foreign base company income." In addition, present law provides for the current taxation of the income derived by a controlled foreign corporation from the insurance of U.S. risks. Foreign base company income and income from the insurance of U.S. risks are collectively referred to as subpart F income.

Present law also provides, with certain exceptions, that earnings of controlled foreign corporations are to be taxed currently to U.S. shareholders if they are invested in U.S. property. In general terms, U.S. property is defined as all tangible and intangible property located in the United States.

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[2] See *Taxation of Foreign Source Income: Statistical Data*, Table C–2.

[3] Where it is not anticipated that the income will be brought back to the United States for financial accounting purposes (in accounting for the income of a consolidated group consisting of one or more domestic corporations and its foreign subsidiaries) this income is often shown as income exempt from U.S. tax.

Prior to the enactment of the Tax Reduction Act of 1975 there were a number of significant exceptions to the rules providing for current taxation of tax haven income. By repealing these exceptions, the Tax Reduction Act of 1975 substantially expanded the extent to which foreign subsidiaries of U.S. corporations are subject to current U.S. taxation on tax haven types of income, under the subpart F rules of the code. The Act repealed the minimum distribution exception to the subpart F rules, which permitted deferral of U.S. taxation on tax haven types of income in cases where the foreign corporation (or various combinations of foreign-related corporations) distributed certain minimum dividends to their U.S. shareholders. This provision was the main device used by multinational corporations for avoiding taxation of their tax haven income, and its repeal will result in the current taxation of all tax haven income of foreign subsidiaries of U.S. corporations.

The Act also repealed the exception to the subpart F rules which permitted deferral of taxation in cases where the tax haven income was reinvested in less developed countries. In addition, the Act provided that the deferral of U.S. tax for shipping income received by a foreign subsidiary of a U.S. corporation is to be continued only to the extent that the profits of these corporations are reinvested in shipping operations. Finally, the Act modified the subpart F provision which permitted corporations having less than 30 percent of their gross income in the form of tax haven income to avoid the current taxation provisions of subpart F. The Act provided that this tax haven income is to be taxed currently under the subpart F rules in any case where it equals or exceeds 10 percent of gross income. The provisions of the Act apply to taxable years beginning after December 31, 1975.

It is estimated that when fully effective these provisions will raise $225 million in revenue.

While the above-described provisions in the 1975 Act all resulted in the elimination or tightening of exceptions to the current taxation of income rules under subpart F, one modification was made in the 1975 Act which resulted in a loosening of those rules. This amendment provides that base company sales income (i.e., income from selling activities in a tax haven) does not include the sale of agricultural commodities which are not grown in the United States in commercially marketable quantities. This amendment was intended to provide a narrow exception to the base company sales income rules in cases where farm products cannot be grown in the United States. Technical amendments may be needed to make it clear that the exception does not apply to agricultural products which are of a different grade or varying type of the product grown in the United States.

Issues

The merits of the present system of deferral have been frequently debated in recent years. In 1962 the Administration proposed an almost total elimination of deferral. Congress responded by focusing on the abuses of tax haven activities and eliminating deferral for the types of income which are normally susceptible to tax haven arrangements.

However, the general debate over whether to eliminate deferral completely or to limit its use for all taxpayers has continued. No one disputes the fact that deferral permits foreign corporations controlled by U.S. persons to avoid or postpone paying some U.S. tax by retaining their earnings abroad. But whether deferral constitutes a significant incentive for foreign investment and, if so, whether that incentive means more or less investment (and jobs) in the United States are still subjects for debate. Further, it is not clear that funds not invested abroad will necessarily be invested in the United States.

Advocates of the elimination of deferral believe that deferral does constitute an incentive for foreign investment which leads to a loss of U.S. jobs. Further, it is argued that deferral has tended to encourage countries to set up tax havens and their use by U.S. multinationals.

On the other hand, those who advocate retention of deferral argue that it is necessary to maintain neutrality between competing overseas companies. Since other countries provide deferral for overseas income, the elimination of deferral for U.S. corporations would put them at a competitive disadvantage.

They argue that overseas investment, rather than resulting in a decrease of jobs in the United States, in fact tends to create U.S. employment by enabling U.S. companies to penetrate foreign markets. Although part of what is sold in the foreign markets is manufactured overseas, a part also is manufactured in the United States for sale or for further processing abroad.

Advocates of deferral also note that the abuse problems of tax havens can be dealt with without the total elimination of deferral. They point to the Tax Reduction Act of 1975, which eliminated some of the tax avoidance rules pertaining to deferral.

Thus, the present tax treatment of U.S. foreign subsidiaries is seen by those defending deferral as essentially neutral from the perspective of the effect on U.S. companies operating abroad and competing with foreign companies. On the other hand, those who favor repeal of deferral see it from the perspective of providing incentives in favor of foreign investment in comparison with domestic investment.

A measure of the advantage of deferral of U.S. tax by not repatriating profits of overseas subsidiaries can be seen by measuring the effective foreign income tax rate relative to the effective U.S. tax rate. While the U.S. effective tax rate for 1968 was 41.6 percent, the average rate for controlled foreign corporations was 37 percent and ranged from a low of 16.8 percent in Switzerland to a high of 45.6 percent in France. These lower foreign tax rates and the problems associated with deferral have, in the past, led the Treasury to recommend the end of deferral in the case of runaway plants and tax holiday corporations.

To put the issue in perspective, total elmination of deferral would result in additional revenues of $365 million per year. Over $100 million of this amount would be attributable to foreign flag shipping, which presently pays little tax any place in the world. The balance of less than $265 million would be attributable to manufacturing and other operations overseas. Thus, the total elimination of deferral would result in less than a two percent reduction in after-tax earnings from overseas investments which would be a reduction of less than one-half of one percent in the rate of return on that investment.

There are, of course, many reasons for making investments abroad in addition to tax reasons. Commercial laws, tariffs and import restrictions, currency laws, or merely the attitude of government officials or the public generally may make it advisable to invest abroad rather than in the United States, if a corporation is to sell its products in a foreign market. Similarly, labor costs, transportation costs, or perhaps merely location in a country which provides favorable access to the Common Market may be the factors requiring investment overseas rather than in the United States. Of course, tax concessions in one country may influence the choice of a location in that particular country after the decision to produce outside the United States has been made for nontax reasons.

While it is difficult to evaluate the incentive effects of tax deferral generally, clearly the longer the tax deferral period and the higher the rate of return on the amount deferred relative to the difference between the United States and foreign tax burden, the greater the incentive to invest abroad. Thus, the present tax treatment of controlled foreign corporations probably does in some cases provide some inducement to reinvest abroad earnings from foreign sources.

The present rules of taxation of foreign income are complicated due to the tension created in the law by providing for deferral but yet placing limitations as to when deferral ceases. Thus, permitting deferral has created the need for rules dealing with tax haven type income (the subpart F provisions, sec. 951 through 964), rules for determining when earnings are repatriated (secs. 367 and 1248), rules for pricing between related parties to prevent shifting of profits to a foreign subsidiary (sec. 482), and rules to prevent untaxed earnings from being transferred outside the United States and escaping U.S. taxing jurisdiction (sec. 367). Thus, regardless of the merits of retaining or eliminating deferral, the termination of deferral would greatly simplify the Internal Revenue Code and eliminate many sources of conflict between the Internal Revenue Service and taxpayers.

Eliminating deferral might, however, have a particular impact in a few specific areas. Over $100 million of revenue would be gained from foreign flag shipping companies controlled by U.S. corporations. These companies are often based in countries (such as Panama and Liberia) which do not tax shipping income. Since the shipping income of the foreign competitors of these taxpayers is also untaxed, taxing the income of U.S. owned companies could lead to a competitive disadvantage. Some argue that this disadvantage would lead some U.S. companies to charter ships owned by foreigners not subject to U.S. tax rather than use their own ships to carry their products. Foreign ownership of these ships could produce difficulties if international emergencies occur.

In addition, the elimination of deferral could have a significant impact on some developing nations which have a policy of encouraging foreign investment through tax holidays and other special tax provisions. These countries believe that the tax incentives are an essential aid to their economic growth. The eliminination of deferral would mean that U.S. taxpayers would not benefit from these foreign tax holidays or other special tax provisions (since the income would be taxed by the United States) which might discourage some investments in less developed countries. However, there are alternative methods (such as subsidized capital financing) available to most foreign governments to attract investment without relying on tax incentives.

The balance of payments impact from any elimination of deferral would be small and to the extent that future foreign investment is discouraged and future overseas profits are reduced, the net result could be adverse. While under present conditions it may well be preferable to emphasize domestic investment over investments abroad, it would also appear undesirable to abandon foreign investments to foreign competitors. While fundamental revisions in the foreign tax credit might result in U.S. corporations disposing of their foreign investments, the elimination of tax deferral would not generally in and of itself be a significant factor causing such a disposition.

As an alternative to the complete elimination of deferral the committee might want to consider a provision of general application to income of controlled foreign subsidiaries. Such an alternative could provide that if a controlled foreign corporation failed to distribute one-half of its after-tax earnings and profits to its U.S. shareholders, a deemed distribution would result to the extent of the shortfall.

The requirement of a 50-percent repatriation could be justified because, as a rule, domestic corporations distribute close to 50 percent of their after-tax income to their shareholders.[4] On this basis, it would not appear unreasonable to expect controlled foreign corporations to contribute their equitable share of the funds to be paid out to the shareholders. In fact, in a number of years, controlled foreign corporations as a group have distributed one-half of their earnings to their U.S. parents.[5]

Alternative proposals

Mr. Ullman

Controlled foreign corporations not repatriating 50 percent of their earnings would be subject to tax on deemed distributions (resulting to the extent of the shortfall) under the existing statutory framework used to tax tax haven income presently (e.g., the subpart F provisions of the Internal Revenue Code).

The U.S. parent corporation would be given the option of satisfying the required distribution on a worldwide basis for all of its controlled foreign subsidiaries. Under this consolidated approach, a U.S. parent corporation would satisfy the 50-percent requirement if it brought back

[4] In the period 1974 back to 1967 the percentage of profits after tax distributed were as follows: 1974, 38.5 percent; 1973, 40.6 percent; 1972, 47.8 percent; 1971, 54.3 percent; 1970, 62.9 percent; 1969, 54.2 percent; 1968, 49.4 percent; and 1967, 45.9 percent.

[5] See tables A–4 and A–S of the pamphlet, "Taxation of Foreign Sources Income: Statistical Data."

one-half of its worldwide consolidated earnings and profits. To the extent that there is a shortfall of the required distribution, the shortfall would be made up by providing for deemed distributions on a pro rata basis from those controlled foreign corporations which did not distribute one-half of their earnings and profits.

Earnings which are distributed would be entitled to the foreign tax credit under the normal Internal Revenue Code provisions dealing with credit for taxes paid on foreign source income. Earnings which are deemed distributed would be subject to the special foreign tax credit provisions which are provided under present law for subpart F income.

Losses of one controlled foreign corporation under this approach would be offset against the earnings and profits of other controlled foreign corporations. Earnings and profits for purposes of the 50-percent deemed distribution provision would be determined (under the provisions of section 964(a)) with adjustments for U.S. accounting purposes only for items which are material in nature.

In some cases, foreign countries have made it difficult to make the actual distributions either by prohibiting or by imposing heavy penalties or taxes on dividend distributions. In some cases, however, the companies are allowed to make royalty or management fee payments to the parent corporation with respect to patents or fees based upon technical know-how. While the present subpart F provisions provides some relief for blocked currency, treating royalties and management fees paid from controlled foreign corporations as payments in satisfaction of the 50-percent requirement will substantially lessen any problem. Additionally, since branch income is taxed on a current basis under present law, that income could be treated as income which is 100 percent repatriated for purposes of satisfying the 50-percent requirement on an overall basis.

Messrs. Vanik, Corman, Green, Gibbons, Karth, Rangel, Stark, Jacobs, Mikva, Fisher and Mrs. Keys

The proposal would eliminate deferral completely.

Mr. Vander Veen

The proposal would eliminate tax deferral over several years.

Mr. Pickle

The proposal would deny tax deferral to runaway plants.

IV. FOREIGN TAX CREDIT

Present Law

As discussed above (in the Overview section), present law permits taxpayers subject to U.S. tax on foreign income to take a foreign tax credit for the amount of foreign taxes paid on income from sources outside of the United States. The credit is provided only for amounts paid as income, war profits or excess profits taxes to any foreign country or to a possession of the United States.

The foreign tax credit is allowed not only for taxes paid on income derived from operations in a foreign country, but it is also allowed for dividends received from foreign corporations operating in foreign countries and paying foreign taxes. This latter credit, called the deemed-paid credit, is provided for dividends paid by foreign corporations to U.S. corporations which own at least 10 percent of the voting stock of the foreign corporation. Dividends to these U.S. corporations are considered as carrying with them a proportionate amount of the foreign taxes paid by the foreign corporation.[6]

The computation of the amount of the foreign taxes allowed as a deemed-paid credit in the case of a dividend distribution differs depending upon whether or not the payor of the dividend is a less developed country corporation. Initially, a question arose as to how much of the foreign taxes for purposes of this credit should be attributed to the earnings out of which dividends were paid and how much should be attributed to the portion of earnings used to pay the foreign taxes. This was decided in the Supreme Court case, *American Chicle Company*,[7] which required the foreign taxes paid for purposes of the credit to be allocated between the dividend distribution and the portion of the earnings used to pay the foreign taxes. The Congress in 1962, however, recognized that this resolution obtained less than the full U.S. tax on the dividend income because it omitted from the U.S. tax base the portion of the earnings used to pay the foreign tax. Where the foreign tax was less than the U.S. tax (but above zero), this gave an advantage to dividend income over income subject to the full United States tax. In 1962, the Congress corrected this problem for all corporations other than less developed country corporations.

The correction made in 1962 took the form of requiring the earnings used to pay the foreign tax allowed as a credit in the distribution base and then allowing the credit for foreign taxes paid to be based upon the earnings, including the amount paid as foreign taxes, and not merely the portion paid as a dividend.

In order to prevent a taxpayer from using foreign tax credits to reduce U.S. tax liability on income from sources within the United States, two alternative limitations on the amount of foreign tax credits which can be claimed are provided by present law. Under the overall limitation, the amount of foreign tax credits which a taxpayer can apply against his U.S. tax liability on his worldwide income is limited to his U.S. tax liability multiplied by a fraction the numerator of which is taxable income from sources outside the United States (after taking all relevant deductions) and the denominator of which is his worldwide taxable income. Under this limitation, the taxpayer thus aggregates his income and taxes from all foreign countries; a taxpayer may credit taxes from any foreign country as long as the total amount of foreign taxes applied as a credit in each year does not exceed the amount of tax which the United States would impose on the taxpayer's income from all sources without the United States.

[6] These rules for the deemed-paid credit apply to distributions to a domestic corporation from a first-tier foreign corporation in which the domestic corporation is a 10-percent shareholder and to distributions from a second-tier or third-tier foreign corporation (through a first-tier foreign corporation), as long as each receiving corporation in the chain of dividend distributions is a 10-percent shareholder in the corporation making the distribution. However, distributions originating from a foreign corporation that is more than three tiers beyond the domestic corporate shareholder do not carry with it any deemed-paid foreign tax credit.

[7] *American Chicle Company* v. *United States*, 316 U.S. 450 (1942).

The alternative limitation to the overall limitation is the per-country limitation. Under this limitation the same calculation made under the overall limitation is made on a country-by-country basis. The allowable credits from any single foreign country cannot exceed an amount equal to U.S. tax on worldwide income multiplied by a fraction the numerator of which is the taxpayer's taxable income from that country and the denominator of which is his worldwide taxable income. Taxpayers are required to use the per-country limitation unless they elect the overall limitation. Once the overall limitation is elected, it cannot be revoked except with the consent of the Secretary or his delegate.

The Tax Reduction Act of 1975 prohibits the limitation on the foreign tax credit on income from oil and oil-related activities from being calculated under the per-country method. Instead, this income (and any losses) are computed under a separate overall limitation which applies only to oil-related income. Any losses from oil-related activity are to be "recaptured" in future years through a reduction in the amount of allowable foreign tax credits which can be used to offset subsequent foreign oil-related income.

In addition, the Tax Reduction Act of 1975 requires that the amount of any taxes paid to foreign governments which will be allowed as tax credit on foreign oil extraction income is limited to 52.8 percent of that income (after deductions) in 1975. 50.4 percent in 1976 and 50 percent in subsequent years.

In computing taxable income from any particular country or from all foreign countries for purposes of the fractions used in the tax credit limitations, all types of income are included as well as the deductions which relate to that income and a proportionate part of deductions unrelated to any specific item of income. Thus, for example, income from capital gains is included in the numerator and denominator of the limiting fraction as well as the deductions allocable to those gains (e.g., the 50-percent exclusion of capital gains for individuals).[8]

In cases where the applicable limitation on foreign tax credits reduces the amount of tax credits which can be used by the taxpayer to offset U.S. tax liability in any one year, present law provides that the excess credits not used may be carried back for two years or carried forward for five years. However, if a person using the per-country limitation in any year elects subsequently to use the overall limitation, no carryovers are permitted from years in which the per-country limitation was used to years in which the overall limitation was elected.

Issues

A preliminary problem in discussing the problems of the foreign tax credit is whether any credit should be allowed at all. Some argue that foreign taxes should be treated as business expenses (or State

[8] However, an exception is provided for interest income if that income is not derived from the conduct of a banking or financing business, or is not otherwise directly related to the active conduct of a trade or business in the foreign country. Such interest income and the taxes paid on it are subject to a separate per-country limitation to be calculated without regard to the other foreign income of the taxpayer.

taxes) and be deducted rather than credited. If foreign taxes were deducted, individuals and corporations investing in foreign countries would bear a greater total tax burden than investors in the United States and than other foreign investors. The result would be that trade and capital movement between countries would be diminished.

Furthermore, determining tax policy on the foreign tax credit based on an analogy between the deduction for State taxes and deducting foreign taxes is not necessarily appropriate. State governments, of course, are not independent sovereign entities as are the foreign governments. These governments are instead comparable to the U.S. Federal Government rather than to the States. Thus, the analogy between State and Federal Government is probably inappropriate because the foreign taxes on a sovereign nation should be treated as comparable to taxes paid to the U.S. Federal Government and thus should be credited against U.S. taxes.

With the growth of U.S. investment abroad and the rise in foreign tax rates, the foreign tax credit has become a relatively more important provision in recent years. Foreign statutory tax rates for 1973 and 1974 were 48 percent or greater in 7 out of 20 developed countries, and were 40 percent or greater in 14 out of 20 developed countries. Also, in 21 out of 30 African and South American less developed countries, statutory tax rates for those years were 40 percent or greater. As is indicated by Table 5 for 1968, effective tax rates are somewhat less than the statutory rates. If withholding taxes on dividends paid to U.S. investors, which range from 5 to 30 percent in various countries, are added to these foreign tax rates, the foreign tax rate in most countries exceeds the U.S. tax rate applicable to that income.

TABLE 5.—1968 STATUTORY AND REALIZED AND 1973–74 STATUTORY CORPORATE INCOME TAX RATES [1]

Country	1968 statutory rates				1968 realized rates [4]			1973/74 statutory rates				
	Corporate tax rate	Distributed profits if different	Local income taxes [3]	Mining and/or petroleum [3]	All industries	Manufacturing	Mining	Corporate tax rate	Distributed profits if different	Local income taxes [3]	Mining and/or petroleum [3]	Dividend withholding rate to United States [5]
Developed countries:												
Canada	50.0		12.0		39.1	42.8	8.4	48.0		13.0		15.0
Austria	44.0	22.0	14.0		42.6	42.7	(6)	55.0	27.5	15.0		5.0
Belgium	38.5	33.0	6.0		34.0	34.4	0	42.0				15.0
Denmark	36.0				31.1	32.5	36.2	36.0				5.0
France	50.0				45.5	48.0	34.3	50.0				5.0
Germany	52.5	15.5	13.5		41.4	43.0	.1	52.6	15.8	15.0		15.0
Greece	38.24				11.7	11.9	(6)	38.24				30.0
Ireland	50.0				13.4	12.7	0	50.0				5.0
Italy	43.0		(7)		42.1	41.1	49.8	43.8		(7)		5.0
Luxembourg	40.0		10.0		14.5	17.1	0	40.0		14.0		5.0
Netherlands	46.0				32.7	34.5	26.1	48.0				5.0
Norway	30.0		19.0		51.8	45.8	46.4	26.5		21.3		10.0
Spain	42.8				35.3	39.5	(6)	32.8				15.0
Sweden	40.0		19.0		41.0	43.1	(6)	40.0		25.0		5.0
Switzerland	7.2		24.0		16.7	22.2	(6)	8.8		28.0		5.0
United Kingdom	45.0				38.7	38.6	48.7	50.0				15.0
Australia	45.0				40.2	40.6	36.0	47.5				15.0
New Zealand	42.5				50.5	48.7	(6)	45.0			33.3	5.0
South Africa	36.7			(8)	34.8	35.8	34.2	43.0			(7)	15.0
Japan	35.0	26.0			41.1	41.5	(6)	36.75	26.0	12.0		10.0
South America:												
Mexico	42.0				40.7	42.2	51.8	42.0				20.0
Argentina	33.0				21.8	21.7	26.7	42.9				12.0
Brazil	30.0	38.5			27.6	30.0	96.7	30.3	33.5			25.0
Chile	37.2			(8)	24.5	33.0	41.7	44.43			(7)	40.0
Colombia	36.0				43.4	47.3	17.5	36.0				20.0
Ecuador	20.0	25.0		(8)	24.3	18.7	33.3	20.0	40.0		(7)	40.0
Paraguay	25.0				24.4	(6)	(6)	30.0				10.0
Peru	37.0				32.2	32.1	42.4	55.0				30.0
Uruguay	21.0				15.7	14.1	(6)	37.5				25.0
Venezuela	50.0			52.0	28.1	30.0	12.5	50.0			60.0	15.0
Costa Rica	30.0				15.1	25.3	(6)	40.0				15.0
El Salvador	15.0				6.6	7.6	(6)	15.0				38.0
Guatemala	52.8				16.8	21.0	(6)	52.8				10.0
Honduras	40.0				21.7	25.2	(6)	40.0				5.0
Nicaragua	30.0				10.6	1.8	(6)	30.0				0
Dominican Republic	39.1				16.3	20.6	(6)	41.14				18.0
Jamaica	42.5				14.0	21.3	40.9	45.0				37.5
Puerto Rico	36.75				17.2	11.2	(6)	40.0				15.0
Trinidad and Tobago	45.0				28.2	36.7	(6)	45.0				10.0

Africa:												
Algeria	50.0				32.5	0	(6)	50.0				18.0
Morocco	40.0				43.1	45.4	(6)	48.0				25.0
UAR	34.45				NA	NA	(6)	34.45				34.45
Ethiopia	40.0				23.3	38.6	(6)	40.0				0
Kenya	40.0			22.5	27.6	19.0	(6)	40.0			22.5	12.5
Tanzania	40.0			22.5	46.6	(6)	(6)	40.0			22.5	12.5
Nigeria	50.0			50.0	11.2	5.2	(6)	45.0			55.0	15.0
Malawi	37.5				42.1	(6)	(6)	40.0				0
Rhodesia	36.25				34.9	28.0	(6)	40.0				15.0
Zambia	45.0			(8)	38.4	28.0	(6)	45.0			(7)	15.0
Middle East:												
Iran	NA				10.5	9.7	NA	10.0	55.0	3.35		60.0
Iraq	55.0				NA	(6)	(6)	55.0			50	0
Israel	47.0	32.0			39.0	37.2	(6)	56.5	42.0			30.0
Kuwait	NA				NA	(6)	(6)	55.0				0
Lebanon	42.0		10.0		32.3	15.1	(6)	42.0		15.0		10.0
Saudi Arabia	40.0			50.0	(6)	(6)	(6)	45.0			(7)	0
Asia:												
Ceylon (Sri Lanka)	50.0	33.3			27.5	17.7	(6)	60.0	33.3			39.3
India	60.0				57.1	57.0	(6)	60.0				25.725
Indonesia	60.0				48.5	NA	(6)	45.0				20.0
Malaysia	40.0				26.9	27.9	(6)	40.0				40.0
Pakistan	60.0				52.5	52.6	(6)	60.0				15.0
Philippines	35.0				29.6	29.6	(6)	35.0				35.0
Singapore	40.0				26.4	26.9	NA	40.0				40.0
South Korea	45.0				0	NA	(6)	40.0				5.0
China (Taiwan)	25.0				7.8	6.0	(6)	25.0				10.0
Thailand	25.0				17.7	12.4	(6)	30.0				25.0
Low-tax countries:												
Bahamas	0				10.2	5.1	8.9	0				0
Bermuda	0				9.9	.3	NA	0				0
Hong Kong	15.0				17.1	15.5	(6)	15.0				0
Liberia	45.0				5.7	NA	15.3	45.0				15.0
Netherlands Antilles	34.0		15.0		4.5	NA	NA	34.0		15.0		0
Panama	45.0				9.9	13.9	5.4	50.0				10.0

[1] This table does not include taxes on capital, net worth, and other special taxes. It covers corporate income and dividend withholding taxes only. Rates do not take into account tax holidays or incentives for new or special industries.

[2] Local taxes where significant.

[3] Statutory rates are cited for mining and petroleum if the rates differ from the general statutory rate. However, data on special rates for mining and petroleum industries are not always available.

[4] 0 indicates that no taxes were paid but some income was reported.

[5] Foreign withholding rate on dividends paid to the U.S. parent. Where a tax treaty with the U.S. exists, the applicable treaty rate is used.

[6] No income was reported by any controlled foreign corporations in that industry.

[7] Included in corporate tax rate.

[8] The rate is computed according to special formula or several rates exist.

NA Data either unavailable or not usable because of disclosure problems.

Note: Reprinted from "National Tax Journal," vol. XXVIII, No. 1, March 1975.

Sources: Statutory rates: Diamond, Walter H. "Foreign Tax and Trade Briefs," Federation of British Industries. "Taxation in Western Europe 1964–68;" Grundy, Milton. "Tax Havens," 1969; International Bureau of Fiscal Documentation. "Corporate Taxation in Africa;" International Bureau of Fiscal Documentation." Corporate Taxation in Latin America"; International Bureau of Fiscal Documentation. "European Taxation"; International Bureau of Fiscal Documentation. "Tax News Service"; Japan Tax Association. "Asian Taxation"; 1968; Price Waterhouse and Co. "Corporate Taxes in 70 Countries," August, 1973; Price Waterhouse and Co. "Information Guides" (various countries, various years); and United Kingdom, Board of Inland Revenue. "Income Taxes Outside the United Kingdom," 1971. In addition, information contained in the International Tax Staff files was used. "Realized Rates": IRS, Preliminary Data, forms 1120 and 2952, 1968, table 14a.

These high foreign taxes can be shown from the amount of taxes actually paid to foreign governments in 1972 and claimed as foreign tax credits. In that year $6.3 billion in foreign tax credits were claimed by U.S. corporations. Disregarding oil companies, the amount of taxes claimed as credits increased from $3.3 billion in 1972 to about $4.7 billion in 1974.[9]

1. Limitation on the Credit

The two alternative limitations on foreign tax credits present different advantages for different taxpayers. The use of the per-country limitation often permits a U.S. taxpayer who has losses in a foreign country to obtain what is, in effect, a double tax benefit. Since the limitation is computed separately for each foreign country, branch losses in any foreign country do not have the effect of reducing the amount of credits allowed for foreign taxes paid in other foreign countries from which other income was derived. Instead, such losses reduce U.S. taxes on U.S. source income by decreasing the worldwide taxable income on which the U.S. tax is based. In addition, when the business operations in the loss country become profitable in a subsequent tax year, a credit will be allowed for the taxes paid in that country. Thus, if the foreign country in which the loss occurs does not have a net operating loss carryforward provision (or some similar method of using prior losses to reduce subsequent taxable income), the taxpayer receives a second tax benefit when income is derived from that foreign country because no U.S. tax is imposed on the income from the country (to the extent of foreign taxes paid on that income) even though earlier losses from that country have reduced U.S. tax liability on U.S. source income.

Because this double benefit can in some cases result in considerable tax savings, companies which frequently incur sizable losses (usually on new ventures) often use the per-country limitation. These companies have included in the past most oil companies, which have large losses on new drilling operations (in part because of the deduction for intangible drilling). Hard mineral companies, which generally incur substantial losses from new mines, are currently the primary beneficiaries of the per-country computation.

The overall limitation does not allow this same advantage to be gained from foreign losses, because these losses are offset against income from other foreign countries rather than against U.S. income. Thus, the losses reduce the amount of overall foreign income on which a foreign tax credit can be claimed. However, where a company has a net loss from all foreign operations the total net loss would still reduce U.S. taxes on U.S. income under the overall limitation in its present form. This situation occurs primarily in the case of corporations just beginning their first foreign operations.

In spite of the fact that in most cases foreign losses do not reduce U.S. tax liability under the overall limitation, most companies that operate in more than one country elect to use this limitation because it is substantially less complex and does offer other advantages for

[9] It is estimated that the amount of credits claimed in 1974 has increased to about $17.8 billion, largely as a result of the OPEC increase in oil prices which were charged to oil companies in the form of taxes.

companies which do not incur substantial losses. Under the overall limitation, a company averages together all of its foreign income and taxes from all foreign countries. Thus, an individual or company which annually pays taxes in one foreign country at a rate higher than the U.S. tax rate (and thus would have some tax credits disallowed under the per-country limitation) is able to average those taxes with any taxes which might be paid at lower rates in other foreign countries when applying the overall limitation.

The result is that a taxpayer can use more of the taxes paid in high tax countries as credits against U.S. tax on foreign income under the overall limitation if he also has income from relatively low-tax countries against which the highly taxed income can be averaged.[10]

In many cases this averaging of foreign taxes would appear be appropriate. Many businesses do not have separate operations in each foreign country but have an integrated structure that covers an entire region (such as Western Europe). In these cases a good case can be made for allowing the taxes paid to the various countries within the region to be added together for purposes of the tax credit limitation. However, the overall limitation also permits averaging of the taxes paid on the income from busineseses which are not integrated.

A special situation exists in the case of oil companies which are presently making up to 90 percent of their payments to the OPEC countries for producing and selling oil through what are called taxes but what in reality may in part to royalty payments. The capability of companies to use these credits in effect to shelter low-taxed foreign income led to the Congress' decision in the Tax Reduction Act of 1975 to limit the amount of payments for oil and gas extraction which would be treated as creditable taxes to 52.8 percent of taxable extraction income in 1975, 50.4 percent in 1976, and 50 percent in 1977. Other than the oil industry, there is no general area where comparably high foreign taxes are normally paid.

In addition, even the per-country limitation permits some averaging of income since a taxpayer often has considerable discretion in deciding in which country income is to be sourced. Under existing source rules, dividend income is attributable to the country in which the foreign corporation paying the dividend to the U.S. shareholder is incorporated. Thus, a corporation could, for example, interpose a first-tier Bermudan corporation as the parent of second-tier subsidiary corporations operating in Germany and Panama. The taxes paid by the German and Panamanian corporations would be carried along (under the deemed paid tax credit) with any dividend paid to the Bermudan company and then when that company in turn pays a dividend to the U.S. shareholder the taxes paid to both countries are combined and treated as if the Bermudan company had paid them to Bermuda. A similar result can be obtained with sales income because the source rules attribute that income to the country in which title to the goods sold passes. A company can often pass title on the sale of goods in a

[10] For example, a company earning $100 each in countries A & B and paying $60 in tax in A on that income and $30 in tax in B could use all $90 in foreign taxes under the overall limitation (the limitation would be 48 percent of $200 or $96). Under the per-country limitation only $48 of the taxes paid to country A would be creditable, thus limiting total credits to $78.

country where it has excess tax credits which can be used to prevent any U.S. tax from arising on that sale. Thus, the benefit of averaging, which is obtained automatically under the overall limitation, can also be obtained under the per-country limitation if a taxpayer makes some effort to structure his operations.

A second but equally important consideration in comparing the overall limitation with the per-country limitation is the relative burden which each places on taxpayers and on the IRS. The per-country limitation requires that a separate computation must be made for each country in which a taxpayer operates. Each of these computations require the taxpayer to calculate the gross income and deductions to be allocated to each country. Since, as discussed above, many large corporations operate on an integrated basis in a number of countries, assigning the income and deductions to each of the various countries in which a corporation operates is often a complicated process leading to an arbitrary result. It constitutes a substantial burden for taxpayers and places the IRS in the difficult position of attempting (upon audit) to review a company's operations in every country around the world.

These administrative and enforcement problems are greatly alleviated under the overall limitation since the only allocation of income and deductions that is required is between the United States and all other foreign countries as a group.

Applying a strict per-country limitation concept at a 48-percent rate would of course create the greatest number of administrative and enforcement problems. However, these problems are not eliminated by applying a per-country type of limitation at a 50-percent rate. The same difficulties in determining source of income are present at a 50-percent or higher rate. Moreover, this limitation would apply to most countries. Even in the United States, if the 50-percent limitation were applied to foreign investors, some foreign tax credits would be disallowed since to the 48-percent tax rate must be added the additional withholding tax of 30 percent of dividends paid (where no treaty is in effect), producing an aggregate rate of tax of over 63 percent.

Further, many of the differences between U.S. and foreign effective rates can be attributed to questions of timing as to when income and deductions are taken into account under the tax laws of the United States and the other taxing jurisdiction. This difference in effective rates can be further exacerbated by gains or losses arising from changes in the rate of exchange of the U.S. dollar and the foreign currency. Thus, in one year it is quite possible for a foreign subsidiary to have a very low effective rate of tax and in the following year to have a high effective rate of tax primarily due to the impact of exchange rates gains and losses. Thus, a per-country type of limitation on the credit would result in disallowance of a foreign tax credit when viewed over a number of years no foreign taxes at a rate higher than the U.S. rate are being paid. Taking these differences into account by providing for a carryback and carryforward of these taxes would somewhat solve the problem but would necessitate a separate carryback and carryforward provision for each country for which a taxpayer engages in a trade or business.

It has been suggested that applying a 50-percent limitation to the foreign tax credit is an extension of the limitation which was added by the 1975 Tax Reduction Act in the case of the foreign extraction operations of the petroleum companies. The problem dealt with, in the case of the petroleum companies, is different than that which arises in the case of multinationals in general. The question with petroleum companies was whether payments made to foreign governments were in the nature of a creditable income tax or a deductible royalty payment. Since it is generally quite difficult to distinguish between royalties and taxes in the case of the foreign operation of petroleum companies, it was felt necessary to provide for a special limitation on these payments. There is no question in the taxation of multinationals in general that the payments made to foreign governments are creditible foreign taxes. The question with respect to multinationals is to what extent these valid foreign taxes should be entitled to the averaging benefits of the overall limitation.

Alternative Approaches

Some of the alternative approaches focus on the loss problem while others on the averaging question. In addition, some of the approaches deal with both questions.

Special limitation

1974 committee bill

Last year's bill contained no limitation on the foreign tax credit of multinational corporations. However, it did contain a limitation on the foreign operations of petroleum companies which was enacted into law as part of the Tax Reduction Act of 1975.

Mr. Vanik

The proposal would substitute a deduction for the foreign tax credit.

Messrs. Corman, Green, Gibbons, Karth, Rangel, Stark, Jacobs, Mikva and Mrs. Keys

The proposal would lower the percentage limitation for foreign oil extraction income in the Tax Reduction Act of 1975 to 48 percent and apply it and all other provisions of section 601 of the 1975 Act to the extraction of all other natural resources.

Messrs. Corman, Karth, Vander Veen, and Rangel

The proposal would make the foreign tax credit subject to both the per-country and the overall limitations.

Mr. Karth

He recommends that for all foreign income, all excess tax credits be eliminated. To the extent foreign taxes paid exceed the U.S. tax and, as a result are not subject to credit under this recommendation, they would be deductible as a business expense.

Foreign Tax Credit Determined on Overall Basis

1974 committee bill

Last year's bill repealed the per country limitation on the foreign tax credit for all industries.

Mr. Ullman

His proposal is the same as that in the 1974 committee bill.

Mr. Waggonner

The proposal would allow taxpayers engaged in mining to retain the option to elect the per country limitation.

Recapture of Foreign Losses

1974 committee bill

Last year's bill had a provision that required any foreign losses which offset U.S. income to be recaptured in future years when foreign income is earned.

Mr. Ullman

His proposal is the same as that in the 1974 committee bill.

Mr. Corman

The proposal would deal with one aspect of the loss offset problem by excluding income, deductions, and losses from the exploration and operation of mineral property located outside of the United States from the U.S. tax base.

2. Dividends from less-developed country corporations

Under present law, the amount of dividend from a less developed country corporation included in income by the recipient domestic corporation is not increased (i.e., grossed up) by the amount of taxes which the domestic corporation receiving the dividend is deemed to have paid to the foreign government. Instead the amount of taxes is reduced by the ratio of the foreign taxes paid by the less developed country corporation to its pretax profits.

The failure to grossup the dividend by the amount of the foreign taxes that are deemed paid results, in effect, in a double allowance for foreign taxes. The problem arises from the fact that the amount paid in foreign taxes not only is allowed as a credit in computing the U.S. tax of the corporation receiving the dividend, but also is allowed as a deduction (since the dividends can only be paid out of income remaining after payment of the foreign tax). The result is that the combined foreign and U.S. tax paid by the domestic corporation is less than 48 percent of the taxpayer's income in cases where the foreign tax rate of the less developed country corporation is lower than the 48 percent U.S. corporate tax rate (but not zero or lower).[11] In cases where the

[11] For example, assume that a foreign country imposes a 30-percent tax on $1,000 of income. If the foreign corporation earns $1,000 as a less developed country corporation in that country, a distribution by that corporation of the remaining $700 to its U.S. parent corporation would result in $700 income to the U.S. parent. The parent's U.S. tax would be $336 before allowance of a foreign tax credit. In calculating the foreign tax credit, the $300 amount of foreign taxes paid would be reduced by 300/1000 to $210. The $210 could then be credited against U.S. tax liability of $336, leaving a net liability of $126. Thus, the combined U.S. tax and foreign tax liability on the original $1,000 of income would be $426 ($300 foreign taxes plus $126 U.S. tax), not the $480 which should be paid at a 48-percent rate.

If that same foreign corporation earning $1,000 were not a less developed country corporation, the entire $1,000 would be included in the parent corporation's income if it received a dividend of $700 which would carry with it foreign taxes of $300. In this case, the U.S. tax before credit would be $480. The entire $300 of foreign taxes would be credited, leaving a U.S. tax liability of $180. The combined U.S. tax and foreign tax liabilities would be $480.

foreign tax rate exceeds 48 percent, the dividend does not bring with it all the foreign taxes that were paid and thus the size of foreign tax credit carryover is reduced.

The size of the tax differential which exists in the case of dividends from less developed country corporations varies with the foreign tax rate. Further, the tax differential disappears either when the foreign tax rate equals or exceeds the U.S. tax or when there is no foreign tax imposed at all. The maximum tax differential, given a 48-percent U.S. tax rate, occurs when the foreign tax is half that, or 24 percent. The differential at this point is 5.76 percentage points.

Alternative Approaches

1974 committee bill

Last year's bill provided that dividends received by U.S. shareholders from less developed country corporations are to be "grossed up" by the amount of taxes paid in the less developed country both for purposes of computing U.S. income and for purposes of computing the U.S. foreign tax credit applicable to that income (in the same manner as is presently true in the case of dividends from developed countries).

Mr. Ullman

His proposal is the same as that in the 1974 committee bill.

3. Treatment of Capital Gains

The present foreign tax credit limitation creates a number of problems in the treatment of capital gains income stemming from the fact that capital gains are taxed differently than ordinary income. In many cases the source of income derived from the sale or exchange of an asset is determined by the location of the asset, or, if the asset is personal property, by the place of sale (i.e., the place where title to the property passes). In the latter cases, taxpayers presently can often exercise a choice of the country from which the income from the sale of tangible personal property is to be derived. It has thus been possible, in some cases, for a taxpayer to plan sales of personal property (including stocks or securities) in such a way as to maximize his use of foreign tax credits within the per-country or overall limitations by arranging that the sale of that property take place in a certain country.

Since many foreign countries do not tax any gain from sales of personal property, and most countries that do tax these gains do not apply the tax to sales by foreigners (if the sales are not connected with a trade or business in that country), the present system permits taxpayers to plan sales of their assets in such a way so that the income from the sale results in little or no additional foreign taxes and yet the amount of foreign taxes they can use as a credit against their U.S. tax liability is increased.

Further problems in the treatment of income from the sale or exchange of assets for purposes of the foreign tax credit limitations are presented by the rules for netting long-term and short-term gains and losses in cases where some gains or losses are U.S. source income while other gains or losses are foreign source income.

A final problem with the treatment of capital gains under the foreign tax credit system is presented by the fact that the credit limitations are not adjusted to reflect the lower tax rate on capital gains income received by corporations.[12] Under present law, corporations having a net long-term capital gain in most instances pay only a 30-percent rate of tax on that gain. But for purposes of determining foreign source and worldwide income in the limiting fraction of the foreign tax credit limitation, income from long-term capital gain is treated the same as ordinary income (i.e., as if it were subject to a 48-percent rate of tax).[13] Similarly, a taxpayer who has a capital gain income from U.S. sources and has foreign source income that is not capital gain income does not receive a full credit for the amount of U.S. tax attributable to foreign source income.[14]

Alternative Approaches

1974 committee bill

Last year's bill provided that in cases where a U.S. taxpayer sells a capital asset in a foreign country, the amount of any income received from the sale is not to be included as foreign source income for purposes of computing the taxpayer's foreign tax credit limitation if no substantial foreign tax is paid upon the sale of the asset. In this case and in cases where U.S. source capital gains are realized, the foreign tax credit limitation is to be adjusted to the extent of the capital gains.

Mr. Ullman

His proposal is the same as that in the 1974 committee bill.

4. Treatment of Exempt Income

There are other Code provisions which provide for the exemption or nonrecognition of certain income. Taxpayers who derive exempt income or are not required to recognize certain income may pay foreign income taxes on that income and use those foreign taxes as an offset against U.S. tax on other foreign source income.

Alternative Approaches

Messrs. Corman and Rangel

The proposal would deny the foreign tax credit on income exempt from U.S. tax.

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[12] A similar problem exists to a much lesser extent for capital gains income of individuals under the alternative tax (secs. 1201 (b) and (c)).

[13] For example, if a corporation has worldwide income of $20 million. $10 million of which is ordinary income from sources within the United States and $10 million of which is income from the sale of an asset from sources without the United States, that corporation is allowed a foreign tax credit equal to one-half (10/20) of his U.S. tax liability, even though only $3 million of the $7.8 million in U.S. tax liability is attributable to foreign source income. Present law thus favors the taxpayer with foreign source capital gain since his U.S. tax on U.S. ordinary income of $10 million is not treated as being $4.8 million but as $3.9 million.

[14] For example, if such a taxpayer had $10 million of U.S. source capital gain and $10 million of foreign ordinary income, the foreign tax credit limitation would limit the credit to $3.9 million even though he would be liable for $4.8 million of U.S. tax on his foreign source income.

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