THE IMPACT OF INTERNATIONAL TAX REFORM: BACKGROUND AND SELECTED ISSUES RELATING TO U.S. INTERNATIONAL TAX RULES AND THE COMPETITIVENESS OF U.S. BUSINESSES

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SUBCOMMITTEE ON SELECT REVENUE MEASURES
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INTRODUCTION

The Subcommittee on Select Revenue Measures of the House Ways and Means Committee has scheduled a public hearing for June 22, 2006, on the impact of international tax reform on U.S. competitiveness. This document,[1] prepared by the staff of the Joint Committee on Taxation, provides general background on the U.S. international tax rules and certain other countries' tax systems, and discusses selected issues relating to international tax reform and U.S. competitiveness.

[1] This document may be cited as follows: Joint Committee on Taxation, *The Impact of International Tax Reform: Background and Selected Issues Relating to U.S. International Tax Rules and the Competitiveness of U.S Businesses* (JCX-22-06), June 21, 2006.

I. WORLDWIDE VS. TERRITORIAL TAX SYSTEMS

A. In General

Worldwide tax system

In a pure worldwide tax system, resident individuals and entities are taxable on their worldwide income, regardless of where the income is derived. Double taxation of foreign income is mitigated through the allowance of a foreign tax credit. However, the credit is generally limited to ensure that the taxpayer's country of legal residence (the "residence country") preserves its right to tax income derived within the residence country. Because corporations are generally respected as separate entities, foreign-source income earned by a resident through a foreign corporation generally is not subject to tax until repatriated. This mechanism is known as "deferral." In the United States, complex anti-deferral regimes apply as exceptions to this general rule and tax U.S. shareholders currently on certain mobile or passive income derived through certain foreign corporations. It is also possible for a worldwide tax system not to offer deferral. As in the case of a "classic" worldwide system, double taxation would be mitigated through the allowance of a foreign tax credit.

Territorial tax system

In a pure territorial tax system, the country taxes only income derived within its borders, irrespective of the residence of the taxpayer. Thus, unlike in a worldwide tax system, foreign-source income earned by a resident is exempt from residence-country tax. There is no need for a foreign tax credit, because exemption generally eliminates the possibility of double taxation of foreign income. There also is no need for complicated anti-deferral rules, because foreign-source income is exempt from tax in the first place. As a practical matter, however, countries that have adopted territorial-type tax systems generally have included exceptions to the principle of territoriality for certain cases deemed to be abusive, using mechanisms similar to the U.S. anti-deferral rules and foreign tax credit.

Mixed systems

No country uses a pure worldwide or territorial system. Systems may be accurately characterized as predominantly worldwide or territorial, but all systems currently in use share at least some features of both worldwide and territorial approaches.

B. General Rationales for a Worldwide Tax System

Economic efficiency

Proponents of a worldwide tax system argue that it promotes economic efficiency better than a territorial system, because it does not distort the decision of whether to locate investment at home or abroad. A resident has no tax incentive under a worldwide system either to move activities abroad or to keep them within the residence country − in either case the income generally will be subject to tax at the residence-country rate. Thus, investment-location decisions are governed by business considerations, instead of by tax law. This efficiency norm is referred to as "capital export neutrality." Common deviations from the "pure" form of the worldwide tax system, such as the foreign tax credit limitation and deferral, reduce this neutrality.[2]

Equity

In general

Proponents of a worldwide tax system argue that it promotes equity in a number of ways.

Horizontal equity

First, it is argued that a worldwide system furthers the policy objective that taxpayers earning similar levels of income should be subject to tax at similar overall effective rates. Thus, a resident taxpayer earning income abroad should be subject to tax at the same effective rate as a taxpayer earning the same amount of income domestically. Subjecting foreign-source income to residence-country tax mitigates the possibility that the taxpayer earning income abroad will be subject to a lower overall effective rate than the taxpayer earning income domestically; providing a foreign tax credit mitigates the possibility that the taxpayer earning income abroad will be subject to a higher overall effective rate. Thus, a worldwide system provides a framework for treating similarly situated individuals similarly − a concept known as horizontal equity.

Vertical equity

The U.S. Federal income tax system is progressive. Resident individuals earning higher levels of income are taxed at progressively higher marginal rates, on the theory that it is fair to require them to shoulder a greater proportionate share of the tax burden based on their greater ability to pay. If ability to pay is regarded as important, then income earned abroad should also be included in the tax base and subjected to progressive rates. Otherwise, the overall progressivity of the tax system may be eroded, as higher-earning taxpayers might shift activities and income abroad. Thus, a worldwide system helps to promote the policy that higher income-

[2] By contrast, as discussed in section I.C., proponents of a territorial system argue that it better promotes a different form of neutrality. See section IV.B. for a fuller discussion the different measures of neutrality.

earners should bear a larger proportionate share of the tax burden − a concept known as vertical equity.

Benefits of U.S. citizenship and residency

Taxing U.S. citizens and residents on their worldwide income may also reflect the notion that U.S. citizenship and residency bestow important benefits that are unavailable to non-citizens and non-residents (e.g., a highly developed legal and technical business infrastructure, military protection, and passport and embassy services) for which U.S. citizens and residents should pay, regardless of where they might earn their income.[3]

Preservation of the U.S. tax base

A worldwide tax system arguably preserves the residence-country tax base more effectively than a pure territorial system. If foreign-source income is entirely exempt from taxation, then resident taxpayers will shift investment and income into lower-tax jurisdictions, thus eroding the residence-country tax base. For this reason, even those countries that employ predominantly territorial systems (e.g., France)[4] typically provide for current taxation of certain types of foreign-source income that may easily be earned in tax havens − a significant departure from "pure" territorial taxation.[5]

[3] Consistent with this notion, the United States taxes its citizens on their worldwide income, even if they reside outside the country. Reflecting the mixed nature of the U.S. system, however, the United States provides to qualifying individuals living abroad a partial exclusion for certain foreign source service income and housing expenses. Sec. 911.

[4] See the descriptions of certain countries' territorial systems in section III.A.

[5] Likewise, both worldwide and territorial tax systems may employ various rules to limit the improper shifting of income from high-tax to low-tax countries (such as transfer pricing and expense allocation rules).

C. General Rationales for a Territorial Tax System

Economic efficiency

Proponents of a territorial system argue that it promotes economic efficiency better than a worldwide tax system, because a territorial system treats all investment within a particular country (the "source country") the same, regardless of the residence of the investor. This efficiency norm is referred to as "capital import neutrality" (referred to by some as "competitiveness"[6]). Thus, if a residence country adopts a pure territorial system, residents of that country, when investing abroad in a particular source country, are not disadvantaged relative to other investors by virtue of their country of residence. For example, if a source country provides low effective tax rates on manufacturing income, a taxpayer resident in a country with a territorial tax system will fully enjoy the benefits of the lower source-country rate, while a taxpayer resident in a country with a worldwide tax system generally will not. In a world with diverse tax systems and rates, it is generally impossible to fully achieve both capital import neutrality and capital export neutrality at the same time.[7] Thus, difficult balancing decisions are unavoidable, and there is no consensus as to which of the two goals should take precedence.[8]

Simplicity in compliance and administration

Proponents argue that territorial tax systems are less complex from an administrative and compliance standpoint than worldwide tax systems. It is true that many complicated features of a worldwide system are not necessary in a pure territorial system. For example, the foreign tax credit and anti-deferral regimes, two of the most complex features of a worldwide tax system, are not necessary in a pure territorial system. However, as noted above, a pure territorial system is probably not workable because the country's tax base would be significantly eroded as residents shifted investments and activities abroad to low-tax jurisdictions. Thus, in order to make a territorial system work as a practical matter, various features of a worldwide system probably must be incorporated, which in turn adds back much of the complexity that a pure territorial system would avoid. For example, a set of rules similar to an anti-deferral regime (e.g., for passive income shifted to tax havens) is probably necessary to protect the tax base, but once adopted, such a regime would add substantial complexity to the system, both in terms of the anti-deferral regime itself and as a result of the collateral consequences of having such a regime, such as the need for a foreign tax credit or other mechanism to mitigate double taxation of the "tainted" income. In addition, because source of income is the fundamental basis for taxation under a territorial system, the rules for sourcing income and expenses (e.g., interest expense), as

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[6] See discussion of the various meanings of the term "competitiveness" in section IV.A. See section IV.B. for a fuller discussion of the concepts of capital export neutrality and capital import neutrality.

[7] It is possible to satisfy both principles at the same time if effective tax rates on capital income are the same in all countries. See discussion in section IV.B.

[8] It has been argued that these concepts are inadequate, and too indeterminate to be of any use in formulating policy in the first place, but this is a minority view in the relevant literature.

well as the transfer pricing rules, would bear considerably more weight than they do under a worldwide system, and thus might need to become more complex to serve their expanded role.

Source vs. residence as basis for taxation

The concept of residence is the fundamental basis of taxation under a worldwide tax system, whereas a pure territorial system, by relying on source, renders the concept of residence generally irrelevant. Several commentators have argued that, as applied to corporations, the concept of residence is becoming meaningless as a practical matter, because large multinational corporations are becoming "nationless" in the sense that their shareholders, employees, business activities, and income are increasingly spread throughout the world, rather than concentrated predominantly in any one country.[9] Because of this, the de-emphasis of residence is arguably one advantage of a territorial system. Of course, in a territorial system that incorporates some attributes of a worldwide system, the concept of residence would become important again, although probably less so than under a predominantly worldwide system.

Territoriality as a response to global economic developments

How the world has changed

As noted above, large corporations are increasingly performing their activities on a global scale. This is occurring in part because the capital markets constantly demand growth and growth may not be available in the corporation's home country, and in part because such corporations have the means to do so, due to their size and access to capital markets. Factors such as improvements in communications and other information technologies, more efficient transportation of goods (e.g., by containers) and people (e.g., by air), and the lowering of economic-political barriers such as tariffs and currency restrictions have created larger regional markets such as the European Union and the Association of Southeast Asian Nations ("ASEAN"). The rise of relatively low-cost manufacturing and service jurisdictions such as China and India and the regionalization of markets have created a large potential for large corporations to lower their cross-border transaction costs.

How business has changed

International businesses have adapted to these developments by altering their practices. Improved transportation of goods and logistics minimize the potentially negative effects of cost-saving practices such as "just-in-time" manufacturing (i.e., manufacturing on order rather than for inventory) and multiple manufacturing sites. Improved communications and transportation of people facilitate the provision of cross-border services and the creation of large cross-border service organizations to fill the service needs of multinational corporations. As a result of these

[9] There have been proposals to adapt the definition of "residence" to the "nationless" multinational corporation. See, e.g., Joint Committee on Taxation, *Options to Improve Tax Compliance and Reform Tax Expenditures* (JCS-02-05), January 27, 2005, at 178-181 (a foreign-incorporated entity is resident in the United States if its primary place of management and control is in the United States).

developments, businesses in many cases are efficiently producing goods or performing services in lower-cost jurisdictions for customers in regionalized markets.

Implications for territoriality

Some proponents of capital import neutrality argue that the changes in the global economy and international business described above require the adoption of a territorial tax system. These proponents argue that the growing volume and importance of cross-border trade have critically heightened the need for the economic efficiency and simplicity gains that they claim a territorial tax system would provide.

D. Methods of Implementing a Territorial Tax System

In general

Some have advocated changing the U.S. tax rules to move towards a territorial system. There are many possible variations of territoriality. Some basic approaches are described below, but others could be developed that contain a mixture of elements described below.

Exempt all foreign-source income

A pure territorial tax system would simply exempt all foreign-source income from residence-country tax. The primary question with regard to the U.S. system, if it were converted to a pure territorial system, would be whether the current source rules are adequate to fairly and efficiently define the exemption.

Exempt only active foreign-source income

A modified territorial tax system might exempt only active foreign-source income, but tax passive (or other highly mobile) foreign-source income. A key question to be addressed under this method would be whether to exempt all active income, or to limit the exemption to active income that is not highly mobile. In any case, defining the operative concepts, such as "active income," "passive income," or "highly mobile income," would be critical to such an approach.

Exempt only high-taxed foreign-source income

Another approach would be to exempt only foreign-source income that is subject to a certain minimum effective (or nominal) foreign tax rate, and to tax foreign-source income that is subject to foreign tax below that rate.

Exempt only certain kinds of foreign-source income

Another approach would be to exempt limited categories of foreign-source income, such as income from e-commerce transactions. Alternatively, such an exemption could be limited in amount. For example, the American Jobs Creation Act of 2004 ("AJCA") provided for a lower rate of tax on certain international shipping income earned by U.S. corporate taxpayers, based upon the net tonnage of the corporation's qualifying vessels.[10]

Exempt only income derived from certain countries

Yet another approach might be to exempt only income earned in a country with which the United States has a tax treaty, or simply to extend more favorable treatment to such income if a

[10] Secs. 1352-1359, added by sec. 248 of Pub. L. No. 108-357. The Tax Increase Prevention and Reconciliation Act of 2005 ("TIPRA"), Pub. L. No. 109-222 (2006), expanded the definition of qualifying vessels subject to these rules.

broader exemption system were adopted (e.g., by not subjecting the exemption to a high-tax test in the case of income derived in a treaty country, if the high-tax variation described above were adopted). Alternatively, a broad exemption system could be adopted, but income derived in identified tax haven jurisdictions could be excepted from the system (a "blacklist" approach).

Exemption with progression

No matter how broadly or narrowly the class of exempt income is defined, a further consideration is whether to employ an exemption system in which the exempt foreign-source income, while not taxed, is nevertheless considered in determining the taxpayer's position on a progressive marginal rate schedule, thus affecting the rate that applies to the taxpayer's local-source income. The rationale for this approach would be to preserve as much progressivity as is possible under a territorial tax system.

"Participation exemption" systems

Many countries (including several in Europe) tax resident multinational enterprises on a predominantly territorial basis by exempting dividends received from certain foreign subsidiaries from residence-country tax. The exemption typically applies only where the parent company's ownership ("participation") in the subsidiary exceeds a certain threshold (commonly 5-10 percent), reflecting an intent not to extend territorial principles to portfolio-type investments. The exemption may be total or partial (e.g., only 95 percent, or 60 percent, of qualifying dividends might be exempted), and other restrictions generally apply, in order to limit the exemption to certain categories of income (e.g., active income) and to address concerns about shifting income to low-tax jurisdictions. The exemption also may or may not be extended to gains on the sale of a participation interest. A participation exemption system generally provides a significant degree of territoriality with respect to parent companies that receive mainly dividend income from their foreign subsidiaries; much less territoriality is achieved with respect to parent companies that receive large volumes of other types of income (e.g., royalties) from their foreign subsidiaries, and indeed these latter companies may even be better off under the present-law credit system than under a participation exemption system.

As a mechanical matter, a participation exemption system might be implemented via a dividends-received deduction. For example, existing dividends-received deduction rules in the United States could be modified to extend to certain dividends received by U.S. corporations from their foreign subsidiaries. An example of this type of system might entail enacting, on a permanent basis, the dividends-received deduction of 85 percent of the cash dividends received from controlled foreign corporations ("CFCs") which AJCA provided on a temporary basis.[11]

[11] Sec. 965, added by sec. 422 of Pub. L. No. 108-357.

E. Issues Raised by a Shift to a Territorial System

Transition issues

A shift from a predominantly worldwide to a predominantly territorial tax system would raise a number of transition issues. For example, it is not clear how the pre-exemption-system deferred income of controlled foreign corporations would be treated. Options would include exempting such income entirely, taxing it upon repatriation, or taxing it immediately as a "toll charge" into the new exemption-based system. The treatment of pre-exemption-system losses would raise similar issues.

Rules accommodating residual tax on certain foreign-source income

As discussed in section I.D. above, most variations of a territorial tax system would continue to tax certain kinds of foreign-source income (e.g., passive, highly mobile, or low-taxed foreign-source income). In order to prevent double taxation of such non-exempt foreign-source income, certain rules similar or identical to those under the present-law U.S. worldwide tax system (but limited in scope to cover only such non-exempt foreign-source income) would be necessary. So, for example, foreign taxes paid with respect to non-exempt foreign-source income would presumably be creditable against the U.S. income tax on such income. Further policy issues implicated in designing such a system include, for instance, whether all non-exempt foreign-source income would be immediately subject to current U.S. income tax or whether certain income (e.g., income earned by foreign subsidiaries of the U.S. taxpayer) would qualify for deferral, and the extent to which foreign tax credits on non-exempt foreign-source income would be subject to limitation rules similar to those under the present-law U.S. worldwide tax system.

Expense disallowance

Under a territorial system, exempt foreign earnings constitute a tax-exempt stream of income. If the United States adopted a territorial system, then the question would arise whether deductions for interest and certain other expenses that would otherwise be deductible for U.S. income tax purposes should be disallowed to the extent allocable to these exempt earnings.[12] The concept behind the disallowance is one of matching − that expenses should not reduce the tax base to the extent incurred to produce income that will never increase the tax base.

The principal deduction that would be affected by such a rule would likely be interest expense. One method for disallowing these interest deductions is to allocate interest expense between U.S. and foreign-source income under rules similar to those of present law. The amount of interest expense allocated to foreign-source income under these rules then would be further allocated between exempt earnings and other foreign-source income on a pro rata basis, based on assets. Interest expense deductions allocated to the foreign-source exempt earnings would be

[12] These allocations would be made as the earnings are generated, as opposed to when they are distributed (e.g., under a participation exemption system).

disallowed. Different classes of expenses[13] would likely have different allocation rules, as under present law.

U.S. employment and "runaway plants"

Some critics argue that a shift to a territorial system, by exempting income earned overseas, would encourage U.S. companies to move their manufacturing and service operations (and thus jobs) abroad. Others respond that, as the present worldwide system allows deferral of certain income earned abroad through a foreign corporation, these incentives already exist, particularly when coupled with favorable source-country tax regimes for various types of manufacturing income. Nevertheless, critics argue, the adoption of a territorial system would not alleviate and would likely exacerbate this problem. On the other hand, it is argued that the adoption of a territorial system would also make the United States a more attractive place in which to incorporate, which may help to create or preserve various "headquarters" jobs, such as R&D, financial, corporate, and other administrative services. Thus, it is argued, adoption of a territorial system could help to halt or reverse the recent trend toward "corporate expatriation" from the United States, via cross-border mergers or otherwise.

Tax competition

Critics argue that if the United States and other major home countries of multinational enterprises were to adopt territorial tax systems, tax competition would intensify. Without the constraint of some residence-based taxation of foreign-source income, it is argued, a major barrier to tax competition would be removed and a "race to the bottom" would ensue.[14] Some would find this state of affairs intolerable, and might advocate a concerted international effort, such as through the Organisation for Economic Co-operation and Development ("OECD"), to ensure an adequate level of tax revenues to finance necessary government operations throughout the world. Others find nothing objectionable in the prospect of increased tax competition, and would reject any effort to prevent a country from determining its own tax rules and rates.

Tax treaties

The United States has an extensive network of bilateral tax treaties. These treaties are based on the fundamental premise that the United States has a worldwide tax system. A switch to a territorial system would require existing tax treaties to be renegotiated, at significant expense both to the country and to our trading partners. For example, the disallowance of interest

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[13] For example, interest expenses, research and experimentation expenses, general and administrative expenses, and stewardship expenses.

[14] Even under a worldwide tax system, there are many competitive pressures. For example, many foreign countries tax income from international shipping activities on a territorial basis, at a relatively lower rate than other types of income, or not at all. AJCA repealed the anti-deferral rule applicable to shipping activities conducted by CFCs and reduced the rate of tax on international shipping activities of U.S.-flag vessels. The legislative history points specifically to lower foreign taxation of shipping income as the rationale for the provisions. H.R. Rep. No. 108-548, Part 1, at 177, 209 (2004).

deductions allocated to exempt income might give rise to double taxation and tax disputes if the relevant treaty partner does not allow the deduction. In addition, switching to a territorial system might weaken the rationale for U.S. arguments to treaty partners for the enforcement or renegotiation of information-sharing treaty provisions or stand-alone agreements.

Transfer pricing

Multinational corporations engage in many cross-border transactions. Transfer pricing rules, in particular the "arm's length standard," govern the determination of the amounts of income attributed to U.S. and foreign legal entities in these transactions. Under a territorial system, the tax stakes involved would be increased: immediate income inclusion versus permanent exemption, as contrasted with the present-law stakes of current taxation versus deferral. This would place additional pressure on the transfer pricing rules. It is possible that there would be a need to increase resources to enforce these rules. In addition, some argue that the current transfer pricing rules or the arm's length standard would not adapt to the pressures of a territorial system.

Winners and losers

A shift to a territorial system would affect taxpayers in different ways and to different degrees. Some taxpayers would benefit, some would be hurt, and others would be relatively unaffected.[15] The effects on a particular taxpayer of implementing a territorial system would depend on the details of such system, the nature and mix of the taxpayer's activities, and the corporate structure of the taxpayer's legal entities. For example, implementation of a participation exemption system might have little or no effect on a U.S. company whose sole activity is exportation. Under a territorial system, taxpayers that receive much of their exempt income from CFCs located in jurisdictions with relatively low taxes would generally see their situation improve. Taxpayers that receive much of their exempt income from CFCs located in jurisdictions with relatively high taxes would generally see their situation worsen if they are currently able to fully credit such taxes. That would be the case if the taxpayer has excess foreign tax credit limitation.[16]

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[15] However, it should be noted that "unaffected" taxpayers might bear the weight of any future increases in the tax rate.

[16] For example, many companies in the technology, pharmaceutical, and financial services industries, and other companies whose income is derived from intangibles, may fall into this category. In addition, a taxpayer that exports goods from the United States but also has a large amount of income from high-tax foreign jurisdictions may also fall into this category.

II. THE U.S. INTERNATIONAL TAX SYSTEM

A. Tax Treatment of Foreign Activities of U.S. Persons

In general

The United States employs a worldwide tax system, under which domestic corporations generally are taxed on all income, whether derived in the United States or abroad. Income earned by a domestic parent corporation from foreign operations conducted by foreign corporate subsidiaries generally is subject to U.S. tax when the income is distributed as a dividend to the domestic parent corporation. Until that repatriation, the U.S. tax on the income generally is deferred. However, certain anti-deferral regimes may cause the domestic parent corporation to be taxed on a current basis in the United States on certain categories of passive or highly mobile income earned by its foreign corporate subsidiaries, regardless of whether the income has been distributed as a dividend to the domestic parent corporation. The main anti-deferral regimes in this context are the controlled foreign corporation rules of subpart F[17] and the passive foreign investment company rules.[18] A foreign tax credit generally is available to offset, in whole or in part, the U.S. tax owed on foreign-source income, whether the income is earned directly by the domestic corporation, repatriated as an actual dividend, or included in the domestic parent corporation's income under one of the anti-deferral regimes.[19]

Foreign tax credit

The United States generally provides a credit for foreign income taxes paid or accrued.[20] In the case of foreign income taxes paid or accrued by a foreign subsidiary, a U.S. parent corporation is generally entitled to an indirect (also referred to as a deemed paid) credit for those taxes when it receives an actual or deemed distribution of the underlying earnings from the foreign subsidiary.[21] The foreign tax credit generally is limited to the U.S. tax liability on a taxpayer's foreign-source income. This limit is intended to ensure that the credit serves its purpose of mitigating double taxation of foreign-source income without offsetting the U.S. tax on U.S.-source income.[22]

To determine the amount of allowable foreign tax credits after taking into account the foreign tax credit limitation, a taxpayer must allocate gross income and expenses between U.S. and foreign sources. Under present law, interest expense that a U.S.-based multinational

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[17] Secs. 951-964.

[18] Secs. 1291-1298.

[19] Secs. 901, 902, 960, 1291(g).

[20] Sec. 901.

[21] Secs. 902, 960.

[22] Secs. 901, 904.

corporate group incurs in the United States is allocated between U.S. and foreign sources based on the gross assets located in the United States relative to those located abroad (measured either by basis or by fair market value).[23] Thus, a U.S.-based multinational with a significant portion of its assets overseas must allocate a significant portion of its U.S. interest expense to foreign-source income. This allocation has the effect of reducing the foreign tax credit limitation and thus reducing the credits allowable (even though the interest expense incurred in the United States is generally not deductible in computing the actual tax liability under applicable foreign law).[24]

To reduce the extent to which excess foreign taxes paid in a high-tax foreign jurisdiction can be cross-credited against the residual U.S. tax on low-taxed foreign-source income, the foreign tax credit limitation is applied separately to different types of foreign-source income. For example, suppose a taxpayer pays foreign tax at an effective rate of 45 percent on certain active income earned in a high-tax jurisdiction, and pays little or no foreign tax on certain passive income earned in a low-tax jurisdiction. In the absence of the separate limitation rules described below, earning untaxed (or low-taxed) passive income could permit the taxpayer to claim a credit for the otherwise uncreditable excess foreign taxes paid to the high-tax jurisdiction by increasing the foreign tax credit limitation without increasing the amount of foreign taxes paid. This sort of cross-crediting is constrained by rules that require the computation of the foreign tax credit limitation on a category-by-category basis.[25] Thus, in the example above, the rules would place the passive income and the active income into separate limitation categories (or "baskets"), and the low-taxed passive income would not be allowed to increase the foreign tax credit limitation applicable to the credits arising from the high-taxed active income. For taxable years beginning prior to January 1, 2007, section 904(d) provides eight separate baskets as a general matter, and effectively many more in situations in which various special rules apply.[26]

Special rules govern the ability of a taxpayer with excess foreign tax credits (that is, an amount of foreign tax credits which exceeds the foreign tax credit limitation for the taxable year) to offset such excess credits against tax liability arising in a prior year (credits so utilized are said to be carried back) or in a subsequent year (carried forward).[27] Excess credits generated in a

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[23] Sec. 864(e); Temp. Reg. sec. 1.861-11T.

[24] AJCA made certain changes to the interest expense allocation rules, effective for taxable years beginning after December 31, 2008, intended to mitigate this effect. AJCA sec. 401. These changes are described in "Recent Legislative Changes" below.

[25] Sec. 904(d).

[26] As discussed in "Recent Legislative Changes" below, AJCA reduced the number of baskets from nine to eight (eliminating the 10/50 basket) for taxable years beginning after December 31, 2002, and further reduced the number of baskets to two for taxable years beginning after December 31, 2006. AJCA sec. 404.

[27] Sec. 904(c).

taxable year are permitted to be carried back to the immediately preceding taxable year and carried forward ten taxable years (in chronological order), and are usable only as a credit (not as a deduction), and only to the extent that there is excess foreign tax credit limitation in the carryover or carryback year. Consequently, foreign tax credits arising in a taxable year are used before excess credits from another taxable year are carried forward or backward and applied to that year. In addition, excess credits are carried forward or carried back on a separate limitation basis. Thus, if a taxpayer has excess foreign tax credits in one basket for a taxable year, those excess credits may be carried back and forward only as taxes allocable to that basket, notwithstanding the fact that the taxpayer may have excess foreign tax credit limitation in another basket for that year. If credits cannot be utilized within the one-year carryback and ten-year carryforward period, they expire and are permanently disallowed.

If a taxpayer generates an overall foreign loss ("OFL") for the year − that is, the amount of its foreign-source income is lower than the amount of expenses allocable to that income (whether as the result of business losses or expense allocations under U.S. tax rules) − it will not be able to claim foreign tax credits for that year, since it will have no foreign-source income and thus will have a foreign tax credit limitation of zero. Moreover, if the taxpayer does generate foreign-source income in later years, some portion of that income will be "recaptured," or recharacterized as U.S.-source, thus reducing the foreign tax credit limitation in those later years.[28] The rationale for OFL recapture is that the foreign-source losses offset U.S.-source income in the year generated, thereby reducing the U.S. tax collected on U.S.-source income. The U.S. treasury would not be made whole when the taxpayer subsequently earns foreign-source income if, in the absence of such a recapture provision, the U.S. taxes on such income were completely offset by foreign tax credits.[29]

Anti-deferral regimes

In general

Generally, income earned indirectly by a domestic corporation through a foreign subsidiary corporation is subject to U.S. tax only when the income is distributed to the domestic parent corporation because corporations generally are treated as separate taxable persons for Federal tax purposes. However, this deferral of U.S. tax is limited by anti-deferral regimes that impose current U.S. tax on certain types of income earned by certain corporations. These anti-deferral rules are intended to prevent taxpayers from avoiding U.S. tax by shifting passive or other highly mobile income into low-tax jurisdictions. Deferral of U.S. tax is considered appropriate, on the other hand, for most types of active business income earned abroad.

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[28] Sec. 904(f). These rules also operate on a category-by-category basis.

[29] As discussed in "Recent Legislative Changes" below, AJCA added a parallel provision that allows a taxpayer that generates an overall domestic loss in a taxable year beginning after December 31, 2006, to recharacterize a portion of its U.S.-source income in succeeding years as foreign-source to the extent of such overall domestic loss. AJCA sec. 402.

Subpart F

Subpart F,[30] applicable to controlled foreign corporations and their shareholders, is the main anti-deferral regime of relevance to a U.S.-based multinational corporate group. A controlled foreign corporation generally is defined as any foreign corporation if U.S. persons own (directly, indirectly, or constructively) more than 50 percent of the corporation's stock (measured by vote or value), taking into account only those U.S. persons that own at least 10 percent of the stock (measured by vote only).[31] Under the subpart F rules, the United States generally taxes the U.S. 10-percent shareholders of a controlled foreign corporation on their pro rata shares of certain income of the controlled foreign corporation (referred to as "subpart F income"), without regard to whether the income is distributed to the shareholders.[32]

Subpart F income generally includes passive income and other income that is readily movable from one taxing jurisdiction to another. Subpart F income consists of foreign base company income,[33] insurance income,[34] and certain income relating to international boycotts and other violations of public policy.[35] Foreign base company income consists of foreign personal holding company income, which includes passive income such as dividends, interest, rents, and royalties, and a number of categories of income from business operations, including foreign base company sales income, foreign base company services income, and foreign base company oil-related income.[36]

In effect, the United States treats the U.S. 10-percent shareholders of a controlled foreign corporation as having received a current distribution out of the corporation's subpart F income.

The U.S. 10-percent shareholders of a controlled foreign corporation also are required to include currently in income for U.S. tax purposes their pro rata shares of the corporation's earnings invested in certain items of U.S. property.[37] This U.S. property generally includes tangible property located in the United States, stock of a U.S. corporation, an obligation of a U.S. person, and certain intangible assets, such as patents and copyrights, acquired or developed by the controlled foreign corporation for use in the United States.[38] There are specific exceptions to

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[30] Secs. 951-964.

[31] Secs. 951(b), 957, 958.

[32] Sec. 951(a).

[33] Sec. 954.

[34] Sec. 953.

[35] Sec. 952(a)(3)-(5).

[36] Sec. 954. AJCA eliminated the category of foreign base company shipping income.

[37] Secs. 951(a)(1)(B), 956.

[38] Sec. 956(c)(1).

the general definition of U.S. property, including for bank deposits, certain export property, and certain trade or business obligations.[39]

Passive foreign investment companies

The Tax Reform Act of 1986 established an anti-deferral regime for passive foreign investment companies. A passive foreign investment company generally is defined as any foreign corporation if 75 percent or more of its gross income for the taxable year consists of passive income, or 50 percent or more of its assets consists of assets that produce, or are held for the production of, passive income.[40] Alternative sets of income inclusion rules apply to U.S. persons that are shareholders in a passive foreign investment company, regardless of their percentage ownership in the company. One set of rules applies to passive foreign investment companies that are "qualified electing funds," under which electing U.S. shareholders currently include in gross income their respective shares of the company's earnings, with a separate election to defer payment of tax, subject to an interest charge, on income not currently received.[41] A second set of rules applies to passive foreign investment companies that are not qualified electing funds, under which U.S. shareholders pay tax on certain income or gain realized through the company, plus an interest charge that is attributable to the value of deferral.[42] A third set of rules applies to passive foreign investment company stock that is marketable, under which electing U.S. shareholders currently take into account as income (or loss) the difference between the fair market value of the stock as of the close of the taxable year and their adjusted basis in such stock (subject to certain limitations), often referred to as "marking to market."[43]

Coordination

Detailed rules for coordination among the anti-deferral regimes are provided to prevent U.S. persons from being subject to U.S. tax on the same item of income under multiple regimes. For example, a corporation generally is not treated as a passive foreign investment company with respect to a particular shareholder if the corporation is also a controlled foreign corporation, and the shareholder is a U.S. shareholder under section 951(b). Thus, subpart F is allowed to trump the passive foreign investment company rules.

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[39] Sec. 956(c)(2).

[40] Sec. 1297.

[41] Secs. 1293-1295.

[42] Sec. 1291.

[43] Sec. 1296.

Recent Legislative Changes

The 108th Congress and the 109th Congress have enacted a number of important changes affecting the taxation of foreign (and, in certain circumstances, domestic) activities of U.S. persons. AJCA and TIPRA included rules intended to simplify and rationalize the application of the anti-deferral and foreign tax credit rules, and to exempt from current U.S. taxation certain items of income that previously had been considered subpart F income. AJCA also included two other important sets of rules: (1) a temporary provision intended to encourage the repatriation of foreign earnings, and (2) the phasing out of certain export-related tax benefits and their replacement with a new deduction for certain domestic manufacturing activities. Preferential rules for activities in U.S. possessions expired at the end of last year. These various changes, and background relevant to the changes, are described below.

Foreign tax credit rules

Interest expense allocation rules

In order to compute the foreign tax credit limitation, a taxpayer must determine the amount of its taxable income from foreign sources by allocating and apportioning deductions between items of U.S.-source gross income, on the one hand, and items of foreign-source gross income, on the other. In the case of interest expense, the rules generally are based on the premise that money is fungible and that interest expense is properly attributable to all business activities and property of a taxpayer, regardless of any specific purpose for incurring an obligation on which interest is paid.[44] For interest allocation purposes, the Code provides that all members of an affiliated group of corporations generally are treated as a single corporation (the so-called "one-taxpayer rule") and allocation must be made on the basis of assets rather than gross income.[45]

The term "affiliated group" in this context generally is defined by reference to the rules for determining whether corporations are eligible to file consolidated returns.[46] These rules generally exclude all foreign corporations from an affiliated group.[47] Thus, while debt generally is considered fungible among the assets of a group of domestic affiliated corporations, the same rules do not apply as between the domestic and foreign members of a group with the same degree of common control as the domestic affiliated group.

AJCA modified the interest expense allocation rules by providing a one-time permanent election, generally available in a taxpayer's first taxable year beginning after December 31, 2008, to determine the taxable income of the domestic members of an affiliated group from

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[44] Sec. 864(e).

[45] Sec. 864(e)(1).

[46] Sec. 864(e)(5); sec. 1504.

[47] Sec. 1504(b)(3).

sources outside the United States generally by allocating and apportioning interest expense of the domestic members of a worldwide affiliated group on a worldwide-group basis (i.e., as if all members of the worldwide group were a single corporation).[48] If a group makes this election, the taxable income of the domestic members of a worldwide affiliated group[49] from sources outside the United States is determined by allocating and apportioning the third-party interest expense of those domestic members to foreign-source income in an amount equal to the excess (if any) of (1) the worldwide affiliated group's worldwide third-party interest expense multiplied by the ratio which the foreign assets of the worldwide affiliated group bears to the total assets of the worldwide affiliated group, over (2) the third-party interest expense incurred by foreign members of the group to the extent such interest would be allocated to foreign sources if the provision's principles were applied separately to the foreign members of the group.[50]

Overall domestic loss

AJCA added a provision, mirroring the long-standing OFL re-sourcing rules, which applies a re-sourcing rule to U.S.-source income in cases in which a taxpayer's foreign tax credit limitation has been reduced as a result of an overall domestic loss ("ODL").[51] An ODL is any domestic loss to the extent it offsets foreign-source taxable income for the current taxable year or

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[48] AJCA sec. 401.

[49] The worldwide affiliated group consists of all corporations in an affiliated group plus, generally, all controlled foreign corporations that would be members of that affiliated group but for the fact that they are foreign corporations. Sec. 864(f)(1)(C) (as in effect for taxable years beginning after December 31, 2008). Thus, if an affiliated group makes this election, the foreign-source income of domestic group members generally is determined by allocating and apportioning interest expense of the domestic members of the worldwide affiliated group as if all of the interest expense and assets of 80-percent or greater owned domestic corporations and certain controlled foreign corporations were attributable to a single corporation.

[50] Such an election may be made only by the common parent of the domestic affiliated group, and may be made only for the first taxable year beginning after December 31, 2008, in which a worldwide affiliated group exists which includes such affiliated group and at least one foreign corporation. Once made, such an election applies to the common parent and all other corporations that are members of the worldwide affiliated group for such taxable year and all subsequent taxable years, and cannot be revoked without consent of the IRS Commissioner. Sec. 864(f)(6) (as in effect for taxable years beginning after December 31, 2008).

[51] AJCA sec. 402. While the OFL rules are intended to prevent taxpayers from claiming an improper double benefit (that is, reducing U.S. tax by means of expenses properly allocable to foreign source income in the OFL year, and subsequently receiving the full benefit of unrecaptured foreign source income in calculating the foreign tax credit limitation for future years), the ODL rules are intended to protect taxpayers from improper double taxation (that is, losing the ability to claim any foreign tax credits in the ODL year, with no opportunity to benefit from the positive ODL-year foreign-source income in calculating the foreign tax credit limitation for future years).

for any preceding taxable year by reason of a loss carryback.[52] Under the provision, which applies to losses incurred in taxable years beginning after December 31, 2006, a portion of the taxpayer's U.S.-source income for each succeeding taxable year will be recharacterized as foreign-source income in an amount equal to the lesser of: (1) the amount of the unrecharacterized ODLs for years prior to such succeeding taxable year, and (2) 50 percent of the taxpayer's U.S.-source income for such succeeding taxable year.[53]

Look-through rules for dividends from noncontrolled section 902 corporations

Prior to AJCA, special foreign tax credit limitations applied in the case of dividends received from a foreign corporation in which the taxpayer owned at least 10 percent of the stock by vote and which was not a controlled foreign corporation (a so-called "10/50 company").[54] Effective for taxable years beginning after December 31, 2002, AJCA eliminated the separate limitation basket for dividends paid by 10/50 companies, and instead provides a look-through approach to such dividends regardless of the year in which the earnings and profits out of which the dividend is paid were accumulated.[55]

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[52] For this purpose, a domestic loss means the amount by which the U.S.-source gross income for the taxable year is exceeded by the sum of the deductions properly apportioned or allocated thereto, determined without regard to any loss carried back from a subsequent taxable year. However, an ODL does not include any loss for any taxable year unless the taxpayer elected the use of the foreign tax credit for such taxable year. Sec. 904(g) (as in effect for taxable years beginning after December 31, 2006).

[53] Any U.S.-source income recharacterized under the ODL rules is allocated among and increases the various foreign tax credit separate limitation categories in the same proportion that those categories were reduced by the prior overall domestic losses, in a manner similar to the recharacterization rules for separate limitation losses.

[54] For example, all dividends paid by a 10/50 company in taxable years beginning before January 1, 2003, as well as dividends paid in taxable years beginning after December 31, 2002 by a 10/50 company that was a passive foreign investment company out of earnings and profits accumulated in taxable years beginning before January 1, 2003, were subject to a separate foreign tax credit limitation for each 10/50 company. Dividends paid after December 31, 2002, by a 10/50 company that was not a passive foreign investment company out of earnings and profits accumulated in taxable years beginning before January 1, 2003, were subject to a single foreign tax credit limitation for all 10/50 companies (other than passive foreign investment companies). Dividends paid by a 10/50 company out of earnings and profits accumulated in taxable years after December 31, 2002, were treated as income in a foreign tax credit limitation category in proportion to the ratio of the 10/50 company's earnings and profits attributable to income in such foreign tax credit limitation category to its total earnings and profits (a "look-through" approach). Sec. 904(d).

[55] AJCA sec. 403. A technical correction made by the Gulf Opportunity Zone Act of 2005, Pub. L. No. 109-135, added a transition rule allowing taxpayers to elect not to apply the look-through rules to taxable years beginning before January 1, 2005.

Foreign tax credit baskets

Prior to AJCA, the foreign tax credit limitation was applied separately to the following categories of income: (1) passive income, (2) high withholding tax interest, (3) financial services income, (4) shipping income, (5) certain dividends received from noncontrolled section 902 foreign corporations ("10/50 companies"), (6) certain dividends from a domestic international sales corporation or former domestic international sales corporation, (7) taxable income attributable to certain foreign trade income, (8) certain distributions from a foreign sales corporation or former foreign sales corporation, and (9) any other income not described in items (1) through (8) (so-called "general basket" income).[56] In addition, a number of other provisions of the Code and U.S. tax treaties effectively create additional separate limitations in certain circumstances.[57]

Effective for taxable years beginning after December 31, 2006, AJCA generally reduced the number of foreign tax credit limitation categories to two: passive category income and general category income.[58] Other income is included in one of the two categories, as appropriate.[59] Taxes paid or accrued in a taxable year beginning before January 1, 2007, and carried to any subsequent taxable year are treated as if this provision were in effect on the date such taxes were paid or accrued. Thus, such taxes are assigned to one of the two foreign tax credit limitation categories.[60]

Ten-year foreign tax credit carryforward; one-year foreign tax credit carryback

Prior to AJCA, the amount of creditable taxes paid or accrued (or deemed paid) in any taxable year which exceeded the foreign tax credit limitation was permitted to be carried back to the two immediately preceding taxable years (to the earliest year first) and carried forward five taxable years (in chronological order) and credited (not deducted) to the extent that the taxpayer

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[56] Sec. 904(d)(1) (as in effect prior to AJCA).

[57] See, e.g., sec. 245(a)(10) (relating to certain dividends treated as foreign source under treaties); sec. 865(h)(1)(B) (relating to certain gains from stock and intangibles treated as foreign source under treaties); sec. 901(j)(1)(B) (relating to income from certain specified countries); and sec. 904(g)(10)(A) (relating to interest, dividends, and certain other amounts derived from U.S.-owned foreign corporations and treated as foreign source under treaties).

[58] AJCA sec. 404.

[59] AJCA did not affect the separate computation of foreign tax credit limitations under special provisions of the Code relating to, for example, treaty-based sourcing rules or specified countries under section 901(j).

[60] Sec. 904(d)(2)(K) (as in effect for taxable years beginning after December 31, 2006).

otherwise had excess foreign tax credit limitation for those years.[61] AJCA extended the excess foreign tax credit carryforward period to ten years and limited the carryback period to one year.[62]

Foreign tax credit under alternative minimum tax

Taxpayers are subject to an alternative minimum tax ("AMT"), which is payable, in addition to all other tax liabilities, to the extent that it exceeds the taxpayer's regular income tax liability.[63] The tax is imposed at a flat rate of 20 percent, in the case of corporate taxpayers, on alternative minimum taxable income ("AMTI") in excess of an exemption amount.[64] AMTI is the taxpayer's taxable income increased for certain tax preferences and adjusted by determining the tax treatment of certain items in a manner that limits the tax benefits resulting from the regular tax treatment of such items.[65]

Taxpayers are permitted to reduce their AMT liability by an AMT foreign tax credit.[66] The AMT foreign tax credit for a taxable year is determined under principles similar to those used in computing the regular tax foreign tax credit, except that (1) the numerator of the AMT foreign tax credit limitation fraction is foreign source AMTI and (2) the denominator of that fraction is total AMTI.[67] Prior to AJCA, the AMT foreign tax credit for any taxable year generally could not offset a taxpayer's entire pre-credit AMT. Rather, the AMT foreign tax credit was limited to 90 percent of AMT computed without any AMT net operating loss deduction and the AMT foreign tax credit.[68] AJCA repealed this 90-percent limitation on the utilization of the AMT foreign tax credit, effective for taxable years beginning after December 31, 2004; thus, a taxpayer with sufficient AMT foreign tax credit limitation is now permitted to offset up to 100 percent of its pre-credit AMT with AMT foreign tax credits.[69]

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[61] Sec. 904(c) (as in effect prior to AJCA).

[62] AJCA sec. 417.

[63] Sec. 55.

[64] Sec. 55(b)(1)(B).

[65] Sec. 55(b)(2).

[66] Sec. 59(a).

[67] Sec. 59(a)(1). Alternatively, a taxpayer may elect to calculate its AMT foreign tax credit as the ratio of foreign source regular taxable income to total AMTI. Such an election must be made in the taxpayer's first taxable year which begins after December 31, 1997, and for which the taxpayer claims an AMT foreign tax credit. Sec. 59(a)(4)(A). Once made, such an election applies to the taxable year for which made and all subsequent taxable years, and cannot be revoked without consent. Sec. 59(a)(4)(B).

[68] Sec. 59(a)(2) (as in effect prior to AJCA).

[69] AJCA sec. 421.

Anti-deferral rules

CFC look-through

As described above, one category of subpart F income is foreign personal holding company income. This category includes passive income such as dividends, interest, rents, and royalties. Foreign personal holding income does not, however, include dividends and interest received by a CFC from a related corporation organized and operating in the same foreign country in which the CFC is organized. It also does not include rents and royalties received by a CFC from a related corporation for the use of property within the country in which the CFC is organized. The exclusions from foreign personal holding company income for these interest, dividend, rent, and royalty payments do not apply to the extent the payments reduce the subpart F income of the payor.

TIPRA added a new exclusion from foreign personal holding company income for dividends, interest, rents, and royalties received by one CFC from a related CFC (with relation based on control) to the extent attributable or properly allocable to non-subpart-F income of the payor.[70] The exclusion applies for taxable years beginning after 2005 and before 2009.

Section 956

As described above, under section 956 the U.S. 10-percent shareholders of a controlled foreign corporation are required to include currently in income their pro rata shares of the corporation's earnings invested in certain kinds of U.S. property. AJCA created two new exceptions to U.S. property under section 956, one for securities acquired and held by a controlled foreign corporation in the ordinary course of its trade or business as a securities dealer, and the other for obligations issued by a U.S. person that is not a domestic corporation and is not (1) a U.S. 10-percent shareholder of the controlled foreign corporation or (2) a partnership, estate, or trust in which the controlled foreign corporation or any related person is a partner, beneficiary, or trustee immediately after the controlled foreign corporation's acquisition of the obligation.[71]

Partnership sales

Subpart F income generally includes gain from the sale of an interest in a partnership.[72] Under AJCA section 412, however, if a controlled foreign corporation owns at least a 25-percent capital or profits interest in a partnership and sells an interest in that partnership, the controlled foreign corporation is treated under subpart F as selling the proportionate share of the assets of the partnership attributable to that interest.[73] Consequently, the sale gives rise to subpart F

[70] TIPRA sec. 103(b).

[71] AJCA sec. 407; Code sec. 956(c)(2)(L) and (M).

[72] Secs. 952(a)(2), 954(a)(1) and (c)(1)(B)(ii).

[73] Sec. 954(c)(4).

income only to the extent that a proportionate sale of the underlying assets would give rise to subpart F income.

Other anti-deferral rules

The subpart F and PFIC rules are not the only anti-deferral regimes. Other rules that impose current U.S. taxation on income earned by a U.S. person through a foreign corporation include the accumulated earnings tax rules[74] and the personal holding company rules.[75] Until the enactment of AJCA, the Code included two other sets of anti-deferral rules, those applicable to foreign personal holding companies and those for foreign investment companies.[76] Because the overlap among the various anti-deferral regimes was seen as creating complexity with no ultimate tax consequences, AJCA repealed the foreign personal holding company and foreign investment company rules.[77]

Active financing income

Under a provision enacted in 1997 and originally applicable only for one taxable year,[78] there is an exclusion from subpart F income for certain income of a controlled foreign corporation that is derived in the active conduct of a banking or financing business ("active financing income").[79] Congress has extended the application of section 954(h) several times, most recently in TIPRA.[80] The exception from subpart F for active financing income now applies to taxable years of foreign corporations starting before January 1, 2009 (and to taxable years of U.S. shareholders with or within which those corporate taxable years end).[81]

AJCA expanded the scope of the active financing income exclusion from subpart F. Income is treated as active financing income (and was so treated before AJCA) only if, among other requirements, it is derived by a controlled foreign corporation or by a qualified business unit of that controlled foreign corporation. After the enactment of AJCA, certain activities conducted by persons related to the controlled foreign corporation or its qualified business unit are treated as conducted directly by the controlled foreign corporation or qualified business

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[74] Secs. 531-537.

[75] Secs. 541-547.

[76] Secs. 551-558 and 1246-1247.

[77] AJCA sec. 413.

[78] Pub. L. No. 105-34, sec. 1175.

[79] Sec. 954(h).

[80] TIPRA sec. 103(a)(2); Pub. L. No. 107-147, sec. 614 (2002); Pub. L. No. 106-170, sec. 503 (1999); Pub. L. No. 105-277 (1998).

[81] TIPRA sec. 103(a)(2); Code sec. 954(h)(9).

unit.[82] An activity qualifies under this rule if the activity is performed by employees of the related person and if the related person is an eligible controlled foreign corporation the home country of which is the same as the home country of the related controlled foreign corporation or qualified business unit; the activity is performed in the home country of the related person; and the related person receives arm's-length compensation that is treated as earned in the home country. Income from an activity qualifying under this rule is excepted from subpart F income so long as the other active financing requirements are satisfied.

Aircraft and vessel leasing

In general, rents are considered subpart F income.[83] Rents (and royalties) are not treated as subpart F income, however, if they are derived in the active conduct of a trade or business and are received from an unrelated person.[84] In AJCA, Congress added to this exception for active rental income a safe harbor for rents derived from aircraft or vessel leasing.[85] Rents derived from leasing an aircraft or vessel in foreign commerce will not fail to be treated as derived in the active conduct of a trade or business if, under Treasury regulations, the active leasing expenses are at least 10 percent of the profit on the lease.[86]

Other recent changes

Temporary dividends received deduction for repatriated foreign earnings

Section 421 of AJCA added to the Code section 965, a temporary provision intended to encourage the repatriation of certain low-taxed foreign earnings. As discussed above, the U.S. tax rules generally allow a U.S. corporation to defer U.S. income tax on the active foreign-source income earned abroad by its CFCs until such income is returned to the United States. By providing a present-value benefit to U.S. taxpayers who keep low-taxed CFC earnings offshore, these rules operate as a disincentive to repatriate such earnings. In addition, U.S. generally accepted accounting principles ("U.S. GAAP") may provide a further (and related) disincentive for publicly traded companies to repatriate low-taxed CFC earnings.[87]

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[82] AJCA sec. 416; Code sec. 954(h)(3)(E).

[83] Secs. 952(a)(2), 954(a)(1) and (c)(1)(A).

[84] Sec. 954(c)(2)(A).

[85] AJCA sec. 415(b).

[86] Sec. 954(c)(2)(A).

[87] In particular, Accounting Principles Board Opinion 23 ("APB 23") provides an exception to the general rule of comprehensive recognition of deferred taxes for temporary book-tax differences. (For a general overview of the financial accounting rules relating to book-tax differences, see Joint Committee on Taxation, *Present Law and Background Relating to Corporate Tax Reform: Issues of Conforming Book and Tax Income and Capital Cost Recovery* (JCX-16-06), May 8, 2006.) The exception applies to temporary differences related to undistributed earnings of foreign subsidiaries and foreign corporate joint

Under section 965, certain dividends received by a U.S. corporation from its controlled foreign corporations are eligible for an 85-percent dividends-received deduction.[88] The deduction is subject to a number of general limitations. First, it applies only to cash repatriations generally in excess of the taxpayer's average repatriation level calculated for recent taxable years. Second, the amount of dividends eligible for the deduction is generally limited to the amount of earnings shown as permanently invested outside the United States on the taxpayer's recent audited financial statements.[89] Third, in order to qualify for the deduction, dividends must be described in a domestic reinvestment plan approved by the taxpayer's senior management and board of directors.[90]

Under section 965(d), no foreign tax credit (or deduction) is allowed for foreign taxes attributable to the deductible portion of any dividend. For this purpose, the taxpayer may specifically identify which dividends are treated as carrying the deduction and which dividends are not. In other words, the taxpayer is allowed to choose which of its dividends are treated as meeting the base-period repatriation level (and thus carry foreign tax credits, to the extent otherwise allowable), and which of its dividends are treated as comprising the excess eligible for the deduction (and thus entail proportional disallowance of any associated foreign tax credits).[91]

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ventures that meet the indefinite reversal criterion in APB 23 (such earnings are said to be "permanently reinvested"). Under U.S. GAAP, a U.S. multinational company generally includes the pre-tax income of its CFCs in the U.S. parent's consolidated financial statements (thereby increasing its reported earnings to reflect the foreign income of its CFCs); however, if the APB 23 exception applies, the company is not required to make an accrual for the residual U.S. tax that will be imposed when the earnings are repatriated (thereby avoiding a reduction of its reported earnings to take into account the U.S. tax liability which would be due upon repatriation). The rationale for this exception is that, when management of the company asserts that certain low-taxed foreign earnings will never be repatriated, it would be inconsistent with the objectives of U.S. GAAP (including the objective of providing investors with accurate information) to require a current accrual for future U.S. taxes that management, according to such assertion, expects that the company will never be required to pay. Instead, under APB 23, the company will reduce its reported consolidated income to account for the residual U.S. tax on the CFC's earnings only at the time such earnings are repatriated (or when such earnings no longer qualify as "permanently reinvested," if earlier). Thus, just as taxpayers can often defer the cash payment of U.S. tax until foreign income is repatriated, so too publicly-traded U.S. multinational companies can often defer accounting for and reflecting this tax cost in their public financial statements until the foreign income is repatriated.

[88] At the taxpayer's election, this deduction is available for dividends received either during the taxpayer's first taxable year beginning on or after October 22, 2004, or during the taxpayer's last taxable year beginning before such date.

[89] This rule refers to elements of APB 23 as described above.

[90] The plan must provide for the reinvestment of the repatriated dividends in the United States, including as a source for the funding of worker hiring and training, infrastructure, research and development, capital investments, and the financial stabilization of the corporation for the purposes of job retention or creation.

[91] Accordingly, taxpayers generally would be expected to pay regular dividends out of high-taxed CFC earnings (thereby generating deemed-paid credits available to offset foreign-source income) and

The deduction itself will have the effect of appropriately reducing the taxpayer's foreign tax credit limitation. In addition, deductions are disallowed for expenses that are directly allocable to the deductible portion of any dividend.

In enacting section 421 of AJCA, the Congress emphasized that this tax reduction is a temporary economic stimulus measure, and that there is no intent to make the measure permanent, or to "extend" or enact it again in the future.[92]

FSC/ETI and section 199

Until recently, the United States provided export-related benefits under various Code rules. For most of the last two decades, these benefits were provided under the foreign sales corporation regime. In 2000, the foreign sales corporation regime was declared a prohibited export subsidy by the World Trade Organization. In response to this ruling, the United States repealed the foreign sales corporation rules and replaced them with a new set of rules, the extraterritorial income regime. This new regime also was found to be a prohibited export subsidy. In AJCA, Congress repealed the extraterritorial income regime, subject to certain transition and grandfather rules.[93] At the same time as it repealed the extraterritorial income rules, Congress enacted a new tax incentive for certain domestic manufacturing activities.[94] When fully phased in, the tax benefit from this manufacturing incentive will be equivalent to a three-percent tax rate reduction.

Expiration of section 936 and 30A credits

Under prior U.S. law, certain domestic corporations with business operations in U.S. possessions could elect under Code section 936 to generally eliminate the U.S. tax (including the alternative minimum tax) on certain foreign source income which was related to their operations in the possessions. The benefit conferred to companies under section 936 is commonly referred to as the possessions tax credit. A majority of the corporations that benefited from the possessions tax credit established operations in Puerto Rico. Companies with significant operations in Puerto Rico operated through a Puerto Rico branch of a domestic U.S. corporation. Such corporations were commonly referred to as "section 936 companies." Income that was not subject to U.S. tax under this provision included income that was derived either from the active conduct of a trade or business within a U.S. possession or from certain investments in the possessions or in certain Caribbean Basin countries which generated qualified possession source

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section 965 dividends out of low-taxed CFC earnings (thereby availing themselves of the 85-percent deduction).

[92] H.R. Rep. No. 108-548, at 43 (2004); S. Rep. No. 108-192, at 50 (2003).

[93] Rules grandfathering certain arrangements under binding contracts subsequently were repealed in TIPRA. Transition period rules were left in place. TIPRA sec. 513.

[94] Sec. 199.

investment income ("QPSII"). The benefit of the possessions tax credit was that it spared the electing corporation U.S. tax whether or not it paid income tax to the possession.

The Small Business Job Protection Act of 1996[95] ("Small Business Act") repealed the possession tax credit for tax years beginning after December 31, 1995. In doing so, the Small Business Act provided grandfather rules that allowed for a 10-year transition period. However, for tax years beginning after December 31, 1995, the Small Business Act stated that QPSII earned after July 1, 1996 no longer qualified for the possession tax credit. The Small Business Act also added an additional income limitation to the calculation of the possession tax credit.[96]

The Small Business Act added a new section 30A to the Code with respect to qualified income earned in Puerto Rico. This section allowed an economic activity credit that was applicable for tax years beginning after December 31, 1995 and before January 1, 2006. While in a separate section of the Code, the economic activity credit (section 30A) was calculated under the rules set forth for the possession tax credit (section 936). The possession tax credit applied generally to taxpayers operating in any U.S. possession. The economic activity credit was a special case of the possession tax credit, applicable only to taxpayers in Puerto Rico.

The possession tax credit and the economic activity credit were subject to either an economic activity limitation or an income limitation. A corporation subject to the economic activity limitation with respect to income earned in Puerto Rico claimed a credit under section 30A rather than under section 936. All other corporations claimed a possession tax credit under section 936.

For the past ten years, domestic corporations with business operations in the U.S. possessions could claim the possession tax credit or the economic activity credit to reduce their U.S. tax on certain income related to operations in the possessions[97] Both credits expired for taxable years beginning after December 31, 2005.[98]

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[95] Pub. L. No. 104-188, August 20, 1988.

[96] A special rule applied to Guam, American Samoa, and the Commonwealth of the Northern Mariana Islands. This rule allowed such applicable possessions to continue to get the full benefit of the possession tax credit, as in effect prior to repeal, until December 31, 2005. See sec. 936(j)(8).

[97] Dividends paid by a section 936 corporation to its U.S. shareholder could qualify for a dividends-received deduction. In cases where at least 80 percent of the stock of the electing corporation was owned by a single domestic corporation, the electing corporation's possession source income generally could be distributed without incurring any regular U.S. income tax. However, such a dividend constituted adjusted current earnings of the shareholder for purposes of computing the alternative minimum tax.

[98] Some companies may still qualify for tax benefits for some period of time under section 936 or section 30A after December 31, 2005 if their taxable year began sometime before December 31, 2005.

B. Tax Treatment of U.S. Activities of Foreign Persons

The United States asserts taxing jurisdiction over nonresident alien individuals and foreign corporations ("foreign persons") only with respect to income that has a sufficient nexus to the United States. Foreign persons are subject to net-basis U.S. tax on income that is "effectively connected" with the conduct of a trade or business in the United States. Effectively connected income generally is taxed in the same manner and at the same rates as the income of a U.S. person.[99]

Foreign persons are also subject to a gross-basis U.S. tax at a 30-percent rate on certain categories of non-effectively-connected income derived from U.S. sources (interest, dividends, rents, royalties, and other similar types of income), subject to a few exceptions.[100] One major exception is that certain types of interest (for example, interest from certain bank deposits and from certain portfolio obligations) are not subject to the tax.[101] The tax generally is collected by means of withholding by the person making the payment to the foreign person receiving the income.[102]

The Code includes certain rules, known as "thin capitalization" rules, intended to prevent foreign corporations from eliminating or inappropriately reducing the income of their U.S. subsidiaries through excessive interest deductions. Those rules provide, in part, that the interest paid or accrued by a domestic corporation is nondeductible if it is paid or accrued to a related party, no tax is imposed on the payment, and the domestic corporation has a debt-equity ratio exceeding 1.5 to one. The amount that is nondeductible generally is limited to the excess of the domestic corporation's net interest expense − that is, interest expense less interest income − over its taxable income (with certain adjustments).[103]

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[99] Secs. 871(b) and 882.

[100] Secs. 871 and 881.

[101] Secs. 871(h)-(i), 881(c)-(d).

[102] Secs. 1441, 1442.

[103] Sec. 163(j).

C. Transfer Pricing

Due to the variation in tax rates and tax systems among countries, a multinational enterprise, whether U.S.-based or foreign-based, may have an incentive to shift income, deductions, or tax credits among commonly controlled entities in order to arrive at a reduced overall tax burden. Such a shifting of items between commonly controlled entities could be accomplished by establishing artificial, non-arm's-length (i.e., non-market) prices for transactions between group members.

Under section 482, the Secretary of the Treasury is authorized to redetermine the income of an entity subject to U.S. taxation when necessary to prevent an improper shifting of income between that entity and a commonly controlled entity. The statute generally does not prescribe any specific reallocation rules that must be followed; it establishes the general standards of preventing tax evasion and clearly reflecting income. Treasury regulations adopt the concept of an arm's length standard as the method for determining whether reallocations are appropriate. Thus, the regulations generally attempt to identify the respective amounts of taxable income of the related parties that would have resulted if the parties had been uncontrolled parties dealing at arm's length.

Special transfer pricing rules apply to transactions involving intangible property and services.[104] These transactions present particular challenges to the administration of the arm's length standard because intangibles and services may be unique. This uniqueness renders a comparison with third-party market transactions difficult or impossible. Cost-sharing rules thus take a different approach. These rules generally permit related parties to share profits from the use of self-developed intangibles in the same proportion as they share the costs of developing the intangibles.

[104] The income with respect to a transfer or license of intangible property must be commensurate with the income attributable to the intangible.

D. Treaties

In addition to the U.S. and foreign statutory rules for the taxation of foreign income of U.S. persons and U.S. income of foreign persons, bilateral income tax treaties limit the amount of income tax that may be imposed by one treaty partner on residents of the other treaty partner. For example, treaties often reduce or eliminate withholding taxes imposed by a treaty country on certain types of income, such as dividends, interest and royalties, paid to residents of the other treaty country. For another example, treaties set the standard for the taxation by a treaty country of the business activities of a resident of the other treaty country (known as a "permanent establishment"). Treaties also include provisions governing the creditability of taxes imposed by the treaty country in which income is earned in computing the amount of tax owed to the other country by its residents with respect to that income. Treaties further provide procedures under which inconsistent positions taken by the treaty countries on a single item of income or deduction may be mutually resolved by the two countries.

The United States has a network of 57 bilateral income tax treaties covering 65 countries. This network includes all other 29 OECD member countries. It also covers the vast majority of foreign trade and investment of U.S. businesses.

Recently, the United States has entered into a series of bilateral tax treaties that eliminate withholding tax on dividends paid by one corporation to another corporation that owns at least 80 percent of the stock of the dividend-paying corporation (often referred to as "direct dividends"), provided that certain conditions are met. The elimination of withholding tax under these circumstances is intended to reduce further the tax barriers to direct investment between the two treaty countries. Many bilateral tax treaties to which the United States is not a party eliminate withholding taxes in similar circumstances. The European Union has eliminated withholding taxes in cases of at least 25-percent ownership under its "Parent Subsidiary Directive."[105]

Over the last three years, the Senate has given advice and consent to ratification of U.S. treaties and protocols containing zero-rate provisions with the United Kingdom, Australia, Mexico, Japan, the Netherlands, and Sweden. In addition, the United States has recently signed protocols with Denmark, Finland, and Germany which all include zero-rate provisions. These provisions are all similar in nature, although the treaty with Japan allows a lower ownership threshold (i.e., more than 50 percent, as opposed to at least 80 percent) than do the other provisions.

[105] The European Union is in the process of decreasing this ownership threshold to 10 percent.

III. BRIEF DESRIPTIONS OF SELECTED TERRITORIAL AND OTHER SYSTEMS[106]

A. Selected Territorial Systems

1. France[107]

In general

Individuals resident in France are taxed on their worldwide income. Corporations, wherever resident, are subject to tax only on income derived from French sources. France imposes four major categories of income taxes: corporation income taxes, individual income taxes, social levies, and payroll taxes. French tax law, like that of the United States, generally takes an expansive view of income including most economic benefits and capital gains. Timing and amounts of taxable income are generally determined by reference to commercial accounting rules. Although individuals resident in France are subject to tax on their worldwide income, corporations, wherever resident, are only subject to tax on income arising in France.

France also imposes a number of indirect taxes, including a value-added tax ("VAT") based on the European Community Directive. The French VAT differs from some "cascade" tax systems, which are applied at each stage of the manufacturing and distribution process. Although collected from and, to a certain extent, funded by the manufacturer or distributor, the VAT is considered to be an indirect tax because it is borne by the final consumer. The amount of tax due on the "added value," is determined by deducting the "input" VAT from the "output" VAT. The VAT covers all economic, commercial, industrial, and professional activities.

Figure 1, below, provides a comparison of tax receipts, as a percentage of GDP, in France, the United States, and the average of the member countries of the OECD.[108]

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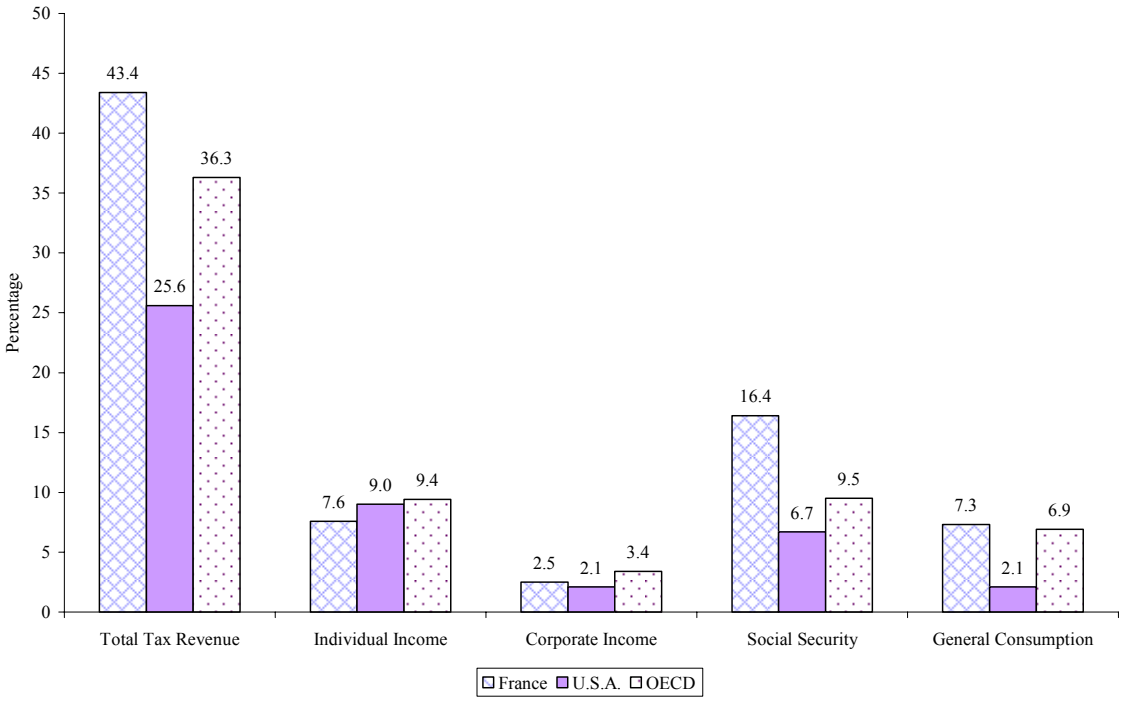
[106] The following descriptions of the tax laws of selected foreign jurisdictions were prepared with the assistance of the staff of the Directorate of Legal Research, Law Library, Library of Congress.

[107] Unless otherwise noted, the following discussion is drawn from Bernard Chesnais, Francois Froment-Meurice and Sandra Hazan, *Foreign Income: Business Operations in France,* BNA Tax Management Portfolio 961-3rd (2005); Ernst & Young, *Worldwide Corporate Tax Guide,* pp. 254-264 (2005); and the National Foreign Trade Council, *International Tax Policy for the 21st Century* (2001).

[108] OECD, *Revenue Statistics, 1965-2004* (OECD: Paris, 2005).

Figure 1

Comparative Revenue Profile of France - Major Taxes as a Percentage of GDP, 2003



Source: OECD.

Taxation of corporations

Domestic corporations

Income from domestic activities

France has a territorial system of corporate income taxation. Thus, corporations, wherever resident, are subject to tax only on income derived from French sources. Certain partnerships may elect entity-level taxation as corporations in lieu of current attribution of their income to partners. Business income is subject to tax at the standard rate of 33.33 percent and long-term capital gains are subject to tax at a rate of 15 percent. A parent company and its at least 95-percent owned subsidiaries may elect taxation as a single corporate entity. Certain special-purpose "headquarters companies" and "logistics center companies" are subject to a simplified tax regime wherein corporate tax at the normal rates is imposed upon an income corresponding to at least six to 10 percent of their annual operating expenses, with exemptions for certain employee allowances. At the election of the companies involved, corporate reorganizations may be accomplished without current tax effect.

Income from foreign activities

As a general rule, foreign income earned directly by a French company is exempt from French taxation. Foreign subsidiary income of a French multinational is also generally exempt from French tax. Such income is not taxed when it is earned by the foreign subsidiaries and 95 percent of it is exempt on repatriation to France. The exemption applies provided the French recipient owns 5 percent of the equity capital of the paying company and provided the recipient either subscribed for the original shares or purchased the shares with the intention of holding them for at least two years.

In order to be exempt from French taxation, income generated abroad must be attributable to a foreign permanent establishment or other independent establishment that regularly conducts business activities. Where there is no applicable treaty, case law is used to provide a definition of what is a "business conducted abroad." In accordance with case law, French corporations are not subject to tax on: (1) profits realized by a foreign establishment; (2) profits from transactions habitually conducted abroad involving the participation of intermediaries who are not professionally independent; or (3) profits from transactions that constitute a "complete commercial cycle" carried out abroad, distinct from the entity's other operations. A complete commercial cycle means the resale of purchased or manufactured goods. The corporate income tax applies to transactions conducted abroad by means of an independent agent or intermediary, and to profits resulting from foreign transactions if: (1) neither their nature nor their mode of execution distinguish them from the company's other business; and (2) they do not represent a commercial activity habitually conducted abroad.

The rules governing foreign source income are subject to an important exception, described below.

Special rules for income from foreign activities

Under the controlled foreign company ("CFC") rules, an exemption is not allowed for specifically defined types of low-taxed, non-business income. A French company is required to pay French tax on its pro rata share of foreign source income received or deemed received from a CFC established in a low-tax jurisdiction. Only certain categories of non-business income are targeted, such as securities or royalty income and intra-group services income. The CFC rules were substantially amended in December 2004. The new legislation is effective starting January 1, 2006.

The French CFC regime is jurisdiction-based, applying to CFCs in countries with a "privileged tax system." Generally, a foreign country is considered to have a privileged tax system when the foreign tax actually borne by the CFC is at least 50 percent lower than that of France. In addition, the resident company must directly or indirectly hold a participation of more than 50 percent in the foreign company. A country is also considered to have a privileged tax system if it does not impose tax on foreign-source income of corporations established there. There is an unofficial list of the countries that are considered tax havens under the French regime.

The new CFC rules do not apply if the company is established within the European Union unless the French tax administration can demonstrate that it is part of "an artificial arrangement aimed at circumventing the French tax legislation." Outside the European Union, the rules do not apply if the foreign company is principally engaged in active commercial or industrial activities. However, even in this case, the French company must prove that the operation of the foreign company is not an artificial arrangement to circumvent French tax when: (1) more than 20 percent of its income is derived from the management of shares, participations, or assets for its own account or for the account of companies belonging to a group controlled by the French company, or more than 20 percent of its income is derived from the sale or concessions of intangible rights related to industrial or intellectual property; or (2) more than 50 percent of its income is derived from operations listed in (1) and from intra-group services.

Foreign corporations

Nonresident corporations are generally subject to withholding taxes at the following rates, in lieu of the progressive income tax to which residents are subject: 25 percent on dividends; 16 percent on interest; and 33.33 percent on royalties from patents and know-how. Furthermore, repatriation of profits from a French branch of a foreign corporation is generally subject to a 25-percent withholding tax.

Avoidance or relief of double taxation

France does not have detailed statutory rules dealing with the allocation of expenses to exempt foreign-source income. Expenses that are directly related to exempt foreign-source income are non-deductible. Expenses that are not directly related must be apportioned between taxable and exempt income and are likewise non-deductible.

Since France fully excludes foreign income from French taxable income, foreign losses never enter into French taxable income. Thus, resourcing provisions like the U.S. overall foreign loss rules are not necessary.

France has entered into a large number of tax treaties whose main objective is the elimination of double taxation of income and capital. These tax treaties are aimed at eliminating conflict between the tax rules of two taxing jurisdictions that, if the national rules alone were applied, would result in the same items being taxed twice in the hands of the same taxpayer by two separate taxing authorities.

Recently, France has entered into a bilateral tax treaty with the United States that eliminates withholding tax on dividends paid by one corporation to another corporation that owns at least 80 percent of the stock of the dividend-paying corporation (often referred to as "direct dividends"), provided that certain conditions are met. The elimination of withholding tax under these circumstances is intended to reduce further the tax barriers to direct investment between the two treaty countries. In addition, under the European Union "Parent Subsidiary Directive," withholding taxes are eliminated on intra-group dividend payments between

European Union countries in the case of shareholdings of at least twenty-five percent.[109] Under the Parent Subsidiary Directive, France generally does not impose withholding tax on such dividends paid by French companies to other European Union companies (e.g., Germany) and other European Union companies generally do not impose a withholding tax on such dividends paid to French companies.

In the absence of a treaty, France generally provides double tax relief to resident individuals by way of a deduction from taxable income. Since corporations are not generally subject to French tax on income from sources outside France, they are not provided double tax relief.

2. Germany[110]

In general

Germany imposes income tax on resident and nonresident individuals at progressive rates. In January 2001, Germany replaced the imputation system[111] of corporate income taxation with a classical system and instituted a flat 25 percent corporate tax rate. To prevent the corporate income tax from having a cascading effect, dividends received by a corporate taxpayer can now be excluded from the taxable income of the recipient corporation. German law generally provides that German resident corporations are subject to tax on their worldwide income. Nevertheless, Germany accomplishes most of its double tax relief through exemption.

Germany also applies a VAT system based on the European Community directive. The German VAT differs from some "cascade" tax systems, which applied at each stage of the manufacturing and distribution process. Although collected from and, to a certain extent, funded by the manufacturer or distributor, the VAT is considered to be an indirect tax because it is borne by the final consumer. The amount of tax due on the "added value," is determined by deducting the "input" VAT from the "output" VAT. The VAT covers all economic, commercial, industrial, and professional activities.

Figure 2, below, provides a comparison of tax receipts, as a percentage of GDP, in Germany, the United States, and the average of the member countries of the OECD.[112]

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[109] The European Union is in the process of decreasing this ownership threshold to 10 percent.

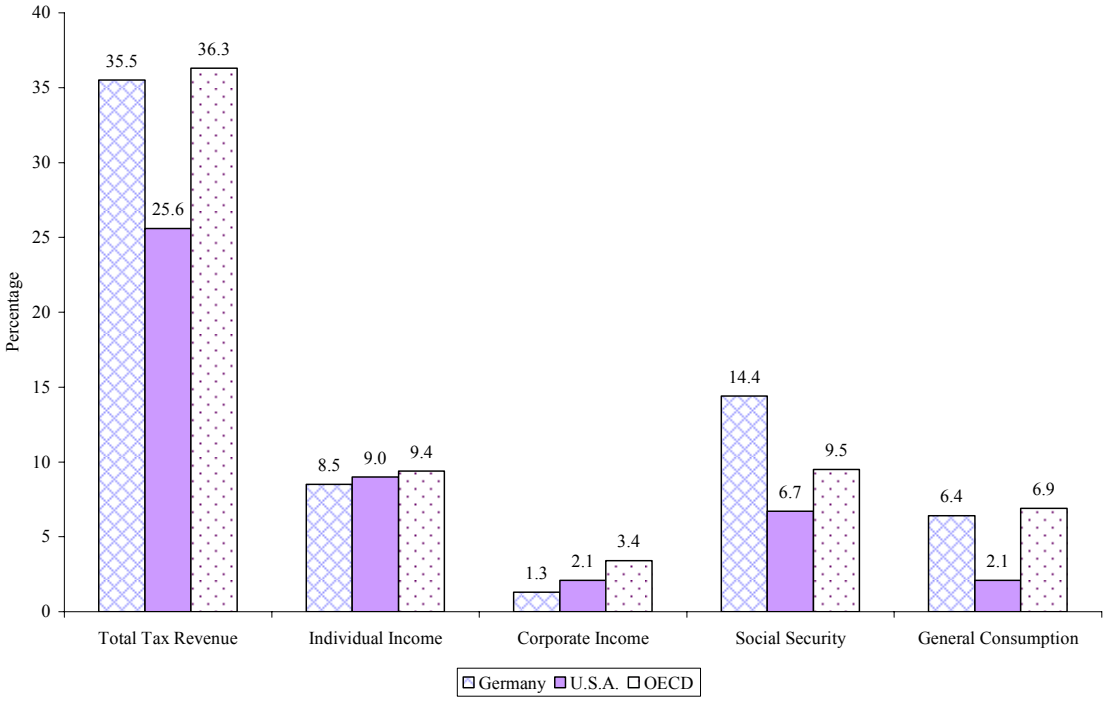
[110] Unless otherwise noted, the following discussion is drawn from Dr. Juergen Killius, *Foreign Income: Business Operations in Germany,* BNA Tax Management Portfolio 962-2nd (2006); Ernst & Young, *Worldwide Corporate Tax Guide,* pp. 291-301 (2005); and the National Foreign Trade Council, *International Tax Policy for the 21st Century* (2001).

[111] Under the German imputation system, the were generally split rates for retained earnings and distributed profits, and there was institutionalized integration of the corporate income tax paid at the company level and the individual or corporate tax paid at the shareholder level.

[112] OECD, *Revenue Statistics, 1965-2004* (OECD: Paris, 2005).

Figure 2

Comparative Revenue Profile of Germany - Major Taxes as a Percentage of GDP, 2003



Source: OECD.

Taxation of corporations

Domestic corporations

Companies resident in Germany are subject to the corporate income tax with respect to their worldwide income. Taxable income is gross income, less business expenses and other statutory allowances incurred by the taxpayer during the fiscal year as determined by the accrual method of accounting for the taxable year. The recent German tax reform abolished the former corporate imputation system and under the new regime, dividends received by German companies and branches of nonresident companies from their German and foreign subsidiaries are exempt from tax. This results from the introduction of a participation exemption (comparable to a full dividend-received deduction) for all intracorporate domestic or foreign dividends. The law imposes neither a minimum shareholding requirement nor a minimum holding period requirement for the participation exemption.

Five percent of the tax-exempt dividend income received from foreign subsidiaries is treated as a nondeductible expense, while expenses actually accrued are deductible. For dividend income received in tax years ending after December 31, 2003, the 95 percent exemption rule applies to dividends received from both resident and nonresident companies. Expenses

related to such income are fully deductible for corporate tax purposes, but interest is deductible only if certain thin-capitalization requirements are met.

Dividends received from corporations in which the parent holds less than 10 percent at the beginning of the fiscal year are subject to trade tax. The same rule applies to dividends received from non-EU corporations, regardless of the percentage of ownership, if passive income accounts for more than 10 percent of the foreign corporation's gross income.

Special rules for income from foreign activities

Special CFC rules apply to specifically defined types of passive investment income. Dividends and branch profits of this nature that are derived in low-tax jurisdictions are not permitted an exemption. Germany, like the United States, has a transaction-based system, but it is modified by jurisdiction-based exemptions. The regime only attributes certain tainted income to the shareholders of a CFC. All income that is not on an enumerated list of exempt types of income is treated as tainted when the income of the CFC is not subject to income taxation at the rate of at least 30 percent. Germany has an unofficial list of the countries whose effective rate is less than 30 percent and a list of countries whose effective rate is more than 30 percent. However, the presumption that a rate is less than or more than 30 percent may be overcome by the tax authorities or the taxpayer. The income excluded by the enumerated list of types of exempt income is generally income from active business.

Foreign corporations

A nonresident corporation, whose corporate seat and place of management are located outside Germany, is subject to corporate income tax only on income derived from German sources. German source income includes, among other items, business income from operations in the country through a branch, office or other permanent establishment, including a permanent representative, and income derived from the leasing and disposal of real estate located in Germany.

Avoidance or relief of double taxation

Germany's expense allocation laws are relatively generous. For instance, interest expense related to the acquisition and financing of a foreign holding generating exempt dividends is fully deductible by a German parent corporation.

Germany's provisions on foreign losses are not very favorable. Foreign branch losses are not deductible. As a result, loss recapture rules are not necessary. However, in situations where the credit regime applies, branch losses can be carried forward for offset against future income of the respective branch. Thus, a benefit for the branch loss, although deferred, is ultimately obtained.

Germany has entered into a large number of tax treaties whose main objective is the elimination of double taxation of income and capital. These tax treaties are aimed at eliminating conflict between the tax rules of two taxing jurisdictions that, if the national rules alone were applied, would result in the same items being taxed twice in the hands of the same taxpayer by two separate taxing authorities.

Recently, Germany has entered into a bilateral tax treaty with the United States that eliminates withholding tax on dividends paid by one corporation to another corporation that owns at least 80 percent of the stock of the dividend-paying corporation (often referred to as "direct dividends"), provided that certain conditions are met.[113] The elimination of withholding tax under these circumstances is intended to reduce further the tax barriers to direct investment between the two treaty countries. In addition, under the European Union "Parent Subsidiary Directive," withholding taxes are eliminated on intra-group dividend payments between European Union countries in the case of shareholdings of at least twenty-five percent.[114] Under the Parent Subsidiary Directive, Germany generally does not impose withholding tax on such dividends paid by German companies to other European Union companies (e.g., France) and other European Union companies generally do not impose a withholding tax on such dividends paid to German companies.

Under German domestic law, foreign-source income, except for foreign intracompany dividends (mentioned above), is usually taxable, with a credit for foreign income taxes paid, up to the amount of German tax payable on the foreign-source income, subject to per-country and per-item limitations. Excess foreign tax credits cannot be carried back or forward. Instead of a foreign tax credit, a deduction may be claimed for foreign income tax. This may be beneficial in loss years and in certain other instances.

3. Netherlands[115]

<u>In general</u>

Individuals resident in the Netherlands are taxed on their worldwide income. The income tax takes into account the origin of the income and distinguishes between three categories known as "boxes." The income in each of the boxes is taxed at a different rate. The sum of the tax owed in each of the three boxes is the total income tax payable. Corporations are subject to tax on their worldwide income, but the Netherlands employs an exemption system that is applicable to both domestic and foreign shareholdings and such exemption allows for the avoidance of double taxation when the profits of a subsidiary are distributed to its parent company.

Netherlands tax law uses a source-of-income model. Only income derived from a source is subject to taxation. Source income arises only in cases where a taxpayer undertakes an economic activity with the intent of deriving a benefit that can objectively be expected to

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[113] In June 2006, the United States and Germany signed a protocol that includes a zero-rate dividends provision, but such protocol has not been ratified by the U.S. Senate.

[114] The European Union is in the process of decreasing this ownership threshold to 10 percent.

[115] Unless otherwise noted, the following discussion is drawn from Kees van Raad, *Foreign Income: Business Operations in The Netherlands,* BNA Tax Management Portfolio 973-2nd (2005); Ernst & Young, *Worldwide Corporate Tax Guide,* pp. 625-642 (2005); and the National Foreign Trade Council, *International Tax Policy for the 21st Century* (2001).

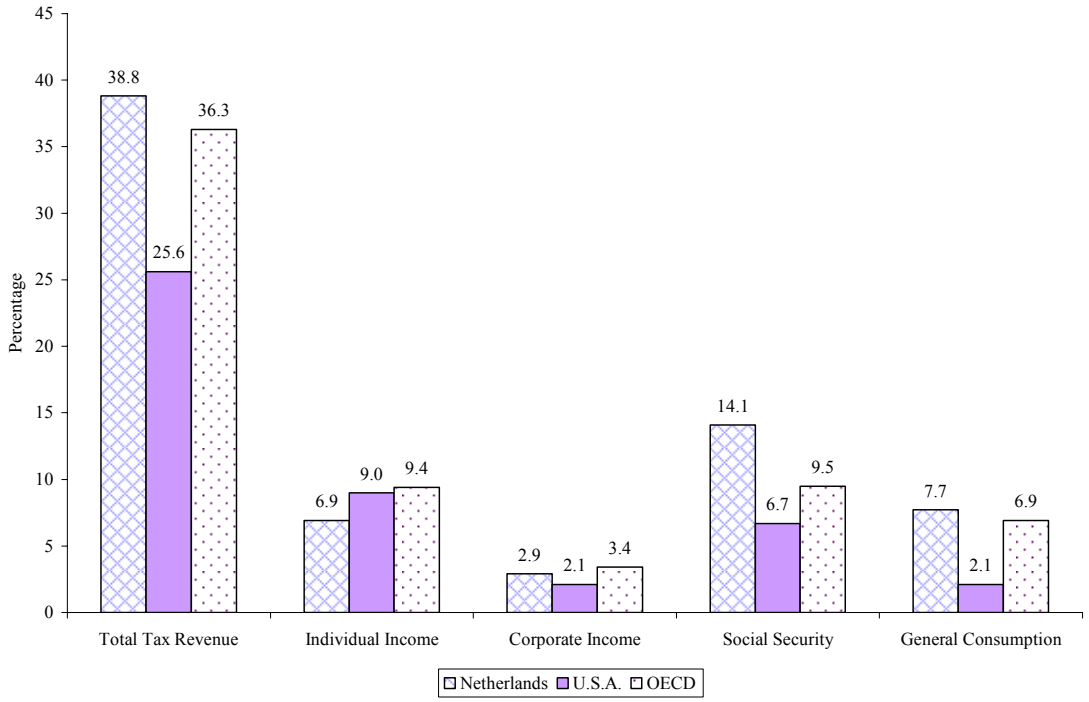
materialize. As a result, activities that are unlikely to produce any positive amount of income (e.g., hobby farms, inventing) will not be deemed a source of income.

The Netherlands also applies a VAT system based on the European Community directive. The Netherlands VAT differs from some "cascade" tax systems, which applied at each stage of the manufacturing and distribution process. Although collected from and, to a certain extent, funded by the manufacturer or distributor, the VAT is considered to be an indirect tax because it is borne by the final consumer. The amount of tax due on the "added value," is determined by deducting the "input" VAT from the "output" VAT. The VAT covers all economic, commercial, industrial, and professional activities.

Figure 3, below, provides a comparison of tax receipts, as a percentage of GDP, in the Netherlands, the United States, and the average of the member countries of the OECD.[116]

Figure 3

Comparative Revenue Profile of the Netherlands - Major Taxes as a Percentage of GDP, 2003



Source: OECD.

[116] OECD, *Revenue Statistics, 1965-2004* (OECD: Paris, 2005).

Taxation of corporations

Domestic corporations

Entities resident in the Netherlands are subject to corporate income tax on their worldwide income. All income earned by companies is deemed to be business income. Corporate income tax is levied at a rate of 29 percent on the first €22,689 of taxable profits and at 31.5 percent on the excess. Losses may be carried forward and deducted from profits in a subsequent year. Profits distributed to shareholders are not deductible from taxable profits for purposes of the corporate income tax.

The Companies Income Tax Act provides for a participation exemption, which is applicable to both domestic and foreign shareholdings. Corporate tax need not be paid on the profits generated by the participation. The exemption allows for the avoidance of double taxation when the profits of a subsidiary are distributed to its parent company. A participation exists if the taxpayer (1) holds at least five percent of the nominal paid-up capital of a company, or (2) holds less than five percent, but ownership of the shares is necessary for the conduct of normal business, or the acquisition of the shares serves a general interest. All profits gained from shareholdings are exempt from taxation unless shares in a foreign corporation are held as an investment or the foreign company in which the shares are held is not subject to tax on its profits in the foreign country (the rate of tax is unimportant). A 25 percent withholding tax is imposed on dividends from corporations resident in the Netherlands, unless the participation exemption applies. Dividends received from a qualifying subsidiary company are exempt from tax in the hands of the parent company. Similarly, capital gains realized on the disposition of shares of such a subsidiary company are exempt.

Under certain conditions a parent corporation may be taxed as a group together with one or more of its subsidiaries. Group taxation allows losses of one company to be set off against profits of another company, and fixed assets may be transferred tax-free from one company to another. Group taxation is allowed only if all the companies involved are based in the Netherlands for tax purposes and the parent company holds at least 95 percent of the shares in the subsidiary.

Special rules for income from foreign activities

As mentioned above, the Netherlands provides for a participation exemption that generally exempts all dividend income received from foreign subsidiaries from taxation in the Netherlands. Because the Netherlands exempts dividends from a foreign subsidiary from income, there is no domestic income on which to defer tax (and thus no need for an extensive anti-deferral regime). However, the Netherlands denies the benefit of the participation exemption to income derived from certain passive investments. One consideration in determining whether an investment is passive is the level of ownership associated with such investment. The greater the ownership, the less likely the investment will be considered passive. In the case of a holding company, there is a look-through to the companies that the holding company owns to determine whether ownership is passive. If the participation exemption does not apply, the annual increase in the value of the subsidiary is fully taxable at the level of the Netherlands parent company, whether or not profits were distributed.

Because multinationals that are resident in the Netherlands are not taxed on current income of a foreign subsidiary under an anti-deferral regime or on the dividends from foreign subsidiaries when remitted, they enjoy a relative advantage over other multinationals that are subject to an extensive anti-deferral regime with CFC rules.

Foreign corporations

Nonresident corporations are subject to tax in the Netherlands on business income derived through a permanent establishment in the Netherlands, real property income and gains, dividends and interest received from a resident country at least five percent of the shares of which are held by the entity as portfolio investment, and certain other categories of income.

Avoidance or relief of double taxation

The Netherlands has entered into a large number of tax treaties whose main objective is the elimination of double taxation of income and capital. These tax treaties are aimed at eliminating conflict between the tax rules of two taxing jurisdictions that, if the national rules alone were applied, would result in the same items being taxed twice in the hands of the same taxpayer by two separate taxing authorities.

Recently, the Netherlands has entered into a bilateral tax treaty with the United States that eliminates withholding tax on dividends paid by one corporation to another corporation that owns at least 80 percent of the stock of the dividend-paying corporation (often referred to as "direct dividends"), provided that certain conditions are met. The elimination of withholding tax under these circumstances is intended to reduce further the tax barriers to direct investment between the two treaty countries. In addition, under the European Union "Parent Subsidiary Directive," withholding taxes are eliminated on intra-group dividend payments between European Union countries in the case of shareholdings of at least twenty-five percent.[117] Under the Parent Subsidiary Directive, the Netherlands generally does not impose withholding tax on such dividends paid by Dutch companies to other European Union companies (e.g., Germany) and other European Union companies generally do not impose a withholding tax on such dividends paid to Dutch companies.

In the absence of a treaty, the Netherlands generally provides double tax relief under the 2001 Unilateral Decree on the Avoidance of Double Taxation ("the Decree"). The Decree relieves international double taxation either by way of a proportional tax reduction (sometimes referred to as "exemption with progression") or by way of a foreign tax credit. The major income elements to which the proportional tax reduction applies are business income, income from foreign real property, and income from employment exercised abroad. Double taxation relief by way of the foreign tax credit applies to dividends, interest and royalties received from sources in developing countries (dividends received by a corporate shareholder generally qualify for double tax relief under the participation exemption).

[117] The European Union is in the process of decreasing this ownership threshold to 10 percent.

4. Singapore[118]

In general

The Singapore tax system includes corporate and individual income taxes; an estate tax; property taxes for residential and commercial property; customs and excise duties on a limited range of items; a goods and services tax ("GST," a form of a value added tax); stamp duties on legal instruments related to real property and securities; and social security taxes.

The GST is imposed at either a five-percent or a zero-percent rate on all goods and services unless a specific exemption applies. GST is collected by sellers from customers and is remitted to the government. Sellers of goods and services collect and remit GST on their sales and can claim a credit for GST charged on their purchases. GST generally is charged on imports, and exports from Singapore are zero rated.

The corporate income tax is discussed next.

Taxation of corporations

In general

Singapore's corporate income tax regime is territorial. A corporation, whether incorporated or registered in Singapore or elsewhere, generally is subject to Singapore tax on all income derived from Singapore sources or received in Singapore. Companies resident in Singapore may be subject to tax by Singapore on non-Singapore source income only when that income is remitted to Singapore. There generally are no special rules for the taxation of non-resident companies. Like resident companies, nonresident companies are taxed in Singapore on income derived from Singapore sources or received in Singapore. In practice, under this rule nonresident companies are taxed in Singapore on income from business operations in Singapore. Certain payments to a nonresident company of Singapore-source income not connected with Singapore business operations of the nonresident may be subject to Singapore withholding tax.

Singapore maintains a variety of preferential tax rules for targeted industries and activities. These rules are briefly summarized below.

Taxation of resident companies

Income from domestic activities

As described above, under Singapore's territorial taxing regime, resident companies are subject to tax on their income derived from Singapore sources or received in Singapore. The

[118] Unless otherwise noted, the following discussion is drawn from Brij S. Soin, *Foreign Income: Business Operations in Singapore,* BNA Tax Management Portfolio 983-3rd (2005); Ernst & Young, *Worldwide Corporate Tax Guide,* pp. 811-21 (2005); and Angela Tan & Tan How Teck, *Singapore Master Tax Guide Handbook 2005,* 24th ed., CCH Asia Pte Ltd. (2005).

place of residence of a company is determined by where the management and control of the company is exercised. Income from Singapore sources encompasses most sorts of profits from business activities but does not include capital gains.

The rate of corporate tax generally is 21 percent in 2006 and is scheduled to be reduced to 20 percent in 2007.

Dividends received by a resident corporation (or by an individual shareholder) from another resident corporation, whether paid out of fully-taxed corporate income or out of income exempt from tax or subject to a reduced rate of tax, are exempt from income tax.[119]

Special tax rules apply in a variety of circumstances. Examples include the following:

- Under rules intended to help small and medium size businesses, companies generally are eligible for a partial exemption from income tax for the first S$100,000 (about $63,000) of taxable income.

- New companies may be exempted from paying income tax on the first S$100,000 of taxable business income − dividend income does not qualify for the exclusion − for each of their first three years of tax assessment.

- Under a headquarters program, entities incorporated or registered in Singapore that provide headquarters services to affiliated companies regionally or worldwide and that satisfy certain other conditions are subject to tax rates of zero to 15 percent for a specified period on certain qualifying income.

- Other tax incentives and preferences exist for, among other things, certain capital expenditures; payments of certain royalties, technical assistance fees, and research and development costs; payments to nonresidents for software and other technological goods and services; remittances of foreign-source royalties and interest income when used for research and development purposes; financial institutions' income from qualifying activities; and income from global trading operations involving commodities and certain other products.

Income from foreign activities

As described previously, resident companies may be subject to tax by Singapore on non-Singapore source income (earned, for example, through foreign branch operations) only when that income is remitted to Singapore. Dividends received from nonresident companies are exempt from Singapore tax so long as the income underlying the dividends has been earned in a country with a headline tax rate of at least 15 percent.

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[119] Before 2003, Singapore maintained a full imputation system under which dividends paid by a resident company out of profits subject to the normal corporate tax rate generally were treated as paid net of a 20-percent tax. Shareholders then could claim a credit for this tax as an offset against their income tax liability. Any excess of the credit over the shareholder's tax liability was refundable.

Special rules for income from foreign activities

Singapore has no rules analogous to the U.S. controlled foreign corporation rules. Various anti-avoidance rules, however, including a general anti-avoidance provision, grant the Singapore tax authorities the power to combat tax avoidance schemes, including schemes involving elements outside Singapore.[120]

Nonresident companies

As described above, nonresident companies are subject to Singapore tax on income derived from business operations in Singapore. No additional branch profits tax is imposed when income is remitted by a Singapore branch of a nonresident company to its foreign base.[121]

Certain payments to nonresident companies of Singapore-source income not derived by the nonresident from Singapore business operations may be subject to Singapore withholding tax. These payments include interest, commissions, fees, and other payments in relation to loans or indebtedness; royalties for the use of moveable property; fees for technical assistance or management; directors remuneration; and gains from real property transactions. Royalty payments for the use of intellectual property in Singapore generally are subject to withholding at a 10-percent rate (reduced from the 15-percent rate in effect before 2005). Singapore-source interest payments generally are subject to withholding tax at a 15-percent rate. Dividend payments are not subject to withholding tax.

Avoidance or relief of double taxation

In general, because foreign-source income of Singapore resident companies is exempt from Singapore tax, no possibility of double taxation arises until income is remitted to Singapore. As described above, moreover, dividend payments to Singapore resident companies are exempt from Singapore taxation so long as the income out of which the dividends are paid is earned in a country with a headline tax rate of 15 percent. To the extent any non-Singapore source income may be subject to tax by both Singapore and another country, a foreign tax credit generally is available to offset the foreign tax imposed on that income.

Singapore has a network of at least 50 bilateral tax treaties. These treaties largely are based on the OECD model income tax treaty. Singapore's tax treaties generally have three chief purposes: the avoidance of double taxation through provisions allocating taxing power between the treaty countries; the promotion of bilateral trade and investment; and, through information exchange provisions, the prevention of tax avoidance and evasion by treaty residents. Many Singapore tax treaties include tax sparing provisions under which each treaty country agrees to provide a credit for taxes forgone by the other treaty country under an incentive measure. Where

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[120] International Bureau of Fiscal Documentation, *Asia-Pacific Taxation Analysis, Singapore, Country Survey,* at ¶28.2 (2006) (accessed through RIA Checkpoint internet-based research service).

[121] International Bureau of Fiscal Documentation, *Asia-Pacific Taxation Analysis, Singapore, Country Survey,* at ¶26.1 (2006) (accessed through RIA Checkpoint internet-based research service).

tax treaties permit a Singapore resident to be taxed by Singapore on an item of income that also may be taxed by the other treaty country, the treaties typically provide a credit against Singapore tax for the foreign tax imposed on the income.

B. Selected Nonterritorial Systems

1. China[122]

In general

The Chinese tax system includes a wide variety of taxes. The most significant taxes include the foreign enterprise tax; an individual income tax; turnover taxes (including a value-added tax, a business tax applicable to most service industries, and a consumption tax applicable to goods such as tobacco, alcohol, jewelry, and motor vehicles); and miscellaneous taxes such as stamp duties, real property taxes, a natural resource tax, and a land appreciation tax.

The value-added tax is a credit-invoice style VAT. Taxpayers are required in each period to pay VAT on the difference in that period between (1) the VAT applicable to revenue from the sale or provision of goods or labor services and (2) the VAT applicable to purchases of goods or labor services. VAT generally is imposed on the customs value of imported goods, and exported goods generally are zero rated (with the result that input VAT paid on exported goods may be refunded to the exporter). Simplified rules apply to a defined category of small taxpayers. Small taxpayers are taxed on the basis of revenue derived from sales of goods or the provision of taxable services.[123] The VAT rates for small taxpayers are four percent for the commercial sector and six percent for other sectors. The general VAT rate on other taxpayers is 17 percent, but the VAT rules include a preferential 13-percent rate for, among other products, agricultural supplies.

Business income taxes are described next.

Taxation of businesses

In general

Since the 1980s, China has undertaken a series of tax reform efforts. Business income taxation in China now is generally carried out through two sets of rules.

State-owned enterprises and other domestic enterprises are subject to the enterprise income tax regulations. Under these regulations, enterprises are subject to tax in China on Chinese and non-Chinese source income at a rate of 33 percent, a significantly lower rate than the 55-percent rate that was applicable to Chinese enterprises before 1994.

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[122] Unless otherwise noted, the following discussion is drawn from Owen D. Nee, Jr. and Deborah J. Goldstein, *Foreign Income: Business Operations in the People's Republic of China,* BNA Tax Management Portfolio 957-2d (2003), and Ernst & Young, *Worldwide Corporate Tax Guide,* pp. 147-56 (2005).

[123] Beijing Local Taxation Bureau, http://english.tax861.gov.cn/zgszky/zgszky04.htm (last visited Jun. 19, 2006).

Chinese-foreign joint ventures and cooperative enterprises and foreign-owned businesses with Chinese business operations or Chinese-source income are subject to tax in China under the Income Tax Law of the People's Republic of China Concerning Foreign Investment Enterprises and Foreign Enterprises ("FEITL"). The FEITL generally imposes a 33-percent tax on income from foreign business activity in China.

State-owned and other domestic enterprises

As mentioned above, under the enterprise income tax regulations, state-owned enterprises and other domestic businesses are liable for tax in China on their worldwide income at a 33-percent rate. Income under the enterprise income tax regulations includes income from business operations, income from the sale of property, and portfolio income such as interest, leases, royalties, and dividends.

Foreign income tax paid on income derived from non-Chinese sources may be offset by a credit against Chinese income tax. The credit may not exceed the amount of the Chinese income tax imposed on the foreign-source income.

Chinese tax law applicable to domestic enterprises does not included controlled foreign corporation rules or other anti-avoidance rules, other than transfer pricing rules, for income earned through foreign subsidiaries.[124]

FEITL

In general

The FEITL is, as described above, applicable to Chinese-foreign joint ventures and cooperative enterprises and to foreign-owned businesses with operations in China. Foreign investment enterprises with headquarters in China are subject to tax under the FEITL on their worldwide income; other foreign enterprises are liable for tax only on Chinese-source income.

The generally applicable FEITL net-basis tax rate on Chinese business operations is, as stated above, 33 percent. This 33-percent rate is comprised of a 30-percent central tax and a 3-percent local tax. The 33-percent rate is reduced or eliminated in certain circumstances described below. Taxable income under the net basis tax generally includes all income from business operations. Capital gains generally are treated the same as other income except that foreign investors are subject to a 10-percent withholding tax on gain from the sale of ownership interests in a foreign owned enterprise in China.

Payments to nonresidents of Chinese-source amounts that are not connected with business operations in China generally are subject to gross-basis withholding tax. The stated

[124] International Bureau of Fiscal Documentation, *Asia-Pacific Taxation Analysis, China, Country Survey,* at ¶ 47 (2006) (accessed through RIA Checkpoint internet-based research service).

withholding rate on interest and royalties under the FEITL is 20 percent, but this rate has been reduced to 10 percent by a notice issued in 2000.[125]

Dividend payments to a nonresident owner of a foreign investment enterprise are not subject to Chinese withholding tax.

Preferential rules

The FEITL offers preferential net-basis tax regimes in many circumstances. A 15-percent rate is available for foreign enterprises operating in Special Economic Zones or in designated zones of various Chinese cities. The 15-percent rate also is available for enterprises in particular sectors, including manufacturing and high technology, provided the enterprises satisfy various other criteria. A 24-percent rate is available for foreign investment enterprises engaged in production and manufacturing activities in certain specified coastal and urban areas. China also grants tax holidays and significant rate reductions for certain favored activities and projects.

If profits are reinvested for at least five years in China in the same enterprise or in another foreign investment enterprise, a 40-percent refund of taxes paid on those profits may be available. A full tax refund may be available if the reinvestment is in a technologically advanced business or an export enterprise.

A foreign investment enterprise that purchases certain domestically-made equipment may be eligible for a credit against their income tax liability under the FEITL. The maximum credit amount is, subject to additional income-based limitations, 40 percent of the amount of the purchase.

Foreign tax credit

A credit against Chinese tax liability under the FEITL generally is available for foreign taxes paid by foreign investment enterprises. The maximum foreign tax credit is the amount of Chinese tax imposed on the income.

Tax treaties[126]

China has entered into bilateral tax treaties with more than 80 countries, including the United States. These tax treaties generally follow the OECD model treaty. Treaties generally provide for reduced rates of withholding tax on cross-border payments. Most treaties also provide for tax sparing and for credits against foreign tax where double taxation otherwise is not eliminated.

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[125] International Bureau of Fiscal Documentation, *Asia-Pacific Taxation Analysis, China, Country Survey,* at ¶ 23.4 (2006) (accessed through RIA Checkpoint internet-based research service).

[126] International Bureau of Fiscal Documentation, *Asia-Pacific Taxation Analysis, China, Country Survey,* at ¶ 45.2 (2006) (accessed through RIA Checkpoint internet-based research service).

2. Ireland[127]

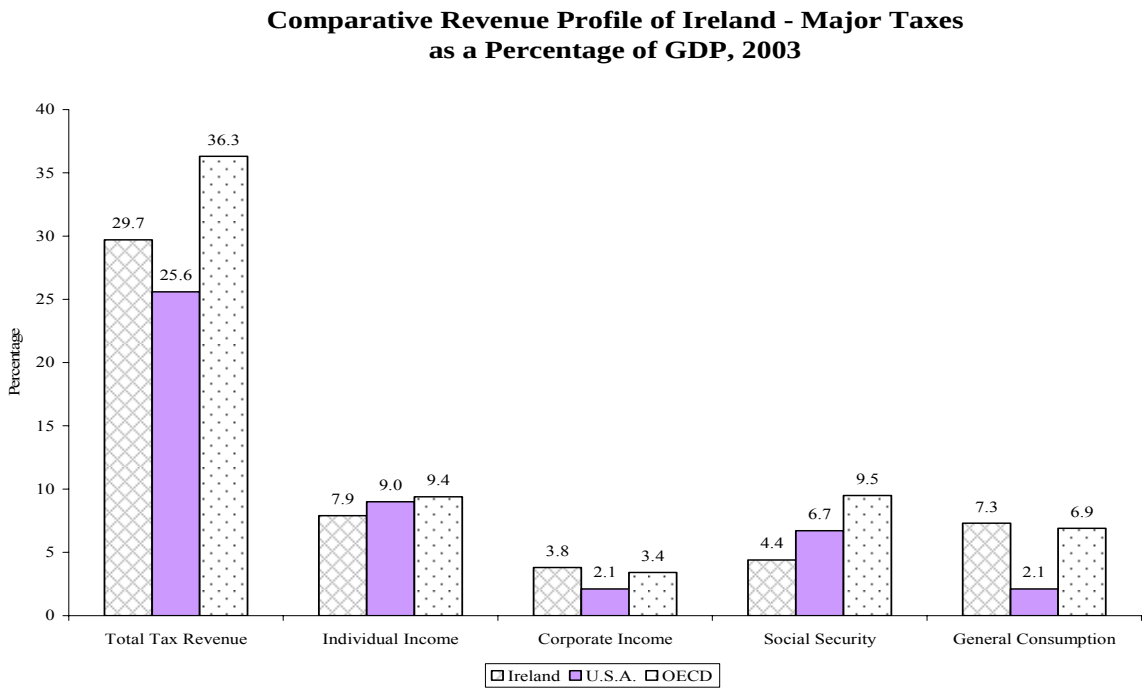
In general

The Irish tax system includes a corporate income tax, an individual income tax, a value-added tax, a capital gain tax (which, in the case of corporations, is part of the income tax), a gift and inheritance tax, and stamp duties on certain legal documents executed in Ireland and related to transactions such as the sale of land in Ireland or of securities in an Irish company.

The value-added tax is a credit-invoice style tax, with tax charged on sales of goods and services and credits available for purchases. The general rate under the VAT is 21 percent; a small number of items are subject to a 13.5-percent rate. VAT generally is imposed on imports from countries outside the EU and is not charged on exports.

Figure 4, below, provides a comparison of tax receipts, as a percentage of GDP, in Ireland, the United States, and the average of the member countries of the OECD.[128]

Figure 4



Source: OECD.

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[127] Unless otherwise noted, the following discussion is drawn from John Ryan, *Foreign Income: Business Operations in Ireland,* BNA Tax Management Portfolio 965-3rd (2004), and Ernst & Young, *Worldwide Corporate Tax Guide,* pp. 391-410 (2005).

[128] OECD, *Revenue Statistics, 1965-2004* (OECD: Paris, 2005).

Taxation of corporations

In general

Under the Irish corporation tax, Irish resident corporations generally are subject to tax on all profits (income and gains) regardless of source. A credit for foreign taxes imposed on foreign source income may be available under a tax treaty, and if a tax treaty does not apply, limited relief may be provided under Irish domestic law. Nonresident companies generally are taxed by Ireland only on income derived from and attributable to a trade or business carried on in Ireland.

Domestic corporations

In general

As described above, Irish resident corporations are subject to tax on their worldwide income. Gross income is determined under a comprehensive schedular system. Items that would be included in calculating income or loss from operations under generally accepted accounting principles are included in gross income for tax purposes.

Tax residence is determined under two tests. First, a corporation is considered a tax resident of Ireland if it is managed and controlled in Ireland. Second, if a company is incorporated in Ireland, it also is considered a resident unless (1) the company or a related company carries on a trade in Ireland and either (a) it is under the control of persons who are resident in a tax treaty country or another EU jurisdiction, provided those persons are not controlled by persons not resident in those countries, or (b) the principal class of shares in the company or a related company are regularly traded on an exchange in another EU country or a treaty country; or (2) the company is treated under a tax treaty country as being a resident in a treaty country and not resident in Ireland.

The general rate of corporate tax is 12.5 percent. Certain items of passive income and income from certain industries such as mining and petroleum are taxed at a rate of 25 percent. Capital gains generally are subject to tax at a 20 percent rate. Until recently, the tax rate on income from manufacturing activities in Ireland was 10 percent, but this preferential rate was considered a harmful tax measure under European Union ("EU") rules. After negotiations with the European Commission, the Irish government enacted phase-out rules for this preferential manufacturing rate. The preferential rate is due to expire completely in 2010.

Special rules for capital gains and dividends

In 2004 the Irish government enacted an exemption from capital gains taxation for gains from certain sales by a corporation of stock in another corporation (the "investee corporation"). The exemption is available if: (1) at the time of the sale, the investee corporation is a resident for tax purposes in Ireland, in another EU member state, or in a country with which Ireland has a tax treaty; (2) the Irish company has owned (directly or indirectly) for at least 12 of the 24 months preceding the sale at least five percent of the shares of the investee company; and (3) the investee company is wholly or principally engaged in a trade or, taken together, the holding company, its five-percent group, and the investee company are wholly or principally engaged in a trade.

Dividend distributions received by an Irish resident company from another Irish resident company generally are excluded from income. Consequently, the 20-percent dividend withholding tax applicable to distributions by an Irish company generally does not apply to distributions made to another Irish resident company provided the recipient owns at least a five-percent interest in the paying corporation.

Special rules for income from foreign activities

In general, as described above, Irish resident corporations are subject to Irish corporate tax on their income from foreign sources, including income earned in a foreign country through a branch (but not through a nonresident subsidiary). This tax applies regardless of whether the income is remitted to Ireland.

Ireland does not have rules analogous to the U.S. controlled foreign corporation rules. Irish taxing authorities instead may argue that a nominally nonresident company in fact is managed and controlled in Ireland and thus should be taxed as an Irish resident company.[129]

Special rules for relief of double taxation with respect to dividends received from foreign subsidiaries are discussed below.

Nonresident companies

As described previously, nonresident companies (including nonresident subsidiaries of Irish resident companies) generally are taxed by Ireland on a net basis only on income derived from and attributable to a trade or business carried on in Ireland through a branch or an agency and on gains from the sale of Irish assets used or held for use by the branch or agency.

Irish-source income of nonresident companies that is not attributable to an Irish trade or business may be subject to Irish withholding tax. A 20-percent withholding tax generally applies to payments of dividends, interest, and royalties, but payments to nonresident companies may be exempt from withholding tax in the circumstances described below.

Dividend distributions to nonresident companies are exempt from the 20-percent dividend withholding tax in certain circumstances, including when the nonresident recipient of the dividend is regularly traded on a recognized stock exchange or is a resident in an EU member country or a treaty country and is not controlled by Irish residents.

Interest and royalties paid by Irish resident companies to nonresident companies also are exempt from Irish withholding tax in certain circumstances. These circumstances include (1) when interest is paid to a company that is a resident of a tax treaty or an EU jurisdiction unless the interest is paid to that company in connection with a trade or business of that company in Ireland; and (2) based on the EU Interest and Royalties Directive, when payments of interest or

[129] International Bureau of Fiscal Documentation, *European Taxation Analysis, Ireland, Corporate Taxation (detailed)* at ¶ 13.4 (2006) (accessed through RIA Checkpoint internet-based research service).

royalties are made by an Irish company to an associated company of another EU member state, with association for this purpose requiring at least 25-percent common ownership.

No branch profits tax or branch remittance tax is imposed on a nonresident corporation's withdrawals from an Irish branch.[130]

Avoidance or relief of double taxation

Foreign tax credit

Irish internal law does not include a general mechanism by which corporations are entitled to a credit against the Irish corporate tax for foreign taxes paid. Under various rules, however, Irish resident companies may be eligible for relief from Irish corporate taxes in respect of foreign taxes paid.

Tax treaties provide relief from double taxation. Those treaties are described below. In the absence of a tax treaty, a deduction for foreign tax paid generally is allowed against the income in respect of which the tax was assessed.

A foreign tax credit is allowed in certain circumstances. A foreign tax credit is available to offset Irish corporate tax on income from certain activities such as sales of computer software and the provision of computer services. Irish internal law also provides for credit for foreign tax imposed in relation to dividends received from nonresident companies. These credit rules for dividends implement the EU Parent-Subsidiary Directive as amended in 2004. Under the rules, an Irish resident company receiving a dividend from a five-percent owned (by voting rights) subsidiary that is a resident of a country with which Ireland does not have a tax treaty is allowed a credit against Irish tax on the dividend for any direct or withholding tax imposed on the dividend and for the portion of any foreign tax imposed on the income out of which the dividend is paid.[131] This credit against Irish tax for foreign tax imposed with respect to dividend payments also is allowed to Irish branches of companies resident in the EU or in European Economic Area states with which Ireland has a tax treaty. An Irish company receiving a dividend from a five-percent subsidiary that has lower-tier subsidiaries is allowed a credit for the portion of any foreign taxes imposed on the lower-tier subsidiaries with respect to the dividend so long as the parent and the lower-tier subsidiaries are connected in a chain of ownership through at least five-percent indirect shareholding (based on vote).

Irish internal law allows cross-crediting (or "onshore pooling") for taxes on different dividend streams and permits unused credits to be carried forward indefinitely.

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[130] International Bureau of Fiscal Documentation, *European Taxation Analysis, Ireland, Corporate Taxation (detailed)* at ¶ 8.4.3 (2006) (accessed through RIA Checkpoint internet-based research service).

[131] This relief also is allowed even if treaty benefits are available for a dividend payment. The internal law credit mechanism in some cases could be more beneficial than the treaty benefits.

Tax treaties

Ireland has a network of more than 40 bilateral tax treaties. Under these tax treaties, any foreign tax on income and gains of an Irish resident company that is not otherwise eliminated by the treaty (for example, foreign tax on income attributable to an Irish company's permanent establishment in the other treaty country) generally can be credited against Irish tax imposed on that income or gain. The foreign tax credit may not exceed Irish corporate tax attributable to that income or gain. With limited exceptions, no cross-crediting is allowed under tax treaties.

IV. DISCUSSION OF ECONOMIC ISSUES RELATED TO THE POSITION OF THE UNITED STATES IN THE GLOBAL ECONOMY

A. Is U.S. Business Competitive in the Global Economy?

For a number of years policymakers, business groups, and economists have argued that improving the international competitiveness of the economy of the United States should be a major policy goal. This focus on competitiveness is certainly related to some of the economic trends of the past two decades: large U.S. trade deficits; large inflows of foreign investment in the Unites States; and low national saving rates.[132] Cross-border mergers of recent years and cases of corporate inversions to re-incorporate outside the United States have heightened interest regarding the position of the United States in the global economy. Although the term "competitiveness" is used frequently, it does not have a consistent definition. The term "competitiveness" encompasses different concepts. This section briefly explores various meanings commonly given to the term "competitiveness" in writings on U.S. economic policy.

Trade competitiveness

One definition of competitiveness is the ability of firms located in the United States to sell their output in foreign markets and to compete in domestic markets with output produced in foreign countries. Trade competitiveness often is measured by the U.S. trade deficit.

A trade deficit is not necessarily undesirable. For example, if a country uncovers profitable investment opportunities, then it will be in that country's interest to obtain funds from abroad to invest in these profitable projects. In this situation, investment will exceed saving, and the initial effect of the foreign capital inflow will be a trade deficit. The investment, however, will lead to increased income and an increased standard of living in the future. If foreign borrowing finances consumption instead of investment, there are no new assets created to generate a return which can support the borrowing; when the debt is eventually repaid, the repayments will come at the expense of future consumption.

Standard of living competitiveness

A second definition of competitiveness does not focus specifically on international trade and investment. Instead, this measure of competitiveness compares the current U.S. living standard and the prospects for the future U.S. living standard with those of other countries. This measure focuses on the productivity growth of U.S. labor and the savings rate of the United States, because both of these factors affect future living standards. According to this concept of competitiveness, policy goals should not focus primarily on either the trade surplus or deficit, or on capital flows between nations, though both of these may be useful as indicators of the success of more fundamental policies.

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[132] Part V of this publication reviews the trends in trade deficits and cross-border investment flows. More detailed data are presented in Joint Committee on Taxation, *The U.S. International Tax Rules: Background, Data, and Selected Issues Relating to the Competitiveness of U.S.-Based Business Operations* (JCX-67-03), July 3, 2003.

There are a number of situations in which standard of living competitiveness is increased, but trade competitiveness may not be. Increases in natural resources, advances in technology, increases in worker efficiency, and other wealth-enhancing innovations have ambiguous effects on the trade deficit in the short and medium run. Because these innovations increase the productivity of U.S. workers and lower production costs, they increase the attractiveness of U.S. goods, and may result in increased exports. To the extent these innovations increase the demand for investment, however, they can have the opposite effect on the trade deficit. Nonetheless, each of these innovations increases the standard of living competitiveness of the United States, because each of these increases the output of the economy, and hence the incomes of U.S. residents. On the other hand, current standards of living do not provide a sufficient measure of competitiveness because a nation can maintain high standards of living for a fairly long time by running large trade deficits. Eventually, large trade deficits that finance consumption will reduce a nation's standard of living.

Multinational competitiveness

A third definition of U.S. competitiveness is the ability of U.S. multinational businesses (businesses headquartered in the United States that operate abroad) that locate production facilities overseas to compete in foreign markets. Overseas production facilities owned by U.S. interests may compete with firms owned by residents of the host country or with multinational firms based in other countries. This definition of competitiveness focuses on the after-tax returns to investment in production facilities abroad. Some also apply this notion of "competitiveness" to the ability of U.S.-based multinational businesses to compete in the United States with firms owned by multinational businesses headquartered abroad. Unlike the two previous notions of competitiveness, this notion does not appeal to macroeconomic measures, but relies on an industry-by-industry assessment. The United States could dominate world markets in one industry and be seen as very "competitive" while in another industry U.S. businesses could be losing market share everywhere.

B. Taxation and Investment in the Global Economy

International investment plays an important role in determining the total amount of worldwide income as well as the distribution of income across nations. In addition, international investment flows can substantially influence the distribution of capital and labor income within nations. Because each government levies taxes by its own method and at its own rates, the resulting system of international taxation can distort investment and contribute to reductions in worldwide economic welfare. A government's tax policies affect the distribution of income directly, by collecting tax from foreigners earning income within its borders and from residents earning income overseas, and indirectly by inducing capital movements across national borders.

The concepts of capital export neutrality and capital import neutrality

Capital movements across national borders in response to tax policy, rather than investment in response to pure economic fundamentals, reduce worldwide economic welfare. The nature of these economic distortions depends on the method of taxing income from international investment. If investment income is taxed only at the source, substantial amounts of capital could be diverted to jurisdictions with the lowest tax rates instead of flowing to investment projects with the highest pre-tax rate of return. If a system of residence taxation is the worldwide norm,[133] enterprises resident in low-tax countries might be able to attract more investment capital or perhaps increase their market share through lower prices to the detriment of enterprises resident in high-tax jurisdictions, even though the latter are more efficient. In either case, capital is diverted from its more productive uses, and worldwide income and efficiency suffer. The most straightforward solution to this problem is equalization of effective tax rates, but this may not be a practical solution given differences in national preferences for the amount and method of taxation. There is no consensus on what method of taxing international investment income minimizes distortions in the allocation of capital when nations tax income at different effective rates, but the alternatives of capital export neutrality and capital import neutrality are the most cited guiding principles. These two standards are each desirable goals of international tax policy. The problem is that, with unequal tax rates, these two goals are not mutually attainable. Satisfying both principles at the same time is possible only if effective tax rates on capital income are the same in all countries.

Capital export neutrality.–Capital export neutrality refers to a system under which an investor residing in a particular locality can locate investment anywhere in the world and pay the same tax.

Capital import neutrality.–Capital import neutrality refers to a system under which income from investment located in each country is taxed at the same rate regardless of the residence of the investor.

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[133] The text envisions a system of residence taxation applied to enterprises. A pure residence system would fully integrate corporate and individual income taxes and tax individuals based upon their residence.

Chart 1, below, compares capital export neutrality with capital import neutrality. The chart provides a taxonomy of the tax that would apply to income from an investment by location of the investment and by residence of the investor under the principle of capital export neutrality (panel a) and capital import neutrality (panel b). Tax rates are always equal for investors residing in the same country under capital export neutrality. Tax rates are always equal for investments located in the same country under capital import neutrality.

Chart 1.–The Principles of Capital Export Neutrality and Capital Import Neutrality

a. Capital Export Neutrality

Domestic investor faces domestic tax rate no matter where investment is located. Foreign investor faces foreign tax rate no matter where investment is located. Foreign investment income is subject to foreign tax rate regardless of the residence of the taxpayer.

		Location of Investment	
		Domestic	*Foreign*
Residence of Investor	*Domestic*	Tax income at domestic rate	Tax income at domestic rate
	Foreign	Tax income at foreign rate	Tax income at foreign rate

b. Capital Import Neutrality

Domestic investment income is subject to the domestic tax rate regardless of the residence of the taxpayer. Foreign investment income is subject to foreign tax rate regardless of the residence of the taxpayer.

		Location of Investment	
		Domestic	*Foreign*
Residence of Investor	*Domestic*	Tax income at domestic rate	Tax income at foreign rate
	Foreign	Tax income at domestic rate	Tax income at foreign rate

Capital export neutrality and location of investment

Under capital export neutrality, decisions on the location of investment are not distorted by taxes. That is, all else being equal, the investor's after-tax return would be equal regardless of location. Proponents of the capital export neutrality principle observe that this implies investments would be made only on the basis of pre-tax profit potential. Capital export neutrality is a principle describing how investors pay tax, not to whom they pay. Capital export neutrality primarily is a framework for discussing the efficiency and incentives faced by private investors, and not the distribution of the revenues and benefits of international investment.

Tax systems may adhere to the principle of capital export neutrality by taxing worldwide income and granting credits for income and profits taxes paid to foreign governments. As an alternative to the system of foreign tax credits, capital export neutrality could be achieved with the source country relinquishing its jurisdiction to tax income derived from investments within its borders and allowing the country of residence the exclusive right to tax this income.

Capital import neutrality and location of investment

Under capital import neutrality, capital income from all businesses operating in any one locality is subject to uniform taxation. The nationality of investors in a particular locality will not affect the rate of tax. Capital import neutrality may be achieved by the residence country exempting income earned from foreign jurisdictions entirely from tax and allowing the source country's taxation to be the only taxation on the income of international investors. This is commonly referred to as a "territorial" or an "exemption" system of international taxation.

Commentators who address competitiveness in terms of multinational competitiveness state that the principle of capital import neutrality promotes the competitiveness of U.S.-based multinational businesses. Overseas production facilities owned by U.S. interests may compete with firms owned by residents of the host country or with multinational firms based in other countries. The notion of capital import neutrality promoting the competitiveness of such businesses focuses on the after-tax returns to investments in production facilities abroad. As described above, under the principle of capital import neutrality, any business would see the return from its investment in any given foreign country taxed only by that foreign country. Under present law, residual U.S. taxation in the case of a U.S. multinational may apply differently than residual taxation by another capital-exporting country. The result may be that the after-tax return to an investment by a U.S. multinational in a given foreign country may be less than the after-tax return earned by another investor, even if that investor makes an identical investment to that of the U.S. multinational. Some argue that this puts the U.S. multinational at a competitive disadvantage.

The concept of national neutrality

Because countries typically tax income arising within their borders, a nation can increase its income through policies that reduce outbound investment by its residents and encourage inbound investment by foreigners. This is the case even if net outbound investment is driven below the level that would prevail in a free and efficient international capital market. Promoting national economic interest may not coincide with promoting worldwide economic income.

In a world of source taxation, the national interest and the interests of outbound investors do not coincide. Outbound investment is only in the national interest if the return after foreign tax (but before domestic tax) equals or exceeds the before-tax return on domestic investment. To further its national interest, a government can reduce outbound investment by reducing the after-tax rate of return on outbound investment and driving its before-tax return above that on domestic investment. A government can penalize outbound investment by imposing a layer of taxation in addition to foreign taxation at source. This result can be achieved when a capital-exporting nation, in response to foreign source taxation, does not cede taxing jurisdiction over

foreign source income (for example, through a foreign tax credit) and allows only a deduction for foreign taxes.[134]

The policy of allowing only deductions for foreign taxes is sometimes known as "national neutrality." A deduction penalizes outbound investment and aligns the interests of the taxpayer with the interests of its home country, but only at the expense of reduced worldwide economic welfare. Despite the potential to maximize national welfare, self-interested nations generally do not adopt tax systems designed to achieve national neutrality. There are at least three possible explanations for this. First, there is reason to expect that one nation's unilateral attempt to improve its own welfare through a policy of national neutrality would meet with retaliation by other nations with similar policies. Such tax competition would reduce worldwide income even further.[135] If, on the other hand, nations can coordinate their tax policies, a tax system can be designed to increase worldwide income above the inefficient level produced by national neutrality. With international coordination, there is potential for adopting a system in which worldwide income could be maximized (and, if necessary, redistributed) so all nations could be better off.

Second, the disincentives to outbound investment embodied in the concept of national neutrality only increase national welfare if outbound investment increases at the expense of domestic investment. If the economy responds to increased outbound investment with increased domestic saving instead of reduced domestic investment, policies to discourage outbound investment may have little positive effect on domestic labor and, furthermore, may reduce national welfare in addition to worldwide welfare.

Third, even if the first two rebuttals to national neutrality do not hold, there is some evidence that outbound investment increases exports by more than it increases imports. This increase in net exports may provide benefits to domestic labor and increase overall domestic income. If this is the case, policies discouraging outbound investment could increase the merchandise trade deficit and reduce national output.

The concept of capital ownership neutrality

Recently, some analysts have suggested that analysis of cross-border investment and tax policy should not be analyzed solely in terms of the location of investments, but rather by the ownership of investments in addition to the location of those investments.[136] They argue that

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[134] Several authors provide a description of how deductions for foreign taxes maximize domestic welfare of a capital-exporting country. See Richard E. Caves, *Multinational Enterprises and Economic Analysis*, (Cambridge, England: Cambridge University Press), 1982, pp. 229-231; and Peggy B. Musgrave, *United States Taxation of Foreign Investment Income: Issues and Arguments*, (Cambridge, Massachusetts: International Tax Program, Harvard Law School), 1969, p. 134.

[135] In the context of international trade, policies that attempt to promote domestic economic welfare at the expense of the rest of the world are referred to as "beggar-thy-neighbor" policies.

[136] Mihir A. Desai and James R. Hines, Jr., "Evaluating International Tax Reform," *National Tax Journal*, 56, September 2003, pp. 487-502. Also, Mihir Desai and James R. Hines, Jr., "Old Rules and

economic efficiency would be promoted if the tax system does not distort the ownership pattern of investments, that is, an efficient system would promote capital ownership neutrality. The underlying premise of this notion of neutrality is that the same units of physical capital (plant and equipment) will have different levels of productivity and profitability, depending upon who owns that capital and manages its operation. The differences in productivity from a given production facility may result from proprietary intangible assets of the owners.[137] If the productivity and profitability, of physical assets depends upon the intangible assets of those who own and manage the assets, efficiency is improved if those who possess the proper intangible assets that will permit the greatest productivity from the physical assets own the physical assets. If the tax system dissuaded the potentially most productive owners from owning any particular physical assets, wherever located, then economic efficiency would be diminished. Capital ownership neutrality would be sustained if all countries were to tax foreign income, but permit a full foreign tax credit. Likewise, if all countries were to exempt foreign income from their tax base, capital ownership neutrality would be sustained. In each circumstance, ownership would be determined by productivity differences and not tax differences.[138] In either circumstance, if any country's tax policy deviated from conformity, ownership neutrality could not be achieved.

Foreign direct investment and domestic investment

Some argue that if U.S. multinationals were exempted from the U.S. corporate tax on their foreign-source income, the after-tax return to establishing facilities overseas would be increased and U.S. multinational corporations would substitute investment in foreign facilities for investment in domestic facilities. For example, instead of manufacturing products in the United States and selling the products domestically and exporting products abroad, a firm might

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New Realities: Corporate Tax Policy in a Global Setting," *National Tax Journal*; 57, December 2004, pp. 937-60.

[137] Some argue that much cross border investment by multinational businesses is motivated because these businesses possess intangible assets such as patents, trade names, and proprietary production skills. The purchase of an under-performing existing business's physical plant allows the owner of these intangible assets the ability to quickly earn returns on these intangible assets and know-how in foreign markets. For example, see Richard E. Caves, *Multinational Enterprise and Economic Analysis*, (Cambridge, U.K.: Cambridge University Press), 1996.

[138] Desai and Hines, "Evaluating International Tax Reform." In the first case, involving taxation of foreign source income and a full tax credit, the tax systems of all countries would be consistent with the principle of capital export neutrality. In the second case, involving the exemption of foreign source income, the tax systems of all countries would be consistent with the principle of capital import neutrality. Each case would result in the multinational enterprise being subject to only the tax imposed by the residence country. In either case the rates of tax imposed by different countries could be different and ownership neutrality would be sustained. This could lead to distortions in the geographic location of physical investment, but not in the ownership of the physical investment. Desai and Hines write, "Whether the [efficiency] cost of having too many factories in the Bahamas is larger or smaller than the cost of discouraging value-enhancing corporate acquisitions is ultimately an empirical question, though the importance of ownership to FDI [foreign direct investment] suggest that its welfare impact may also be substantial."

choose to locate production facilities abroad and import some products back to the United States and serve overseas markets from the foreign location.[139]

Others argue that foreign direct investment undertaken by U.S. persons is not a substitute for U.S. domestic investment, but rather is a complement to U.S. domestic investment. They note that a foreign production facility can be a major source of demand for components from its U.S. affiliate and that the foreign production affiliate relies on U.S.-based research facilities and headquarters operations. If a foreign production facility fosters overall demand for the firm's products, then investment in the U.S.-based component facilities, research facilities, and headquarters operations will be required to sustain the increased worldwide demand.

Empirical studies have attempted to examine whether foreign direct investment is a substitute for or complement to domestic investment. A decade ago the President's Council of Economic Advisors concluded, "On a net basis, it is highly doubtful that U.S. direct investment abroad reduces U.S. exports or displaces U.S. jobs."[140] Generally, empirical studies find either no effect or a positive effect of overseas production in a host-county market on home-country exports to that market. One survey of the empirical literature reports that, on average, studies find one dollar of overseas production by U.S. affiliates generates $0.16 of exports from the United States.[141] The evidence suggests that overseas production does displace certain types of domestic production as the parent firm shifts to more capital intensive and skill intensive domestic production.[142]

There is no definitive conclusion about the effect of outbound investment on U.S. employment. The same survey concludes, "[T]he evidence suggests that the effect of overseas production on the home-country labor market involves the composition of a firm's home employment rather than the total amount. That change in composition is mainly a shift toward more managerial and technical employment...."[143] However, most of the evidence on this subject

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[139] This possibility is often referred to as a "run-away plant."

[140] Council of Economic Advisers, *Economic Report of the President*, (Washington, D.C.: U.S. Government Printing Office), February 1991, p. 259. The report also surveys some of the evidence on the economic effects of outbound investment.

[141] Robert E. Lipsey, "Outward Direct Investment and the U.S. Economy," in Martin Feldstein, James R. Hines, Jr., and R. Glenn Hubbard (eds.), *The Effects of Taxation on Multinational Corporations*, (Chicago: University of Chicago Press), 1995. In a more recent survey, Lipsey reaches similar conclusions. Robert E. Lipsey, "Home and Host Country Effects of FDI," National Bureau of Economic Research Working Paper No. 9293, October 2002.

[142] Lipsey, "Home and Host Country Effects of FDI."

[143] Lipsey, "Outward Direct Investment and the U.S. Economy," p. 31. One recent study does find some substitution of foreign labor for U.S. labor but characterizes the degree of employment substitution as low between domestic and foreign affiliates, finding greater labor substitution between employees in different developing countries. S. Lael Brainard and David A. Riker, "Are U.S. Multinationals Exporting U.S. Jobs?" in David Greenway and Douglas Nelson, eds., *Globalization and Labour Markets*, Elgar, 2001.

examines individual industries rather than aggregate economic effects. In aggregate, it is clear that U.S. manufacturing employment has fallen among U.S.-owned manufacturing enterprises, but the decline has been largely offset by employment at foreign-owned manufacturing facilities located in the United States.[144]

Summary

A government can implement capital export neutrality by taxing worldwide income of its residents but also allowing credits for taxes paid to foreign governments. Alternatively, a government can implement national neutrality by replacing credits with deductions for foreign taxes. Finally, a government can implement capital import neutrality by exempting all foreign source income from tax. Coordinated tax policies across capital exporting and importing countries would be necessary to attempt to achieve capital ownership neutrality. Because national neutrality is less generous to taxpayers than capital export neutrality, deviations from capital export neutrality that increase taxes on foreign income move the U.S. system closer to a system of national neutrality. Conversely, since capital import neutrality is often more generous to taxpayers than capital export neutrality, deviations from capital export neutrality that decrease tax on foreign income move the U.S. system closer to a system of capital import neutrality.

[144] Lipsey, "Home and Host Country Effects of FDI."

C. Characterization of the U.S. System of Taxation of Cross-Border Transactions and Investments

As a whole, the U.S. system of taxation is a hybrid containing elements consistent with both capital import neutrality and capital export neutrality. With regard to the relative treatment of domestic and outbound investment, some provisions work at cross-purposes. Some provisions of current law favor outbound investment, while others discourage it.

Deferral of tax on foreign income

Income from outbound investments earned by the separately incorporated foreign subsidiaries of U.S. corporations generally is not subject to tax until that income is repatriated. However, income from foreign branches of U.S. corporations must be included in current taxable income. The majority of foreign business activity controlled by U.S. corporations is conducted by separate foreign corporations as opposed to branches. In 1998, the largest 7,500 CFCs of U.S. multinationals reported $143.8 billion of earnings and profits from gross receipts of $1.7 trillion and paid $34.7 billion of foreign income taxes.[145] Foreign branches of U.S. multinationals reported $87.3 billion of gross branch income and paid $4.9 billion of foreign income taxes.[146]

If, for a particular taxpayer, the effective rate of foreign tax can be expected to be consistently above the U.S. rate, deferral of U.S. taxes would not provide any tax benefit. However, if the effective rate of foreign tax is at any time or in any jurisdiction below the U.S. rate, U.S. multinationals may enjoy two substantial benefits from deferral. First, deferral may delay the payment of U.S. taxes on foreign source income until earnings are repatriated. Second, because excess foreign tax credits cannot be carried forward indefinitely, deferral expands the opportunity for cross-crediting (if effective foreign tax rates vary across years or across jurisdictions) by not deeming high foreign taxes to be paid until a year when the U.S. taxpayer chooses also to repatriate low-taxed foreign source income.[147] The benefit from the deferral of tax until foreign earnings are repatriated may be viewed as similar to the benefit enjoyed from

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[145] John Comiskey, "Controlled Foreign Corporations, 1998," *Statistics of Income Bulletin*, 22, Winter 2002-2003, pp. 47-86.

[146] Rob Singmaster and Andrea Heilbroner, "Corporate Foreign Tax Credit, 1998," *Statistics of Income Bulletin*, 22, Fall 2002, pp. 177-247.

[147] This second benefit is in some degree limited by the less generous foreign tax credit carryover periods (back one year and forward ten years) as compared to the net operating loss carryover periods (back two years and forward 20 years). For example, when a U.S. source loss for a year in which foreign source income is earned renders the crediting of foreign tax paid or deemed paid in that year unnecessary, the effect of the foreign income and taxes is to convert a loss, usable over the next 20 years, into a credit carry forward, usable only over the next ten years. Thus, while deferral makes it possible for the taxpayer to choose the year in which the tax will be deemed paid, the reduced carry forward period prevents the taxpayer from also enjoying the flexibility to use its excess credits over the full 20 years accorded to losses.

delaying realizations of capital gains. As with capital gains, one method of eliminating the tax benefit of deferral is the payment of taxes on income as it is earned, rather than when payment is received. This is achieved, in limited circumstances, by the various anti-deferral regimes (subpart F and PFIC rules) in the Code.

Deferral does, however, impose costs on taxpayers. For example, subpart F, and its interactions with the credit rules and the other anti-deferral rules, are considered highly complex.[148] In addition, the interest allocation rules, by precluding full worldwide fungibility of interest among commonly controlled domestic and foreign subsidiaries, may impose costs on a U.S. corporation that operates through foreign subsidiaries, which costs might be avoided by operating through foreign branches of a U.S. corporation.

To the extent that deferral continues to provide an advantage to outbound investment, this advantage provides an incentive for outbound investment and therefore moves the U.S. system of taxation of foreign income closer to capital import neutrality and away from capital export neutrality. Deferral provides an incentive for outbound investment, but restrictions on deferral negate this incentive.

Foreign tax credit limitation

For taxpayers in an excess foreign tax credit position (that is, taxpayers with creditable foreign taxes in excess of the foreign tax credit limitation), tightening limitations on the foreign tax credit may, when foreign laws are taken into account and are assumed not to change as a result of the tightening, result in discouraging outbound investment and encouraging domestic investment. In order for a credit system of foreign taxation to be fully consistent with capital export neutrality where it is assumed that no changes in source country law are possible, unlimited credits for foreign tax payments against residence country tax liability would have to be available to taxpayers in their country of residence. This would include a grant by the residence country to the taxpayer of the amount, if any, by which such source country tax exceeds residence country tax. In other words, for a credit system of outbound taxation to be fully capital-export neutral, the residence country must be willing to relinquish tax jurisdiction over domestic income.

It is important to recognize that when the foreign tax credit limitation is binding, the disincentive to outbound investment results primarily from foreign effective rates of tax in excess of the domestic rate. The only "fault" of the foreign tax credit limitation in the context of capital export neutrality is that subsidies are not provided in the form of foreign tax credits in excess of domestic tax liability. The reduced availability of foreign tax credits may, however, be accompanied by reductions in effective foreign tax rates.

In 1921, three years after the foreign tax credit was first made available to U.S. taxpayers, the credit was limited to the amount of tax that would be paid at domestic rates on foreign source income computed under U.S. tax rules. Taxpayers in an "excess limit" position (that is, taxpayers

[148] *E.g.*, David Tillinghast, "International Tax Simplification," 8, *American Journal of Tax Policy,* 1990, pp. 187-190.

with foreign tax credit limitation in excess of creditable taxes) have no incentive to reduce their foreign taxes, and foreign governments have no inducement to lower their income taxes on income earned by those U.S. taxpayers. Without the credit limitation, there would be no reasonable bound on the potential transfer of funds from the U.S. Treasury to foreign governments. To the extent of U.S. tax liability (before foreign tax credits), the level of foreign taxation would be a matter of indifference to the U.S. investor since increased foreign taxes effectively would be paid by the U.S. Treasury.[149] The foreign tax credit limitation is thus among the most important of a variety of revenue protection features of the U.S. system of international taxation. To the extent that U.S. tax rates fall relative to foreign tax rates, the importance of the foreign tax credit limitation increases.

Cross-crediting of foreign taxes

In its 1984 tax reform proposals, the Treasury Department proposed a per-country foreign tax credit limitation to replace the overall limitation which provided "many taxpayers a tax motivated incentive to invest abroad rather than in the United States."[150] This tax reform proposal addressed the use of high foreign taxes imposed by one country (i.e., taxes in excess of the U.S. rate) to offset U.S. tax on income earned by the same U.S. taxpayer in a low-tax country. This is sometimes referred to as "averaging" or "cross-crediting."

The creation of new separate foreign tax credit baskets in the final version of the Tax Reform Act of 1986 reduced in a different way the ability of U.S. taxpayers to average foreign tax liability on highly taxed foreign income against the foreign tax liability on lightly taxed foreign income. For example, the passive income basket included in the 1986 Act reduced the incentive for U.S. taxpayers with excess foreign tax credits to reallocate funds from domestic uses to portfolio investments in low-tax countries. With an ability to "cross-credit" between taxes on active and passive income, a corporate taxpayer paying, for example, 45-percent tax on $100 of active income from one country would be able to make investments yielding $100 in another jurisdiction with a tax rate as high as 25 percent on investment income, and be subject only to foreign tax. The taxpayer in this instance has a tax incentive to invest abroad since his marginal rate of tax is 25 percent on outbound investment compared to 35 percent on domestic investment. Separate basketing requires an additional 10 percent of U.S. tax to be paid on this outbound investment.

In terms of the principles discussed above, limiting the ability to cross-credit moves the tax treatment of the marginal outbound investment by a U.S. investor away from capital import neutrality and toward capital export neutrality. On the other hand, under current U.S. law, taxpayers may cross-credit high foreign taxes paid to one country against U.S. tax on similar types of income earned in other low-tax foreign countries. Complete elimination of cross-crediting may be undesirable for administrative reasons, quite apart from issues of capital import

[149] In this case, the only limitation would be that foreign tax credits cannot exceed U.S. tax liability.

[150] U.S. Treasury Department, *Tax Reform for Fairness, Simplicity, and Economic Growth*, Vol. 2, 1984, p. 361.

and export neutrality. For example, substantial administrative issues could arise in the allocation and apportionment of foreign income of an integrated multinational business among separate foreign countries in which operations take place. Some of the separate foreign tax credit limitation rules of current law already create what may be regarded as undue complexity.

Creditability of subnational foreign taxes

Under present law, taxes paid by U.S. businesses to foreign governments that are by their nature taxes on income or profits, such as a corporate income tax, are fully creditable (within the foreign tax credit limitation) against Federal income taxes. This applies whether the tax is imposed by the national government or by a subnational government of that foreign country. However, income taxes paid by U.S. businesses to the States or to other subnational governments within the United States are only deductible against Federal income tax. Depending upon the rates of U.S. and foreign national and subnational taxes, this disparity in treatment of subnational taxes can create an incentive to invest overseas. This is the case when the foreign tax credit limitation is not binding and the overall (i.e., national and subnational combined) level of foreign income tax is lower than the level of U.S. Federal and local income tax.

To illustrate this point, assume that an investor can earn $100 before both national and local taxes from either a domestic or outbound investment, and that the rate of U.S. Federal income tax is 35 percent and the foreign national rate is 20 percent. Before taking into account other, subnational taxes, the U.S. taxpayer would earn $65 after-tax from either domestic or outbound investment. In the case of outbound investment, the investor pays $20 of tax to the foreign government and $15 (after foreign tax credits) to the U.S. government. Now assume that subnational governments in both the United States and the foreign jurisdiction impose a 10-percent income tax. On domestic investment, the investor pays $31.50 of Federal tax (0.35 times $90) and $10 of subnational income tax, resulting in an effective rate of tax of 41.5 percent and leaving the investor with $58.50 after tax. On outbound investment, the investor pays $18 of tax to the foreign national government and $10 to the foreign subnational government. Because the total foreign tax paid does not exceed the foreign tax credit limitation, all the foreign taxes are creditable. The taxpayer owes $7 to the U.S. government and is left with $65 after tax.

V. BACKGROUND AND DATA RELATING TO INTERNATIONAL TRADE AND INVESTMENT

This part presents background data relating to the scope of the international trade sector in the United States economy. This part discusses the economic relationship between trade deficits, capital inflows, investment, and savings in the economy. It briefly reviews trends in both the current account (the trade surplus or deficit) and the financial account (U.S. investment abroad and foreign investment in the United States).[151]

A. Trade Deficits and Cross-Border Capital Flows

National income accounting

In popular discussion of trade issues, much attention is given to the trade deficit or surplus, that is, the difference between the exports and imports of the economy. In the late 1980s, there was also attention given to inflows of capital from abroad. Capital inflows can take the form of foreign purchases of domestic physical assets, of equity interests, or of debt instruments. These two phenomena, trade balances and capital inflows, are not independent, but are related to each other. Trade deficits, capital inflows, investment, savings, and income are all connected in the economy. The connection among these economic variables can be examined through the national income and product accounts, which measure the flow of goods and services and income in the economy.[152]

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[151] Prior to 1999, the U.S. Department of Commerce, Bureau of Economic Analysis reported and described international transactions by reference to the "current account" and the "capital account." Beginning in June 1999 the Bureau of Economic Analysis adopted a three-group classification to make U.S. data reporting more closely aligned with international guidelines. The three groups are labeled: current account; capital account; and financial account. Under this regrouping, the "financial account" encompasses all transactions that used to fall into the old "capital account," that is, the financial account measures U.S. investment abroad and foreign investment in the United States. Under the new system, the "current account" is redefined by removing a small part of the old measure of unilateral transfers and including it in the newly defined "capital account." The newly defined capital account consists of capital transfers and the acquisition and disposal of non-produced, non-financial assets. For example, the newly defined capital account includes such transactions as forgiveness of foreign debt, migrants' transfers of goods and financial assets when entering or leaving the country, transfers of title to fixed assets, and the acquisition and disposal of non-produced assets such as natural resource rights, patents, copyrights, and leases. In practice, the Bureau of Economic Analysis believes that newly defined "capital account" transactions will be small in comparison to the current account and financial account.

[152] The national income and product accounts measure the flow of goods and services (product) and income in the economy. The most commonly reported measure of national economic income is gross domestic product (GDP). Related to GDP is gross national product (GNP). GNP is GDP plus the net factor income received by residents of United States from abroad. Thus, wages earned by a U.S. resident from temporary work abroad constitutes part of GNP but not GDP. Similarly, the returns from investment abroad constitute part of GNP but not GDP. To help understand the connection between trade deficits and cross border capital flows, in the following it is useful to use GNP, which includes cross border returns to investment, rather than the more commonly reported GDP concept. The GNP of the

The value of an economy's total output must be either consumed domestically (by private individuals and government), invested domestically, or exported abroad. If an economy consumes and invests more than it produces, it must be a net importer of goods and services. If the imports were all consumption goods, in order to pay for those imports, the country must either sell some of its assets or borrow from foreigners. If the imports were investment goods, foreign persons would own the investments. Thus, an economy that runs a trade deficit will also experience foreign capital inflows as foreign persons purchase domestic assets, make equity investments, or lend funds (purchase debt instruments).

For example, when the United States imports more than it exports, the United States pays for the imports with dollars. If foreigners are not buying goods with the dollars, then they will use the dollars to purchase U.S. assets. (An alternate way of viewing these relationships is that dollars flowing out of the U.S. economy in order to purchase goods or to service foreign debt must ultimately return to the economy as payment for exports or as capital inflows.)

The previous discussion focuses on the disposition of the economy's output. If the economy is a net importer, it must attract capital inflows to pay for those imports. If the economy is a net exporter, it must have capital outflows to dispose of the payments it receives

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economy is the total annual value of goods and services produced by the economy and may be measured in several ways. One way to measure GNP is by expenditures on final product. By this measure,

(1) GNP = C + I + G + (X-M) + NI.

Equation (1) is an accounting identity which states that gross national product equals the sum of private consumption expenditures (C), private investment expenditures on plant, equipment, inventory, and residential construction (I), government purchases of goods and services (G), net exports (exports less imports of goods and services and net interest payments to foreigners, or X-M), plus net investment income (the excess of investment income received from abroad over investment income sent abroad or NI).

An alternative is to measure GNP by the manner in which income is spent. By this measure,

(2) GNP = C + S + T.

Equation (2) is another accounting identity which states that gross national product equals the sum of private consumption expenditures (C), saving by consumers and businesses (S), and net tax payments to the government (T) (net tax payments are total tax receipts less transfer, interest, and subsidy payments made by all levels of government).

Because both measures of GNP are simple accounting identities, the right hand side of equation (1) must equal the right hand side of equation (2). From this observation can be derived an additional national income accounting identity:

(3) I = S + (T - G) + (M - X) - NI

Equation (3) states that private investment equals private saving (S), plus public saving (T-G) and net imports (M - X), less net investment income.

for its exports. Another way of looking at the connection between capital flows and the goods and services in the economy is to concentrate on the sources of funds for investment. Because domestic investment must be financed either through saving or foreign borrowing, net capital inflows must also equal the difference between domestic investment and saving.

These relationships can be summarized as follows (the equation ignores relatively small unilateral transfers such as foreign aid and assumes, without loss of generality, that the government budget is balanced):

$$\begin{aligned} \text{Net Foreign Borrowing} &= \text{Investment - Saving} \\ &= \text{(Imports - Exports) - Net Investment Income} \end{aligned}$$

For this purpose, imports and exports include both goods and services, and net investment income is equal to the excess of investment income received from abroad over investment income sent abroad.[153] The excess of imports over exports is called the trade deficit in goods and services. Net investment income can be viewed as payments received on previously-acquired foreign assets (foreign investments) less payments made to service foreign debt.

If the investment in an economy is larger than that country's saving, the country must either be running a trade deficit or the economy is increasing its foreign borrowing. Similarly, a country cannot run a trade surplus without also exporting capital, either by increasing its foreign investments, or by servicing previously-acquired foreign debt. Because the level of net investment income in any year is fixed by the level of previous foreign investment (except for changes in interest rates), changes in investment or saving that are associated with capital inflows will have a negative impact on a country's trade balance.

Economic implications of trade deficits

A trade deficit is not necessarily undesirable. What is important is the present and future consumption possibilities of the economy. That will depend in part on whether the trade deficit is financing consumption or investment. For example, if a country uncovers profitable investment opportunities, then it will be in that country's interest to obtain funds from abroad to invest in these profitable projects.[154] If the economy currently does not have enough domestic savings to invest in these projects, it could reduce its consumption (generating more domestic saving) or look to foreign sources of funds (thus allowing investment without reducing current consumption). For example, suppose new oil reserves that could be profitably recovered through

[153] This equation in the text can be derived from equation (3) in footnote 152 above if the government budget is assumed to be balanced, that is, if G = T. It follows that if the government runs a deficit, that is, if G>T, for a given level of investment, saving, and net investment income, net foreign borrowing must be greater.

[154] This scenario describes the experience of the United States in the mid to late 1800s, when foreign capital inflows financed much of the investment in railroads and other assets.

increased investment are discovered in the United States. The investment may be financed by foreigners. In order to invest in U.S. assets, foreigners will have to buy dollars, thus increasing the value of the dollar. This dollar appreciation makes U.S. goods more expensive to foreigners, thereby reducing their demand for U.S. exports. At the same time, the dollar appreciation makes foreign goods cheaper for U.S. residents, increasing the demand for imports and resulting in a trade deficit. Eventually, the flow of capital will be reversed, as the U.S. demand for new investment falls, and foreigners receive interest and dividend payments on their previous investments.

The foreign borrowing in the above example was used to finance investment. This borrowing did not reduce the living standards of current or future U.S. residents, because the interest and dividends that were paid to foreigners came from the return from the new investment. If foreign borrowing finances consumption instead of investment, there are no new assets created to generate a return that can support the borrowing. When the debt eventually is repaid, the repayments will come at the expense of future consumption. For instance, consider a situation in which the domestic supply of funds for investment decreases because domestic saving rates fall. Foreign borrowing in this case is not associated with increased investment, but instead is devoted to investment that was previously financed with domestic savings. Because the foreign borrowing is not associated with increased investment, future output does not increase, and interest and dividends on the investment will be paid to foreign persons at the expense of future domestic consumption. In this case, there may be an increase in the standard of living for current U.S. residents at the expense of a decrease in the standard of living of future residents.

During the period that foreign borrowing finances U.S. consumption, the United States runs a trade deficit. Although the United States could service its growing foreign debt by increased borrowing, and hence larger trade deficits, in the long run trade deficits cannot keep growing. In fact, the United States must eventually run a trade surplus. If the United States imported more goods than it exported every year, there also would be an inflow of foreign capital every year. This capital inflow would be growing with the increasing costs of servicing the foreign debt. Eventually, foreigners would be unwilling to continue lending to the United States, and the value of the dollar would fall. The fall in the dollar would eliminate the trade deficit, and the United States would eventually run a trade surplus, so that the current account deficit (the sum of the trade deficit in goods and services and the net interest on foreign obligations) would be small enough for foreigners to be willing to lend again to the United States.

Even when foreign investment finances domestic consumption, trade deficits and capital inflows themselves should not necessarily be viewed as undesirable, because the foreign capital inflows help to keep domestic investment, and hence labor productivity, from falling. For instance, the large inflow of foreign capital to the United States in the 1980s is widely viewed to be a result of low U.S. saving rates. If the mobility of foreign capital had been restricted (through capital or import controls, for example), then the low saving rate could have led to higher domestic interest rates and lower rates of investment. That decreased investment would have led to decreases in future living standards because the lower growth rate of the capital stock would have resulted in lower growth rates of U.S. labor productivity. The fact that foreign

capital was not restricted and did finance U.S. investment helped mitigate the negative effects on economic growth of low domestic saving.

The above observations support the argument that the trade deficit does not in itself provide a useful measure of international competitiveness, since trade deficits and trade surpluses can be either good or bad for the United States. The example of oil discovery discussed above shows that even increases in a country's stock of exportable goods can have ambiguous effects on the trade deficit. If the discovery of oil also increases the demand for investment, then the trade deficit may actually increase in the short run. Increases in natural resources, advances in technology, increases in worker efficiency, and other wealth-enhancing innovations have ambiguous effects on the trade deficit in the short and medium run. Because these innovations increase the productivity of U.S. workers and lower production costs, they increase the attractiveness of U.S. goods, and may result in increased exports. To the extent these innovations increase the demand for investment, however, they can have the opposite effect on the trade deficit. Nonetheless, each of these innovations increases the output of the economy, and hence the incomes of U.S. residents.

The balance of payments accounts, presented in Table 1, are analogous to a sources and uses of funds statement of the United States with the rest of the world. As demonstrated above, the current account balance, which consists primarily of the trade balance, should be exactly offset by the capital account and financial account balances, which measure the net inflow or outflow of capital to or from the United States. The difference between the current account surplus or deficit and the capital and financial accounts deficit or surplus is recorded as a statistical discrepancy. Problems of measurement, which have been large in some years, cause the accounts to be somewhat mismatched in practice, but basic patterns are unlikely to be significantly distorted by these problems. The subsequent sections examine trends in the current account and financial account in more detail.

Table 1 – International Transactions of the United States, Selected Years, 1975-2005
($ Billions nominal)

	1975	1985	1995	2000	2005[1]
Current Account Balance	**18.1**	**-118.2**	**-109.9**	**-444.7**	**-804.9**
Exports of Goods and Services	157.9	387.6	1,005.9	1,418.6	1,740.9
Merchandise	107.1	215.9	575.2	772.2	892.6
Services	25.5	73.2	219.2	293.5	379.6
Receipts from U.S. assets abroad	25.4	98.5	211.5	352.9	468.7
Imports of Goods and Services	132.7	483.8	1,081.8	1,809.1	2,462.9
Merchandise	98.2	338.1	749.4	1,224.4	1,674.3
Services	22.0	72.9	141.4	217.0	321.6
Payments on foreign-owned U.S. assets	12.6	72.8	191.0	367.7	467.1
Unilateral Transfers	7.1	22.0	34.1	54.1	82.9
Financial Account Balance	**-22.5**	**101.3**	**113.3**	**443.2**	**801.0**
Foreign Investment in the United States	17.2	146.1	465.7	1,024.2	1,292.7
Direct Investment	2.6	19.7	57.8	287.7	128.6
Private non-direct investment	7.5	127.5	298.0	700.2	943.4
Official	7.0	-1.1	109.9	37.6	220.7
U.S. Investment Abroad	39.7	44.8	352.4	581.0	491.7
Direct Investment	14.2	18.9	98.8	152.4	21.5
Private non-direct investment	21.1	19.1	242.9	427.3	491.9
Increase in government assets	4.3	6.7	10.7	1.2	-21.7
Capital Account Transactions, net	**n.a.**	**0.3**	**0.4**	**0.7**	**5.6**
Statistical Discrepancy	**4.4**	**16.5**	**3.8**	**0.7**	**9.6**

Source: Douglas B. Weinberg, "U.S. International Transactions, First Quarter 2001," Survey of Current Business, 81, July 2001, pp. 37-81, and Christopher L. Bach, "U.S. International Transactions in 2005," Survey of Current Business, 86, April 2006, pp. 22-68.

n.a. - not applicable.
[1] Preliminary figures for 2005.

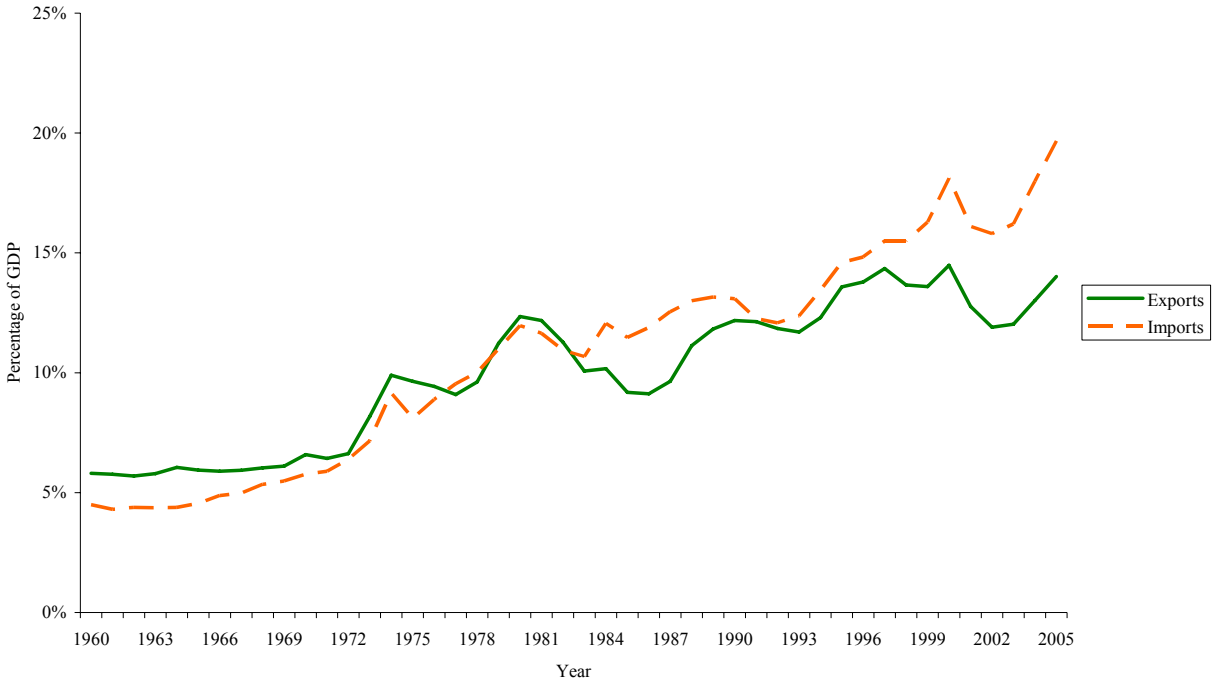
B. Trends in the U.S. Balance of Payments

Overview of U.S. balance of payments (current account)

Foreign trade has become increasingly important to the United States economy. Figure 5 presents the value of exports from the United States and imports into the United States as a percentage of GDP for the period 1960-2005.[155] As depicted in Figure 5, exports and imports each have risen from less than six percent of GDP in 1960 to more than 12 percent in 2005. Imports have consistently exceeded 15 percent of U.S. GDP since 1997. Figure 5 also shows that the United States generally was a net exporter of goods and services prior to 1982. Since that time, the United States has been a net importer of goods and services.

Figure 5

Exports and Imports as a Percentage of United States GDP, 1960-2005



Source: Department of Commerce, Bureau of Economic Analysis.

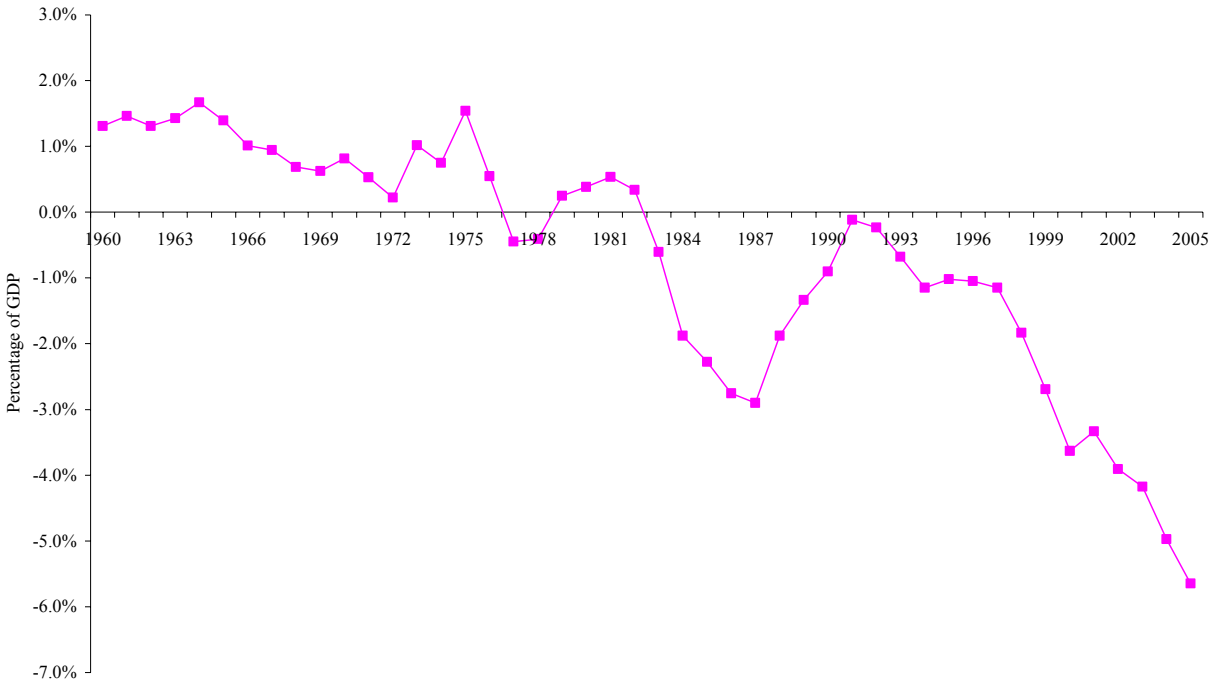
The net trade position of a country is commonly summarized by its current account. The U.S. current account as a whole, which compares exports of goods and services and income earned by U.S. persons on foreign investments to imports of goods and services and income earned by foreign persons on their investments in the United States (plus unilateral remittances),

[155] Data for Figure 5 are from the U.S. Commerce Department, Bureau of Economic Analysis.

generally was positive from 1960 through 1981, but generally has been in deficit since 1982. Figure 6 reports the current account balance of the United States for the period 1960 through 2005 as a percentage of GDP to eliminate the effect of inflation on reported nominal figures.[156] Figure 6 reflects a substantial reduction in the current account deficit for 1992. In that year, the United States received substantial payments from abroad related to the Persian Gulf War.

Figure 6

United Sates Current Account as a Percentage of GDP, 1960-2005



Source: Department of Commerce, Bureau of Economic Analysis.

Components of the current account

Merchandise trade, trade in services, and income from investments

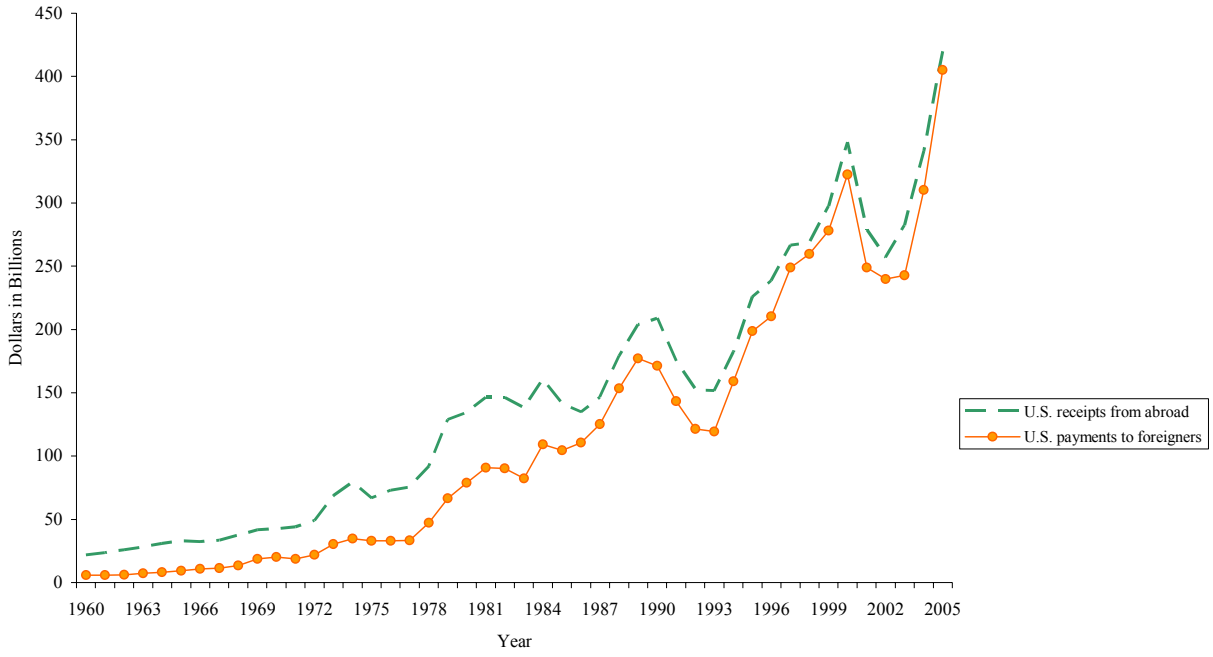
The aggregate data reported in Figure 5 and Figure 6 mask differences in the trade position of various sectors of the economy. As explained above, the current account compares exports of goods and services and payments of income earned by U.S. persons on foreign investments to imports of goods and services and payments of income earned by foreign persons on their investments in the United States.

[156] Data for Figure 6 are from the U.S. Commerce Department, Bureau of Economic Analysis.

Several different trends are embedded within the data. Measuring the trade deficit in real, inflation adjusted year 2000 dollars, as has been widely reported, the merchandise (goods only) trade deficit has been over $200 billion per year since 1997 and over $500 billion per year the last three years. On the other hand, the United States has been a net exporter of services since the 1970s. This surplus in trade in services has averaged more than $50 billion per year (real, 2000 dollars) since 2001. Also, throughout the entire period covered in Figure 6, U.S. receipts of income on investments abroad have exceeded payments of income to foreign persons on their U.S. investments (see Figure 7, below).

Figure 7

Receipts of Income from Investments Abroad and U.S. Payments to Foreign Persons on Investments in the U.S., 1960-2005
(Billions of Real 2000 Dollars)



Source: Department of Commerce, Bureau of Economic Analysis.

Intra-firm trade

These aggregate data also do not reveal the extent to which growing trade flows result from trade between related parties. For example, a domestic company might ship components manufactured in the United States to its foreign subsidiary for final assembly and sale. Such shipments would be counted as exports from the United States. A domestic company might produce components abroad and ship them to the United States for final assembly and sale. Such shipments would be counted as imports to the United States. Likewise, a foreign parent company might ship components from abroad to its U.S. affiliate for final assembly and sale in the United States. Such shipments would be counted as imports into the United States. The

foreign affiliate might ship components to another country for assembly and sale. Such shipments would be counted as exports from the United States.

For example, in 2003, U.S. multinational enterprises shipped $156.9 billion of goods to their foreign affiliates, a figure representing 22 percent of U.S. merchandise exports in 2003. Foreign affiliates of U.S. multinational enterprises shipped $191.9 billion of goods to their U.S. parent enterprise, a figure representing 15 percent of U.S. merchandise imports in 2003.[157] Similarly, in 2003, U.S. affiliates of foreign multinational enterprises exported $71.7 billion worth of goods to other enterprises in the foreign parent's group (10 percent of U.S. merchandise exports). U.S. affiliates of foreign multinational enterprises imported $285.9 billion worth of goods from other enterprises in the foreign parent's group (23 percent of U.S. merchandise imports).[158] Thus, in total, in 2003 intra-firm trade accounted for approximately 32 percent of U.S. merchandise exports and 38 percent of U.S. merchandise imports.

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[157] Raymond J. Mataloni, Jr. "U.S. Multinational Companies: Operations in 2003," *Survey of Current Business*, 85, July 2005, p. 13.

[158] William J. Zeile, "U.S. Affiliates of Foreign Companies: Operations in 2003," *Survey of Current Business*, 85, August 2005, p. 208.

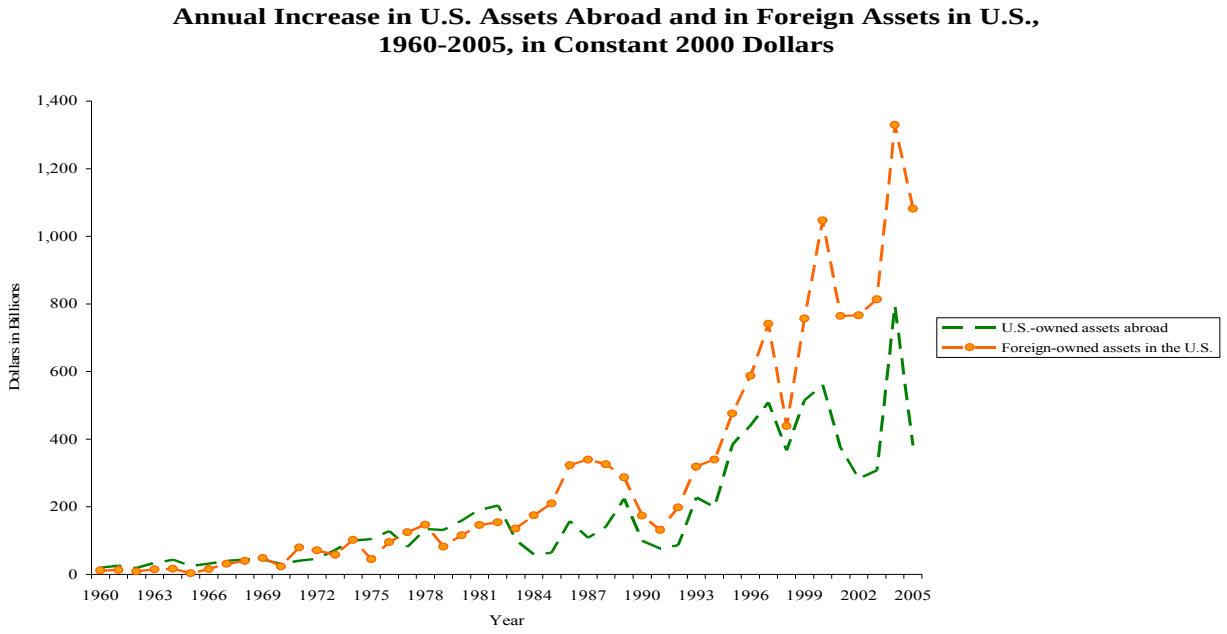
C. Trends in the U.S. Financial Account

Overview of the United States' financial account

As explained above, when the United States imports more than it exports, the dollars the United States uses to buy the imports must ultimately return to the United States as payment for U.S. exports or to purchase U.S. assets. As Figure 6 and Table 1 document, the U.S. current account has been in deficit since the early 1980s. Net foreign investment became a larger proportion of the economy since 1982. At the same time, the United States changed from being a modest exporter of capital in relation to GDP to being a large importer of capital. Net foreign investment has become a larger proportion of the economy and a more significant proportion of total domestic investment than in the past. In 2004, gross investment in the United States was $2.30 trillion and net foreign investment was $653 billion, or 28.4 percent of gross domestic investment. In 1993, net foreign investment comprised 8.9 percent of gross domestic investment.

The net foreign investment in the United States is measured by the U.S. financial account. The financial account measures the increase in U.S. assets abroad compared to the increase in foreign assets in the United States. Figure 8 plots the annual increase of U.S. assets abroad and of foreign assets in the United States in constant dollars for the period 1960-2005 in constant 2000 dollars. Foreign assets in the United States increased by $865 billion in 2003, $1.45 trillion in 2004, and $1.21 trillion in 2005 in nominal dollars. At the same time, foreign assets owned by U.S. persons increased by $326 billion in 2003, $868 billion in 2004, and $427 billion in 2005 (nominal dollars).

Figure 8



Source: Department of Commerce, Bureau of Economic Analysis.

Growth in foreign-owned assets in the United States and U.S.-owned assets abroad

Overview

Measured in nominal dollars, the amount of foreign-owned assets in the United States grew more than 700 percent between 1975 and 1988[159] and by nearly 400 percent between 1980 and 2000. The total amount of foreign-owned assets in the United States exceeded $8 trillion by the end of 2000.[160] The recorded value of U.S.-owned assets abroad grew less rapidly during the same period. The Department of Commerce reports that in 1975 the amount of U.S.-owned assets abroad exceeded foreign-owned assets in the United States by $74 billion. By the end of 1988, however, the situation had reversed, so that the amount of foreign-owned assets in the United States exceeded U.S.-owned assets abroad by $162 billion. By 2000, the amount of foreign-owned assets in the United States exceeded U.S.-owned assets abroad by $1.8 trillion.[161] These investments are measured at their so-called "current cost."[162] Some argue that the market value of U.S.-owned assets abroad is similar to, or greater than, the market value of foreign-owned assets in the United States, if market values were measured accurately.[163] Figure 9 and Figure 10 display the value of U.S.-owned assets abroad and foreign-owned assets in the United States for selected years measured under both current cost and based on estimates of current market values. Whether this argument is correct with respect to the current net investment position, it is clear that foreign-owned U.S. assets are growing more rapidly than U.S.-owned assets abroad, as depicted in Figure 10.

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[159] Russell B. Scholl, "The International Investment Position of the United States in 1988," Survey of Current Business, U.S. Department of Commerce, *Bureau of Economic Analysis*, June 1989, p. 43.

[160] *Ibid*.

[161] *Ibid*.

[162] The Bureau of Economic Analysis estimates the values of U.S. foreign direct investment abroad and foreign direct investment in the United States using three different bases: historical cost, current cost, and market value. Using the historical cost base, assets are measured according to values carried on taxpayers' books. Thus, investments reflect the price level of the year in which the asset was acquired. Under the current cost measure, a parent's share of its affiliates' tangible assets (property, plant, and equipment and inventories) is revalued from historical cost to replacement cost. Under the market value measure, an owner's equity in foreign assets is revalued to current market value using indexes of stock prices.

[163] The distinction between book valuation and market valuation is only relevant for the category of investment labeled "direct investment," not for "portfolio investment." The distinction between direct and portfolio investment is explained in the text below.

Figure 9

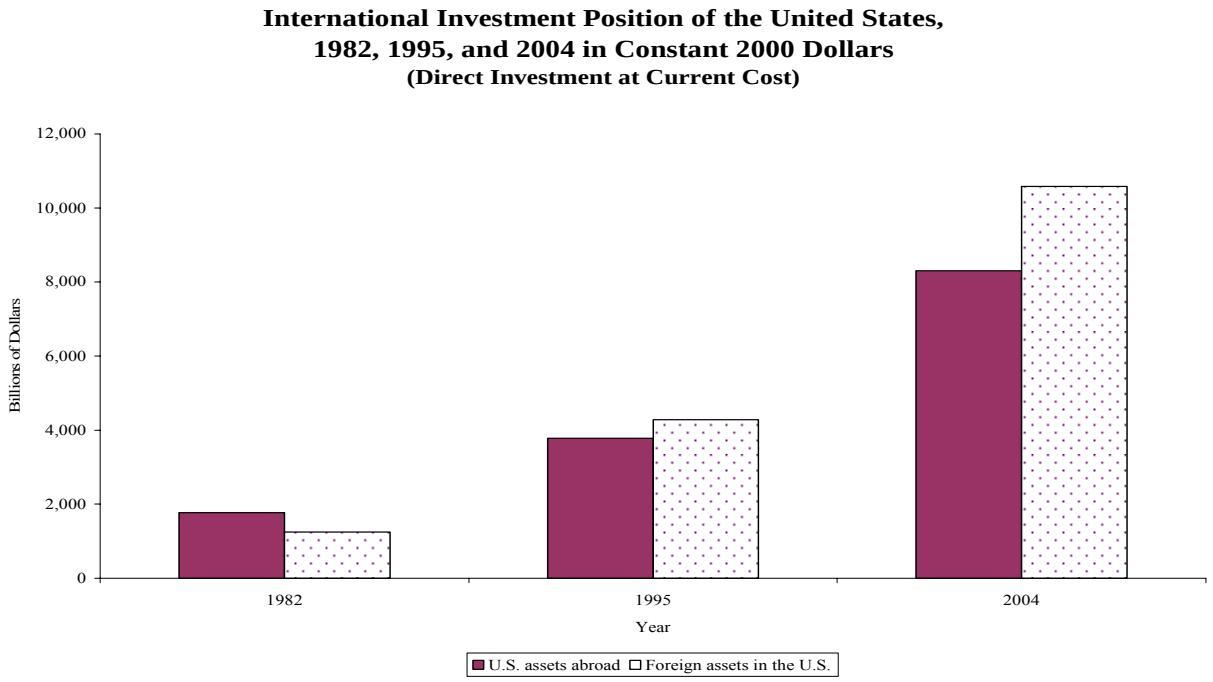
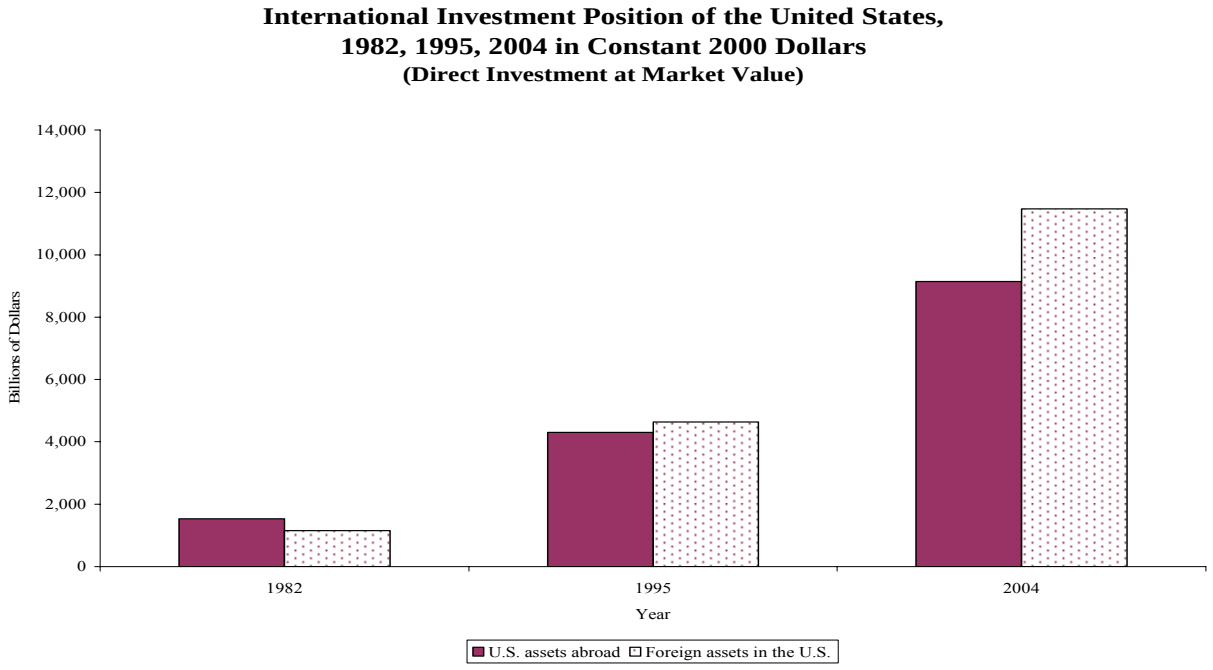


Figure 10



Source: Department of Commerce, Bureau of Economic Analysis.

Direct investment, non-direct (portfolio) investment, and official investment

Foreign assets in the United States (and U.S. assets abroad) can be categorized as direct investment, non-direct investment, and official assets. Direct investment constitutes assets over which the owner has direct control. The Department of Commerce defines an investment as direct when a single person owns or controls, directly or indirectly, at least 10 percent of the voting securities of a corporate enterprise or the equivalent interests in an unincorporated business. Foreign persons held direct investments of $1.71 trillion in the United States in 2004, having grown from $127 billion in 1980.[164]

The largest category of investment is non-direct investment held by private (non-governmental) foreign investors, commonly referred to as portfolio investment. For most of the past decade foreign portfolio investment annually has exceeded foreign direct investment, making portfolio investment responsible for the majority of growth in foreign ownership of U.S. assets. Foreign portfolio investment consists mostly of holdings of corporate equities, corporate and government bonds, and bank deposits. The portfolio investor generally does not have control over the assets that underlie the financial claims. In 2004, portfolio assets of foreign persons in the United States were more than four times the recorded value of direct investment, $7.85 trillion compared to $1.71 trillion, respectively. Bank deposits account for more than one-quarter of this total ($2.3 trillion), and reflect, in part, the increasingly global nature of banking activities. Foreign investment in bonds, corporate equities, and bank deposits, like other types of financial investment, provide a source of funds for investment in the United States but also represent a claim on future U.S. resources.

The final category of foreign-owned U.S. assets is official assets: U.S. assets held by governments, central banking systems, and certain international organizations. The foreign currency reserves of other governments and banking systems, for example, are treated as official assets. Levels of foreign-held official assets have grown more slowly than foreign-held direct and portfolio investment of private investors.

The value of investments abroad by private U.S. persons has grown from $693 billion in 1980 to $8.78 trillion in 2004.[165] This growth has not been as rapid as the growth in the value of investments by foreign persons in the United States. As has been the case for foreign investors in U.S. assets, over the past decade U.S. investors' portfolio holdings of foreign assets has increased more rapidly than U.S. foreign direct investment. At year-end 2004, U.S. foreign direct investment constituted approximately one-quarter of U.S. ownership of foreign assets, with foreign direct investment valued at $2.38 trillion and portfolio investment valued at $6.41 trillion (with direct investment measured at current cost). Measured at current cost, the value of U.S. direct investment abroad has remained above the value of foreign direct investment in the United States. (See Figure 11) Measured at market value, the value of foreign direct investment in the

[164] This values the direct investment at current cost. The Bureau of Economic Analysis estimate for 2004 when valued at market value is $2.69 trillion.

[165] This figure values the direct investment at current cost.

United States and the value of U.S. direct investment abroad were estimated to have been comparable for 1998-2002, but recent preliminary estimates place the value of U.S. owned foreign direct investment in excess of foreign owned direct investments in the United States. (See Figure 12)

Figure 11

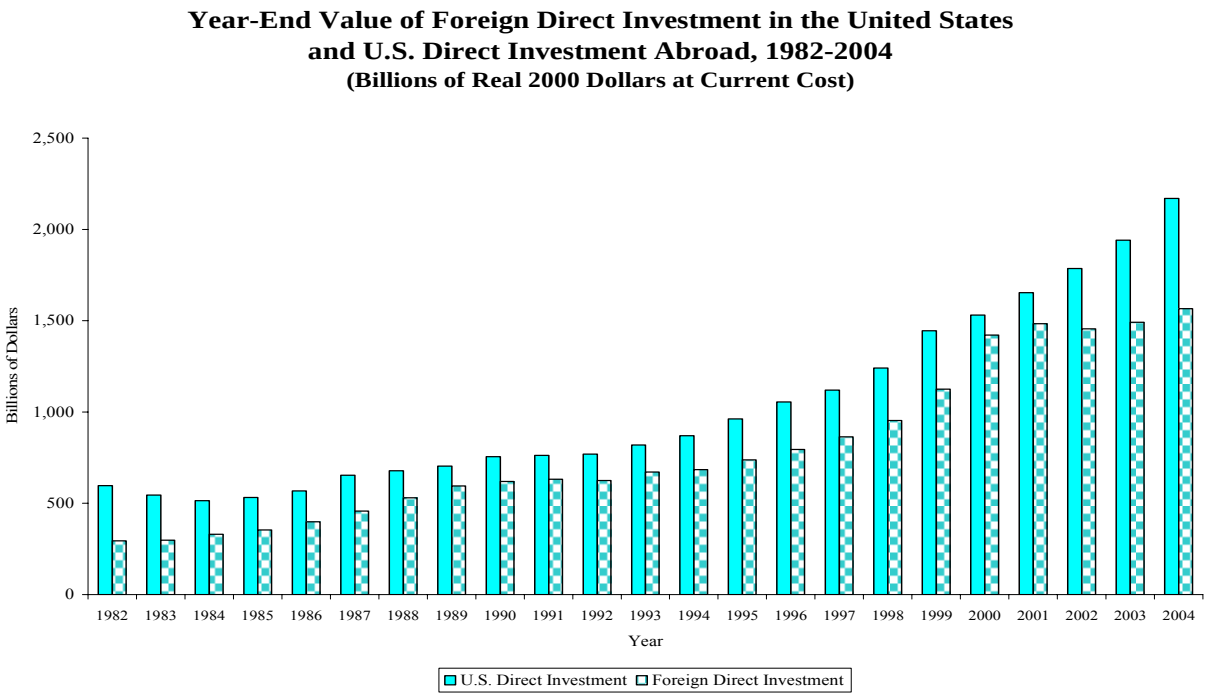
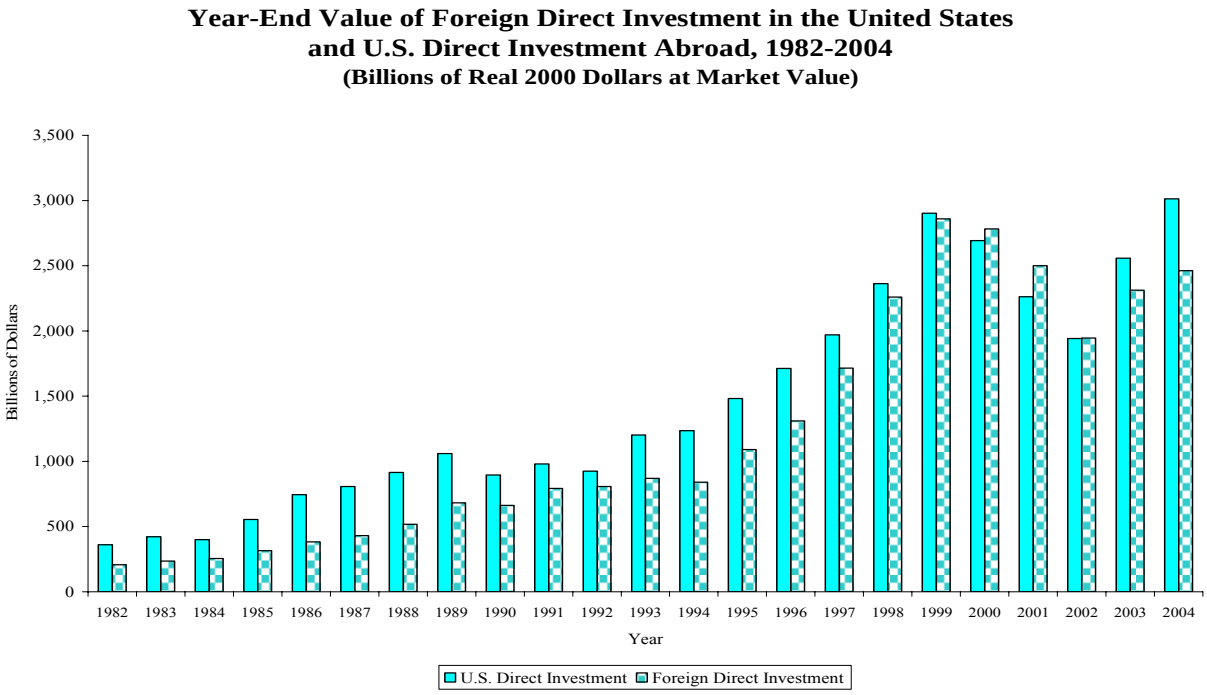


Figure 12



Source: Department of Commerce, Bureau of Economic Analysis.