DESCRIPTION AND ANALYSIS OF PRESENT-LAW RULES RELATING TO INTERNATIONAL TAXATION

Scheduled for a Hearing

Before the

HOUSE COMMITTEE ON WAYS AND MEANS

on June 30, 1999

Prepared by the Staff

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CONTENTS

INTRODUCTION

The House Committee on Ways and Means has scheduled a public hearing on June 30, 1999, on international tax issues. This document,[1] prepared by the staff of the Joint Committee on Taxation, provides a description of certain aspects of present law and issues relating to international taxation.

Part I of this document is a summary. Part II provides a description of certain present-law income tax rules that apply to U.S. persons doing business abroad and foreign persons doing business in the United States. Part III contains background and data relating to international trade and investment. Part IV is an analysis of issues relating to international investment. Part V is a summary of the taxation of foreign income in the United Kingdom, Germany, and Japan. The Appendix presents data used in Figures 1-7 and 10.

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[1] This document may be cited as follows: Joint Committee on Taxation, *Description and Analysis of Present-Law Rules Relating to International Taxation* (JCX-40-99), June 28, 1999.

I. SUMMARY

Present law

Under the present-law Federal income tax system, U.S. persons are subject to U.S. income tax on all income, whether derived in the United States or abroad. However, the United States generally allows a credit against the U.S. tax imposed on income derived from foreign sources for foreign income taxes imposed on such income. Foreign persons are subject to U.S. tax only on income that has a sufficient connection to the United States.

Within this basic framework, there are a variety of rules that affect the U.S. taxation of international transactions. Detailed rules govern the determination of the source of income and the allocation and apportionment of expenses between foreign-source and U.S.-source income. Such rules are relevant not only for purposes of determining the U.S. taxation of foreign persons (because foreign persons are subject to U.S. tax only on income that is from U.S. sources or otherwise has sufficient U.S. nexus), but also for purposes of determining the U.S. taxation of U.S. persons (because the U.S. tax on a U.S. person's foreign-source income may be reduced or eliminated by foreign tax credits). Authority is provided for the reallocation of items of income and deduction between related persons in order to ensure the clear reflection of the income of each person and to prevent the evasion of tax. Although U.S. tax generally is not imposed on a foreign corporation that operates abroad, several anti-deferral regimes apply to impose current U.S. tax on certain income from foreign operations of a U.S.-owned foreign corporation.

An international transaction potentially gives rise to tax consequences in two (or more) countries. The tax treatment in each country generally is determined under the tax laws of the respective country. However, an income tax treaty between the two countries may operate to coordinate the two tax regimes and minimize the double taxation of the transaction. In this regard, the United States' network of bilateral income tax treaties includes provisions affecting both U.S. and foreign taxation of both U.S. persons with foreign income and foreign persons with U.S. income.

Trends in U.S. international trade and investment

Foreign trade has become increasingly important to the United States economy. Exports and imports each have risen from less than 6 percent of GDP in 1962 to more than 13.5 percent in 1998. 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.

Trade deficits, capital inflows, investment, savings, and income are all connected in the economy. 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).

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 1982, the United States changed from being a modest exporter of capital in relation to GDP to being a large importer of capital. In 1998, gross investment in the United States was $1,392 billion and net foreign investment was $213 billion, or 15.3 percent of gross domestic investment. The value of foreign assets owned by private U.S. persons has grown from $295.1 billion in 1980 to $4,237 billion in 1997. This growth in value has not been as rapid as the growth in the value of assets in the United States owned by foreign persons.

Issues relating to international investment

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.

If a system of residence taxation is the worldwide norm, 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, 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 where 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 of international taxation where income from investment located in each country is taxed at the same rate regardless of the residence of the investor.

Some commentators refer to the principle of capital import neutrality as promoting "competitiveness." This notion of competitiveness refers to the ability of U.S. multinationals (firms 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. 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 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, many provisions work at cross purposes. Some provisions of current law favor outbound investment, while others discourage it.

II. PRESENT LAW

A. U.S. Taxation of U.S. Persons with Foreign Income

1. Overview

The United States taxes U.S. citizens, residents, and corporations (collectively, U.S. persons) on all income, whether derived in the United States or elsewhere. By contrast, the United States taxes nonresident alien individuals and foreign corporations only on income with a sufficient nexus to the United States.

The United States generally cedes the primary right to tax income derived from sources outside the United States to the foreign country where such income is derived. Thus, a credit against the U.S. income tax imposed on foreign-source taxable income is provided for foreign taxes paid on that income. In order to implement the rules for computing the foreign tax credit, the Code and the regulations thereunder set forth an extensive set of rules governing the determination of the source, either U.S. or foreign, of items of income and the allocation and apportionment of items of expense against such categories of income.

The tax rules of foreign countries that apply to foreign income of U.S. persons vary widely. For example, some foreign countries impose income tax at higher effective rates than those of the United States. In such cases, the foreign tax credit allowed by the United States is likely to eliminate any U.S. tax on income from a U.S. person's operations in the foreign country. On the other hand, operations in countries that have low statutory tax rates or generous deduction allowances or that offer tax incentives (e.g., tax holidays) to foreign investors are apt to be taxed at effective tax rates lower than the U.S. rates. In such cases, after application of the foreign tax credit, a residual U.S. tax generally is imposed on income from a U.S. person's operations in the foreign country.

Under income tax treaties, the tax that otherwise would be imposed under applicable foreign law on certain foreign-source income earned by U.S. persons may be reduced or eliminated. Moreover, U.S. tax on foreign-source income may be reduced or eliminated by treaty provisions that treat certain foreign taxes as creditable for purposes of computing U.S. tax liability.

2. Foreign operations conducted directly

The tax rules applicable to U.S. persons that control business operations in foreign countries depend on whether the business operations are conducted directly (through a foreign branch, for example) or indirectly (through a separate foreign corporation). A U.S. person that conducts foreign operations directly includes the income and losses from such operations on the person's U.S. tax return for the year the income is earned or the loss is incurred. Detailed rules are provided for the translation into U.S. currency of amounts with respect to such foreign operations. The income from the U.S. person's foreign operations thus is subject to current U.S. tax. However, the foreign tax credit may reduce or eliminate the U.S. tax on such income.

3. Foreign operations conducted through a foreign corporation

a. In general

Income earned by a foreign corporation from its foreign operations generally is subject to U.S. tax only when such income is distributed to any U.S. persons that hold stock in such corporation. Accordingly, a U.S. person that conducts foreign operations through a foreign corporation generally is subject to U.S. tax on the income from those operations when the income is repatriated to the United States through a dividend distribution to the U.S. person. The income is reported on the U.S. person's tax return for the year the distribution is received, and the United States imposes tax on such income at that time. The foreign tax credit may reduce the U.S. tax imposed on such income.

A variety of complex anti-deferral regimes impose current U.S. tax on income earned by a U.S. person through a foreign corporation. Detailed rules for coordination among the anti-deferral regimes are provided to prevent the U.S. person from being subject to U.S. tax on the same item of income under multiple regimes.

The Code sets forth the following anti-deferral regimes: the controlled foreign corporation rules of subpart F (secs. 951-964); the passive foreign investment company rules (secs. 1291-1298); the foreign personal holding company rules (secs. 551-558); the personal holding company rules (secs. 541-547); the accumulated earnings tax rules (secs. 531-537); and the foreign investment company rules (sec. 1246). The operation and application of these regimes are briefly described in the following sections.

b. Controlled foreign corporations

<u>**General rules**</u>

U.S. 10-percent shareholders of a controlled foreign corporation (a "CFC") are required to include in income for U.S. tax purposes currently certain income of the CFC (referred to as "subpart F income"), without regard to whether the income is distributed to the shareholders (sec. 951(a)(1)(A)). In effect, the Code treats the U.S. 10-percent shareholders of a CFC as having received a current distribution of their pro rata shares of the CFC's subpart F income. In addition, the U.S. 10-percent shareholders of a CFC are required to include in income for U.S. tax purposes their pro rata shares of the CFC's earnings to the extent invested by the CFC in U.S. property (sec. 951(a)(1)(B)). The amounts included in income by the CFC's U.S. 10-percent shareholders under these rules are subject to U.S. tax currently. The U.S. tax on such amounts may be reduced through foreign tax credits.

For this purpose, a U.S. 10-percent shareholder is a U.S. person that owns 10 percent or more of the corporation's stock (measured by vote) (sec. 951(b)). A foreign corporation is a CFC if U.S. 10-percent shareholders own more than 50 percent of such corporation's stock (measured by vote or by value) (sec. 957).[2]

In determining stock ownership for purposes of the subpart F rules, a U.S. person generally is considered to own a proportionate share of stock owned, directly or indirectly, by or for a foreign corporation, foreign partnership, or foreign trust or estate of which the U.S. person is a shareholder, partner, or beneficiary (sec. 958(a)). In addition, constructive ownership rules apply for purposes of determining whether a U.S. person is a U.S. 10-percent shareholder, whether a foreign corporation is a CFC, and whether two persons are related, but not for purposes of requiring the inclusion of amounts with respect to the CFC in a U.S. shareholder's gross income (secs. 958(b) and 318(a)).

Earnings and profits of a CFC that have been included in income by the U.S. 10-percent shareholders are not taxed again when such earnings are actually distributed to such shareholders (sec. 959(a)(1)). Similarly, previously-taxed earnings are not included in income by the U.S. 10-percent shareholders in the event that such earnings are invested by the CFC in U.S. property (sec. 959(a)(2)). In the event that stock in the CFC is transferred subsequent to an income inclusion by a U.S. 10-percent shareholder but prior to the actual distribution of previously taxed income, the transferee shareholder generally is similarly exempt from U.S. tax on the distribution.

Subpart F income

In general

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

The subpart F income of a CFC is limited to its current earnings and profits (sec. 952(c)). Under this rule, current deficits in earnings and profits in any income category reduce the CFC's subpart F income. In addition, accumulated deficits in a CFC's earnings and profits generated by

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[2] A broader definition of a CFC applies in the case of a foreign corporation engaged in certain insurance activities (see secs. 953(c) and 957(b)).

certain activities in prior years may be used to reduce the CFC's subpart F income generated by similar activities in the current year.

Pursuant to a de minimis rule, generally none of a CFC's income for a taxable year is treated as foreign base company income or subpart F insurance income if the CFC's gross foreign base company income and gross subpart F insurance income total less than the lesser of 5 percent of the CFC's gross income or $1 million (sec. 954(b)(3)(A)). Pursuant to a full inclusion rule, if more than 70 percent of a CFC's gross income is foreign base company income and/or subpart F insurance income, generally all of the CFC's income is treated as foreign base company income or subpart F insurance income (whichever is appropriate) (sec. 954(b)(3)(B)). Under an elective exception for income that is subject to high foreign taxes, foreign base company income and subpart F insurance income generally do not include items of income received by the CFC that the taxpayer establishes were subject to an effective foreign tax rate greater than 90 percent of the maximum U.S. corporate tax rate (sec. 954(b)(4)).

Foreign base company income

Foreign base company income includes five categories of income: foreign personal holding company income, foreign base company sales income, foreign base company services income, foreign base company shipping income, and foreign base company oil related income (sec. 954(a)). In computing foreign base company income, income in these five categories is reduced by allowable deductions properly allocable to such income (sec. 954(b)(5)).

Foreign personal holding company income

One major category of foreign base company income is foreign personal holding company income (sec. 954(c)). For subpart F purposes, foreign personal holding company income generally consists of the following: (1) dividends, interest, royalties, rents and annuities; (2) net gains from the sale or exchange of (a) property that gives rise to the preceding types of income, (b) property that does not give rise to income, and (c) interests in trusts, partnerships, and REMICS; (3) net gains from commodities transactions; (4) net gains from foreign currency transactions; (5) income that is equivalent to interest; (6) income from notional principal contracts; and (7) payments in lieu of dividends.

Subpart F foreign personal holding company income generally includes the excess of gains over losses from sales and exchanges of non-income producing property and property that gives rise to certain passive income (sec. 954(c)(1)(B)). However, an exclusion is provided for gains and losses from the sale or exchange of property that is inventory property in the hands of the CFC. Also excluded are gains and losses from the sale or exchange of property (including gains or losses arising out of bona fide hedging transactions) by a CFC that is a regular dealer in such property. A temporary exclusion also applies to gains and losses from the sale or exchange of property that gives rise to dividends, interest, rents, royalties, or annuities if such property gives rise to certain active financing income (secs. 954(c)(1)(B) and 954(h) and (i)).

Subpart F foreign personal holding company income generally includes the excess of gains over losses from transactions (including futures, forward, and similar transactions) in any commodities (sec. 954(c)(1)(C)). However, exceptions are provided for gains and losses from certain bona fide hedging transactions and certain active business transactions.

Subpart F foreign personal holding company income generally includes the excess of foreign currency gains over foreign currency losses attributable to section 988 transactions (sec. 954(c)(1)(D)). An exception is provided for hedging and other transactions directly related to the business needs of the CFC.

Subpart F foreign personal holding income generally includes net income from notional principal contracts (sec. 954(c)(1)(F)). However, income, gain, deduction or loss from a notional principal contract entered into to hedge an item of income in another category of foreign personal holding company income is included in that other category.

Subpart F foreign personal holding company income does not include rents and royalties received by the CFC in the active conduct of a trade or business from unrelated persons (sec. 954(c)(2)(A)). Also generally excluded are dividends and interest received by the CFC from a related corporation organized and operating in the same foreign country in which the CFC was organized, and rents and royalties received by the CFC from a related corporation for the use of property within the country in which the CFC was organized (sec. 954(c)(3)). However, interest, rent, and royalty payments do not qualify for this exclusion to the extent that such payments reduce subpart F income of the payor.

Temporary exceptions from foreign personal holding company income (as well as foreign base company services income) apply for subpart F purposes for certain income that is derived in the active conduct of a banking, financing, or similar business, or in the conduct of an insurance business (so-called "active financing income") (sec. 954(h) and (i)). These exceptions for active financing income are applicable only for taxable years beginning in 1999.[3]

The 1999 exceptions from subpart F foreign personal holding company income apply to income derived in the active conduct of a banking, financing, or similar business by a CFC that is predominantly engaged in such business and that conducts substantial activity with respect to such business. Detailed rules apply in determining whether the predominantly engaged and substantial activity requirements are satisfied, as well as whether income is treated as derived in the active conduct of a banking, financing, or similar business. In addition, certain nexus

[3] Temporary exceptions from foreign personal holding company income (as well as foreign base company services income) applied for subpart F purposes for certain income derived in the active conduct of a banking, financing, insurance, or similar business, only for taxable years beginning in 1998. Those exceptions were extended and modified as part of the present-law provision.

requirements apply, which provide that income derived by a CFC or a qualified business unit ("QBU") of a CFC from transactions with customers is eligible for the exceptions if, among other things, substantially all of the activities in connection with such transactions are conducted directly by the CFC or QBU in its home country, and such income is treated as earned by the CFC or QBU in its home country for purposes of such country's tax laws. Moreover, the 1999 exceptions apply to income derived from certain cross border transactions, provided that certain additional requirements are met. Additional temporary exceptions from foreign personal holding company income apply for certain income derived by a securities dealer within the meaning of section 475 and for gain from the sale of active financing assets.

The 1999 provision also provides a temporary exception from foreign personal holding company income for certain investment income derived by a qualifying insurance company and by certain qualifying insurance company branches. The exception applies to income (received from a person other than a related person) from investments made by a qualifying insurance company or qualifying insurance company branch of its reserves allocable to exempt contracts or 80 percent of its unearned premiums from exempt contracts.[4]

In addition, temporary and proposed regulations treat certain payments under certain hybrid arrangements as subpart F foreign personal holding company income. The regulations were issued under Notice 98-11. That Notice, issued on January 16, 1998, stated that the Treasury Department and the Internal Revenue Service have concluded that the use of certain arrangements involving hybrid branches is contrary to the policy and rules of subpart F. The hybrid branch arrangements identified in Notice 98-11 involve structures that are characterized for U.S. tax purposes as branches of a CFC but are characterized for purposes of the tax law of the country in which the CFC is incorporated as a separate entity. Notice 98-11 stated that regulations would provide that the branch and the CFC would be treated as separate corporations for subpart F purposes, with the result that the regulations would treat certain payments made between a hybrid branch and a CFC as subpart F income taxable to the CFC's U.S. 10-percent shareholders.

Under the Notice 98-11 regulations, issued on March 23, 1998, certain payments between a CFC and its hybrid branch or between hybrid branches of the CFC (so-called "hybrid branch payments") are treated as giving rise to subpart F income. The regulations generally provide that non-subpart F income of the CFC, in the amount of the hybrid branch payment, is recharacterized as subpart F income of the CFC if: (1) the hybrid branch payment reduces the foreign tax of the payor, (2) the hybrid branch payment would have been foreign personal holding company income if made between separate CFCs, and (3) there is a disparity between the effective tax rate on the payment in the hands of the payee and the effective tax rate that would have applied if the income had been taxed in the hands of the payor. The regulations also apply to other hybrid branch arrangements involving a partnership, including a CFC's

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[4] A 1999 exception from insurance income also is provided, as described below.

proportionate share of any hybrid branch payment made between a partnership in which the CFC is a partner and a hybrid branch of the partnership or between hybrid branches of such a partnership. Under the regulations, if a partnership is treated as fiscally transparent by the CFC's taxing jurisdiction, the recharacterization rules are applied by treating the hybrid branch payment as if it had been made directly between the CFC and the hybrid branch, or as if the hybrid branches of the partnership were hybrid branches of the CFC, as applicable. If the partnership is treated as a separate entity by the CFC's taxing jurisdiction, the recharacterization rules are applied to treat the partnership as if it were a CFC.

The regulations also address the application of the same-country exception to the foreign personal holding company income rules under subpart F in the case of certain hybrid branch arrangements. Under the regulations, the same-country exception applies to payments by a CFC to a hybrid branch of a related CFC only if the payment would have qualified for the exception if the hybrid branch had been a separate CFC incorporated in the jurisdiction in which the payment is subject to tax (other than a withholding tax). The regulations provide additional rules regarding the application of the same-country exception in the case of certain hybrid arrangements involving a partnership.

In Notice 98-35, issued on June 19, 1998, the Treasury Department and the Internal Revenue Service withdrew Notice 98-11 and announced their intention to withdraw the related temporary and proposed regulations under Notice 98-11, and to reissue proposed regulations on hybrid transactions to be finalized no earlier than January 1, 2000. To date, the temporary and proposed regulations issued under Notice 98-11 have not been withdrawn.

Under Notice 98-35, future proposed regulations will treat certain payments under hybrid transactions as giving rise to subpart F income under circumstances similar to those in the temporary and proposed regulations under Notice 98-11, with certain modifications including certain grandfathering and transition rules. In this regard, Notice 98-35 states that proposed regulations on hybrid transactions (whether through branches or partnerships) will not be finalized before January 1, 2000, and when finalized, generally will be effective for payments made on or after June 19, 1998, under hybrid arrangements.[5] However, the Notice states that the proposed regulations will not be effective for payments made under hybrid arrangements entered into before June 19, 1998, so long as the arrangement is not substantially modified on or after that date.

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[5] The temporary and proposed regulations under Notice 98-11 generally provide that the rules apply to amounts paid or accrued pursuant to hybrid branch arrangements entered into or substantially modified on or after January 16, 1998. In the case of certain hybrid arrangements involving partnerships, the Notice 98-11 regulations generally provide that the rules apply to amounts paid or accrued pursuant to such arrangements entered into or substantially modified on or after March 23, 1998.

In addition, Notice 98-35 provides transitional relief for certain qualifying hybrid branch payments made under hybrid arrangements entered into on or after June 19, 1998, and before the date the regulations are finalized. In this regard, Notice 98-35 states that proposed regulations will not apply to such payments earlier than the first taxable year of the U.S. shareholder beginning on or after the expiration of five calendar years from the date the regulations are finalized (i.e., no earlier than taxable years beginning on January 1, 2005). The Notice states that this transition rule applies for so long as the arrangement is not substantially modified after the date the regulations are finalized. For purposes of the transition relief, the Notice provides that a qualifying hybrid branch payment is a payment that is attributable to a U.S. shareholder that would otherwise generally be recharacterized as subpart F income under the proposed regulations, but that when aggregated with all other such payments attributable to such U.S. shareholder for a particular country in a taxable year, does not exceed a maximum payment limit attributable to the U.S. shareholder. The Notice states that the maximum payment limit attributable to the U.S. shareholder for a country is 50 percent of the total non-subpart F earnings and profits amount of CFCs or qualified business units in that country and that is owned by such shareholder on June 19, 1998 (the "non-subpart F earnings and profits amount"). The non-subpart F earnings and profits amount generally is defined as the highest of the CFC's or qualified business unit's non-subpart F earnings and profits for any of its last seven taxable years ending before June 19, 1998. In the case of certain newly established businesses, the Notice provides that the U.S. shareholder may elect to treat its non-subpart F earnings and profits amount as equal to 20 percent of the net active equity of the business on June 19, 1998. The Notice also provides special rules relating to qualifying hybrid branch payments in the case of a CFC that is not wholly-owned by a U.S. shareholder.

<u>Foreign base company sales and services income</u>

Foreign base company income also includes foreign base company sales and services income. Foreign base company sales income generally consists of sales income of a CFC located in a country that is neither the origin nor the destination of the goods with respect to sales of property purchased from or sold to a related person (sec. 954(d)). Foreign base company services income consists of income from services performed outside the CFC's country of incorporation for or on behalf of a related party (sec. 954(e)).

A special branch rule applies only for purposes of determining a CFC's foreign base company sales income. Under this rule, a branch of a CFC is treated as a separate corporation where the activities of the CFC through the branch outside the CFC's country of incorporation have substantially the same effect as if such branch were a subsidiary (sec. 954(d)(2)).

For purposes of the subpart F rules, a related person is defined as any individual, corporation, trust, or estate that controls or is controlled by the CFC, or any individual, corporation, trust, or estate that is controlled by the same person or persons that control the CFC (sec. 954(d)(3)). Control with respect to a corporation means ownership of more than 50 percent of the corporation's stock (by vote or value). Control with respect to a partnership, trust, or estate means ownership of more than 50 percent of the value of the beneficial interests of the partnership, trust, or estate. Indirect and constructive ownership rules apply.

Foreign base company shipping income

Foreign base company income includes foreign base company shipping income. Foreign base company shipping income consists of income derived from (1) the use (or hiring or leasing for use) of any aircraft or vessel in foreign commerce, (2) the performance of services directly related to the use of any such aircraft or vessel, or (3) the sale, exchange or other disposition of any such aircraft or vessel (sec. 954(f)). Foreign base company shipping income also includes any income derived from certain space or ocean activities.

Foreign base company oil related income

Foreign base company income includes foreign base company oil related income (i.e., income other than extraction income). Foreign base company oil related income generally includes all oil related income, other than income derived from a source within a foreign country in connection with either (1) oil or gas that was extracted from a well located in that foreign country, or (2) oil, gas, or a primary product of oil or gas that is sold by the CFC or a related person for use or consumption within that foreign country, or is loaded in that country on a vessel or aircraft as fuel for such vessel or aircraft (sec. 954(g)). An exception is available for any CFC that, together with related persons, does not constitute a large oil producer.

Insurance income

Insurance income subject to current inclusion under the subpart F rules generally includes any income of a CFC attributable to the issuing or reinsuring of any insurance or annuity contract in connection with risks located in a country other than the CFC's country of organization (sec. 953(a)). Subpart F insurance income also includes income attributable to an insurance contract in connection with risks located within the CFC's country of organization, as the result of an arrangement under which another corporation receives a substantially equal amount of consideration for insurance of other-country risks. Investment income of a CFC that is allocable to any insurance or annuity contract related to risks located outside the CFC's country of organization is taxable as subpart F insurance income (Prop. Treas. Reg. sec. 1.953-1(a)).

Subpart F insurance income that is related person insurance income generally is taxable under subpart F to an expanded category of U.S. persons (sec. 953(c)). For purposes of taking into account such income under the subpart F provisions, the U.S. ownership threshold for CFC status is 25 percent or more. Any U.S. person who owns (directly or indirectly) stock in the foreign corporation, whatever the degree of ownership, is taken into account in applying this threshold and is subject to current U.S. tax on the CFC's related person insurance income. Certain exceptions apply to these special subpart F rules with respect to related person insurance. For this purpose, related person insurance income is insurance income attributable to a policy of insurance or reinsurance where the insured is a U.S. shareholder of the CFC (or related to such shareholder).

A special exception from insurance income applies for the first taxable year beginning in 1999.[6] The 1999 exception from insurance income applies for income derived by a qualifying insurance company that is attributable to the issuing (or reinsuring) of an exempt contract by the qualifying insurance company or a qualifying insurance company branch of such a company, and that is treated as earned by the company or branch in that company's, or branch's, home country for purposes of that country's tax laws. An exempt contract is an insurance or annuity contract issued or reinsured by a qualifying insurance company or qualified insurance company branch in connection with property in, liability arising out of activity in, or the lives or health of residents of, a country other than the United States. No contract is treated as an exempt contract unless the qualifying insurance company or branch derives more than 30 percent of its net written premiums from exempt contracts (determined without regard to this sentence) covering applicable home country risks, and with respect to which no policyholder, insured, annuitant, or beneficiary is a related person (within the meaning of sec. 954(d)(3)).

Under the 1999 exception, a qualifying insurance company is a CFC that meets three requirements that are intended to distinguish firms that have a real business nexus with a foreign country or countries from firms that do not. The first requirement is that the CFC be subject to regulation as an insurance (or reinsurance) company by its home country, and that the CFC be licensed, authorized, or regulated by the applicable insurance regulatory body for its home country to sell insurance, reinsurance, or annuity contracts to persons other than related persons (within the meaning of sec. 954(d)(3)) in its home country. The second requirement is that the CFC derive more than 50 percent of its aggregate net written premiums from the insurance or reinsurance by the CFC (on an aggregate basis, including qualifying insurance company branches) covering applicable home country risks (as described above) of the CFC or branch, as the case may be. The third requirement is that the CFC be engaged in the insurance business and that it would be subject to tax under subchapter L if it were a domestic corporation.

The 1999 exception imposes additional requirements with respect to any contract that covers cross border risks (that is, risks other than applicable home country risks), due to the increased concern about mobility of income in cross border business. A contract issued by a qualifying insurance company or qualifying insurance company branch that covers risks other than applicable home country risks is not treated as an exempt contract unless such company or branch, as the case may be, (1) conducts substantial activity in its home country with respect to the insurance business, and (2) performs in its home country substantially all of the activities necessary to give rise to the income generated by the contract.

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[6] Investment income attributable to premiums that constitute same-country insurance income may be includable in the gross income of the U.S. shareholder of a CFC as foreign personal holding company income (Prop. Treas. Reg. sec. 1.953-1(a)).

Other subpart F income

Subpart F income also includes three categories of income relating to international boycotts and other violations of public policy. The first category consists of the portion of the CFC's current income, other than amounts otherwise subject to current U.S. taxation, that is treated as attributable to participation in an international boycott (sec. 952(a)(3)). The second category consists of any illegal bribes, kickbacks, or other payments by or on behalf of the corporation directly or indirectly to an official, employee, or agent in fact of a government (sec. 952(a)(4)). The third category consists of income derived from any foreign country during a period in which the taxes imposed by that country are denied eligibility for the foreign tax credit pursuant to the implementation of U.S. foreign policy (sec. 952(a)(5)).

Treatment of investments in U.S. property

As discussed above, the U.S. 10-percent shareholders of a CFC generally are subject to U.S. tax currently on their pro rata shares of the CFC's subpart F income. In addition, the U.S. 10-percent shareholders of a CFC are subject to U.S. tax currently on their pro rata shares of the CFC's earnings to the extent invested by the CFC in U.S. property.

A shareholder's current income inclusion with respect to a CFC's investment in U.S. property for a taxable year is the shareholder's pro rata share of an amount equal to the lesser of (1) the CFC's average investment in U.S. property for such year, to the extent that such investment exceeds the foreign corporation's earnings and profits that were previously taxed on that basis, or (2) the CFC's current or accumulated earnings and profits, reduced by distributions during the year and by earnings that have been taxed previously as earnings invested in U.S. property (secs. 956 and 959). An income inclusion is required only to the extent that the amount so calculated exceeds the amount of the CFC's earnings that have been previously taxed as subpart F income (secs. 951(a)(1)(B) and 959).

The U.S. property held (directly or indirectly) by a CFC must be measured as of the close of each quarter in the taxable year (sec. 956(a)). The amount taken into account with respect to any property is the property's adjusted basis as determined for purposes of reporting the CFC's earnings and profits, reduced by any liability to which the property is subject.

For purposes of section 956, U.S. property generally is defined to include tangible property located in the United States, stock of a U.S. corporation, an obligation of a U.S. person, and the right to use certain intellectual property in the United States (sec. 956(c)(1)). Specified exceptions are provided for, among other things, obligations of the United States, U.S. bank deposits, certain export property, certain trade or business obligations, stock or debt of certain unrelated U.S. corporations, and certain deposits or receipts of collateral or margin by, and certain repurchase or reverse repurchase agreement transactions entered into by or with, a securities or commodities dealer in the ordinary course of the dealer's business (sec. 956(c)(2)).

Gain from sales or exchanges of stock of certain foreign corporations

If a U.S. person sells or exchanges stock in a foreign corporation, or receives a distribution from a foreign corporation that is treated as an exchange of stock, and, at any time during the five-year period ending on the date of the sale or exchange, the foreign corporation was a CFC and the U.S. person was a U.S. 10-percent shareholder, any gain recognized on the sale or exchange generally is recharacterized as dividend income, to the extent of the earnings and profits of the foreign corporation accumulated during the period that the shareholder held stock while the corporation was a CFC (sec. 1248). In addition, if a CFC is treated as having gain from the sale or exchange of stock in a foreign corporation, the gain is treated as a dividend to the same extent that it would have been so treated under section 1248 if the CFC were a U.S. person.

For this purpose, earnings and profits of the foreign corporation do not include amounts that already were subject to U.S. tax (whether imposed on the foreign corporation itself or on the U.S. 10-percent shareholders) (sec. 1248(d)). Detailed rules govern the application of section 1248 in the case of (1) sales or exchanges of certain U.S. stock, (2) certain nonrecognition transactions involving a foreign corporation, and (3) certain indirect transfers of stock of a foreign corporation.

c. Passive foreign investment companies

General rules

The Tax Reform Act of 1986 established an anti-deferral regime applicable to U.S. persons that hold stock in a passive foreign investment company (a "PFIC"). A U.S. shareholder of a PFIC generally is subject to U.S. tax, plus an interest charge that reflects the value of the deferral of tax, upon receipt of a distribution from the PFIC or upon a disposition of PFIC stock. However, if a "qualified electing fund" election is made, the U.S. shareholder is subject to U.S. tax currently on the shareholder's pro rata share of the PFIC's total earnings; a separate election may be made to defer payment of such tax, subject to an interest charge, on income not currently received by the shareholder. In addition, with respect to PFIC stock that is marketable, electing shareholders currently take into account as income (or loss) the difference between the fair market value of their PFIC stock as of the close of the taxable year and their adjusted basis in such stock (subject to certain restrictions).

Constructive ownership rules apply in determining whether a U.S. person owns stock in a PFIC (sec. 1298(a)). Under these rules, a U.S. person generally is treated as owning such person's proportionate share of PFIC stock (1) owned by a partnership, trust or estate of which the person is a partner or beneficiary, (2) owned by a corporation of which the person is a 50-percent or greater shareholder (measured by value), or (3) owned by another PFIC of which the person is a shareholder.

Qualification as a PFIC

A foreign corporation is a PFIC if (1) 75 percent or more of its gross income for the taxable year consists of passive income, or (2) 50 percent or more of the average assets of the corporation consists of assets that produce, or are held for the production of, passive income (sec. 1297(a)). The 50-percent PFIC asset test generally is applied using fair market value for purposes of measuring the PFIC's assets (sec. 1297(f)). For this purpose, fair market value is used for a foreign corporation that is publicly traded. A foreign corporation is treated as publicly traded if stock in such corporation is regularly traded on a national securities exchange that is registered with the Securities Exchange Commission, the national market system established pursuant to applicable securities laws, or any other exchange or market that the Treasury Secretary determines has rules that adequately ensure a sound fair market value for the market price of the stock. However, in the case of a foreign corporation that is a CFC that is not publicly traded (or any other foreign corporation that so elects), the asset test for PFIC status is applied using the adjusted bases of the corporation's assets rather than their fair market value (sec. 1297(f)(2)).

For this purpose, passive income generally means income that satisfies the definition of foreign personal holding company income under the subpart F provisions (sec. 1297(b)). However, except as provided in regulations, passive income does not include certain active-business banking or insurance income. Also excluded from the definition of passive income is certain active-business securities income.

Special exceptions from PFIC classification apply to start-up companies (sec. 1298(b)(2)) and corporations changing businesses during the taxable year (sec. 1298(b)(3)). In both such cases, the corporation may have a substantially higher proportion of passive assets (and passive income, in some cases) than at other times in its history.

In determining whether a foreign corporation that owns a subsidiary is a PFIC, look-through treatment is provided in certain cases. A foreign corporation that owns, directly or indirectly, at least 25 percent of the value of the stock of another corporation is treated as owning a proportionate part of the other corporation's assets and income. Thus, amounts such as interest and dividends received from foreign or domestic subsidiaries are eliminated from the parent's income in applying the income test, and the stock or debt investment is eliminated from the parent's assets in applying the asset test. A special rule treats as active assets certain U.S. stock investments of a 25-percent owned U.S. corporation (sec. 1298(b)(8)). In addition to the rules applicable to 25-percent-owned subsidiaries, interest, dividends, rents, and royalties received from related persons are excepted from treatment as passive income to the extent that such amounts are allocable to income of the payor that is not passive income (sec. 1297(b)(2)(C)).

Treatment of nonqualified funds

In the absence of a qualified electing fund election, a U.S. shareholder of a PFIC is subject to U.S. tax and an interest charge at the time the shareholder receives an "excess" distribution from the PFIC or disposes of stock in the PFIC (sec. 1291). Under this rule, gain recognized on receipt of an "excess" distribution or on disposition of PFIC stock generally is treated as ordinary income earned pro rata over the shareholder's holding period with respect to the PFIC stock, and is taxed at the highest applicable tax rate in effect for each respective year. Interest is imposed at the underpayment rate on the tax liability with respect to amounts allocated to prior taxable years. Special rules apply for purposes of computing foreign tax credits with respect to such distributions (sec. 1291(g)).

An "excess" distribution is any distribution during the current taxable year that exceeds 125 percent of the average amount of distributions received during the three preceding years (or, if shorter, the taxpayer's holding period prior to the current taxable year) (sec. 1291(b)). The determination of an excess distribution excludes from the three-year average distribution base that part of a prior-year excess distribution that is considered attributable to deferred earnings. There are no excess distributions for the first year in the U.S. shareholder's holding period.

Treatment of qualified electing funds

A U.S. person that owns stock in a PFIC may elect that the PFIC be treated as a "qualified electing fund" with respect to that shareholder (sec. 1295). Under such election, the U.S. shareholder must include currently in gross income the shareholder's pro rata share of the PFIC's total earnings and profits (sec. 1293). This inclusion rule generally requires current payment of tax, absent a separate election to defer payment of the tax (sec. 1294).

The amount currently included in the income of an electing shareholder is divided between the shareholder's pro rata share of the ordinary earnings of the PFIC and the shareholder's pro rata share of the net capital gain of the PFIC (sec. 1293(a)(1)). The characterization of income, and the determination of earnings and profits, generally is made pursuant to general Code rules (sec. 1293(e)).

A U.S. shareholder's pro rata share of income generally is determined by attributing the PFIC's income for the taxable year ratably over the days in such year (sec. 1293(b)). Electing shareholders include in income for the period in which they held stock in the PFIC an amount equal to the sum of their daily ownership interest in the PFIC multiplied by the income attributed to such day. If it is established that a PFIC maintains records determining its shareholders' pro rata shares of income more accurately than by allocating a year's income ratably on a daily basis, the shareholders' pro rata shares of income may be determined on that basis.

The distribution of earnings and profits that were previously included in the income of an electing U.S. shareholder under these rules is not taxed as a dividend to the shareholder (sec. 1293(c)). The basis of an electing U.S. shareholder's stock in a PFIC is increased by amounts currently included in income under these rules, and is decreased by any amount that is actually distributed but treated as previously taxed (sec. 1293(d)).

Special rules apply in cases where a U.S. shareholder makes the qualified electing fund election with respect to the PFIC after the beginning of the shareholder's holding period with respect to the PFIC (i.e., where the PFIC is a nonqualified fund with respect to the shareholder for some period before the shareholder makes the election) (sec. 1291(d)).

Foreign tax credits are allowed against U.S. tax on amounts included in income from a qualified electing fund to the same extent, and under the same rules, as in the case of income inclusions from a CFC (sec. 1293(f)). Special rules apply in characterizing such income inclusions from qualified electing funds for foreign tax credit purposes.

U.S. shareholders generally may elect to defer the payment of U.S. tax on amounts that are included currently in income but for which no current distribution has been received (sec. 1294). An election to defer tax is treated as an extension of time to pay tax for which a U.S. shareholder is liable for interest. The disposition of stock in a PFIC terminates all previous extensions of time to pay tax with respect to the earnings attributable to that stock. Any transfer of ownership generally is treated as a disposition for this purpose, regardless of whether the transfer constitutes a realization or recognition event under general Code rules.

Elimination of overlap between subpart F and the PFIC provisions

A 10-percent U.S. shareholder that is subject to current inclusion under the subpart F rules with respect to stock of a PFIC that is also a CFC generally is not subject also to the PFIC provisions with respect to the same stock (sec. 1297(e)). In this regard, a corporation is not treated as a PFIC with respect to a shareholder during the qualified portion of the shareholder's holding period for the stock of such corporation. The qualified portion of the shareholder's holding period generally is the portion of such period which is after December 31, 1997, and during which the shareholder is a U.S. shareholder (withing the meaning of sec. 951(b)) and the corporation is a CFC (within the meaning of sec. 957). The PFIC provisions continue to apply in the case of a PFIC that is also a CFC to shareholders that are not subject to subpart F (i.e., to shareholders that are U.S. persons that own (directly, indirectly, or constructively) less than 10 percent of the corporation's stock by vote).[7]

The elimination of the overlap between the PFIC and CFC provisions does not apply to a shareholder of a corporation that was a PFIC with respect to such shareholder and that was a nonqualified fund, unless the shareholder makes an election to pay tax and an interest charge

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[7] The elimination of the overlap between the PFIC and CFC provisions generally does not apply to a U.S. person with respect to PFIC stock that such person is treated as owning by reason of an option to acquire such stock. However, the elimination of the overlap does apply to a U.S. person that holds an option to acquire stock if such stock is held by a person that is subject to the current inclusion rules of subpart F with respect to such stock and is not a tax-exempt person.

with respect to the unrealized appreciation in the stock or the accumulated earnings of the corporation (sec. 1298(b)(1)). If a shareholder is not subject to the PFIC provisions because the shareholder is subject to subpart F and the shareholder subsequently ceases to be subject to subpart F with respect to the corporation, the shareholder's holding period for such stock is treated as beginning immediately after such cessation for purposes of applying the PFIC rules (sec. 1297(e)).

For purposes of the PFIC provisions, attribution rules apply to the extent that the effect is to treat stock of a PFIC as owned by a U.S. person. In general, if 50 percent or more in value of the stock of a corporation is owned (directly or indirectly) by or for any person, such person is considered as owning a proportionate part of the stock owned directly or indirectly by or for such corporation, determined based on the person's proportionate interest in the value of such corporation's stock. However, this 50-percent limitation does not apply in the case of a corporation that is a PFIC; a person that is a shareholder of a PFIC is considered as owning a proportionate part of the stock owned directly or indirectly by or for such PFIC, without regard to whether such shareholder owns at least 50 percent of the PFIC's stock by value. These attribution rules apply without regard to the provision that treats a corporation as a non-PFIC with respect to a shareholder for the qualified portion of the shareholder's holding period. Accordingly, stock owned directly or indirectly by or for a corporation that is not treated as a PFIC for the qualified portion of the shareholder's holding period nevertheless will be attributed to such shareholder, regardless of the shareholder's ownership percentage of such corporation.

Mark-to-market election

A shareholder of a PFIC may make a mark-to-market election with respect to the stock of a PFIC, provided that such stock is marketable (sec. 1296). Under such an election, the shareholder includes in income each year an amount equal to the excess, if any, of the fair market value of the PFIC stock as of the close of the taxable year over the shareholder's adjusted basis in such stock. The shareholder is allowed a deduction for the excess, if any, of the adjusted basis of the PFIC stock over its fair market value as of the close of the taxable year. However, deductions generally are allowable under this rule to the extent of any net mark-to-market gains with respect to the stock included by the shareholder for prior taxable years.[8]

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[8] Deductions generally are allowable to the extent not only of prior mark-to-market inclusions under section 1296 but also of prior mark-to-market inclusions under a prior proposed Treasury regulation applicable to a regulated investment company that holds stock in a PFIC (Prop. Treas. Reg. sec. 1.1291-8). That proposed regulation recently was withdrawn in light of the enactment of section 1296(e)(2) as part of the Taxpayer Relief Act of 1997, which permits certain regulated investment companies to elect to mark-to-market their PFIC stock (See 64 Fed. Reg. 5015, February 2, 1999).

For purposes of this election, PFIC stock is considered marketable if it is regularly traded on a national securities exchange that is registered with the Securities Exchange Commission, or on the national market system established pursuant to applicable securities laws, or any other exchange or market that the Treasury Secretary determines has rules which adequately ensure a sound fair market value for the market price of the stock (sec. 1296(e)). PFIC stock also is treated as marketable, to the extent provided in regulations, if the PFIC offers for sale (or has outstanding) stock of which it is the issuer and which is redeemable at its net asset value in a manner comparable to a U.S. regulated investment company ("RIC").

In addition, PFIC stock owned by a RIC is treated as marketable for purposes of the election if the RIC offers for sale (or has outstanding) any stock of which it is the issuer and which is redeemable at its net asset value (sec. 1296(e)(2)). PFIC stock held by any other RIC is treated as marketable if the RIC otherwise publishes net asset valuations at least annually, except to the extent provided in regulations.

The shareholder's adjusted basis in marketable PFIC stock is adjusted to reflect the amounts included or deducted under this election (sec. 1296(b)). Amounts included in income pursuant to the election, as well as gain on the actual sale or other disposition of the PFIC stock, are treated as ordinary income (sec. 1296(c)). Ordinary loss treatment also applies to the deductible portion of any mark-to-market loss on the PFIC stock, as well as to any loss realized on the actual sale or other disposition of PFIC stock to the extent that the amount of such loss does not exceed the net mark-to-market gains previously included with respect to such stock. The source of amounts with respect to a mark-to-market election generally is determined in the same manner as if such amounts were gain or loss from the sale of stock in the PFIC (sec. 1296(c)).

A mark-to-market election applies to the taxable year for which made and all subsequent taxable years, unless the PFIC stock ceases to be marketable or the Treasury Secretary consents to the revocation of such election.

The PFIC rules for nonqualified funds generally do not apply to a shareholder of a PFIC if a mark-to-market election is in effect for the shareholder's taxable year.[9] However, in the case of a taxpayer that makes the mark-to-market election with respect to stock of a PFIC that is a nonqualified fund after the beginning of the taxpayer's holding period with respect to such stock, a coordination rule applies to ensure that the taxpayer does not avoid the interest charge with respect to amounts attributable to periods before the election (sec. 1296(j)). Similar coordination rules apply in the case of a taxpayer that marks to market PFIC stock under section 475 or any other provision after the beginning of the taxpayer's holding period for the PFIC stock. A similar rule applies to RICs that make the mark-to-market election after the beginning of their

[9] The PFIC rules for nonqualified funds also generally do not apply to a shareholder of a PFIC that has marked-to-market such stock under section 475 or any other provision.

holding period with respect to PFIC stock, to the extent the RIC had not previously marked to market the stock of the PFIC.

d. Foreign personal holding companies

The foreign personal holding company rules are aimed at preventing U.S. persons from accumulating income tax-free in foreign "incorporated pocketbooks." If a foreign corporation qualifies as a foreign personal holding company, all the U.S. shareholders of the corporation are subject to U.S. tax currently on their pro rata share of the corporation's undistributed foreign personal holding company income.

A foreign corporation is a foreign personal holding company if it satisfies both a stock ownership requirement and a gross income requirement (sec. 552(a)). The stock ownership requirement is satisfied if, at any time during the taxable year, more than 50 percent (measured by vote or by value) of the stock of the corporation is owned by or for five or fewer individual citizens or residents of the United States. Indirect and constructive ownership rules apply for purposes of the stock ownership requirement (sec. 554). The gross income requirement is satisfied initially if at least 60 percent of the corporation's gross income is foreign personal holding company income. Once the corporation qualifies as a foreign personal holding company, however, the gross income threshold for each subsequent year is only 50 percent, until the expiration of either one full taxable year during which the stock ownership requirement is not satisfied or three consecutive taxable years for which the gross income requirement is not satisfied at the 50-percent threshold (sec. 552(a)(1)).

Foreign personal holding company income generally includes passive income such as dividends, interest, certain royalties, and certain rents (sec. 553(a)). It also includes, among other things, gains (other than gains of dealers) from stock and securities transactions, gains (other than gains from bona fide hedging transactions) from commodities transactions, and amounts received with respect to certain personal services contracts. Look-through rules apply for purposes of characterizing certain dividends and interest received from related persons (sec. 552(c)).

If a foreign corporation is a foreign personal holding company, its undistributed foreign personal holding company income is treated as distributed as a dividend on a pro-rata basis to all of its U.S. shareholders (sec. 551(b)). The undistributed foreign personal holding company income that is deemed distributed is treated as recontributed by the shareholders to the foreign personal holding company as a contribution to capital. Accordingly, the earnings and profits of the corporation are reduced by the amount of the deemed distribution (sec. 551(d)), and each shareholder's basis in his or her stock in the foreign personal holding company is increased by the shareholder's pro rata portion of the deemed distribution (sec. 551(e)). If an item of income of a foreign corporation would be includible in the gross income of a U.S. shareholder under both the subpart F rules and the foreign personal holding company rules, that item of income is required to be included only under the subpart F rules (sec. 951(d)).

e. Personal holding companies

In addition to the corporate income tax, a tax is imposed at the rate of 39.6 percent on the undistributed personal holding company income of a personal holding company (sec. 541). This tax substitutes for the tax that would have been incurred by the shareholders on dividends actually distributed by the personal holding company.

A corporation generally is a personal holding company if (1) at least 60 percent of its adjusted gross income for the taxable year is personal holding company income, and (2) at any time during the last half of the taxable year more than 50 percent (by value) of its outstanding stock is owned, directly or indirectly, by or for not more than five individuals (sec. 542(a)). The definition of a personal holding company is very similar to that of a foreign personal holding company, discussed above, but does not depend on the U.S. citizenship or residence status of the shareholders. However, specified exceptions to the definition of a personal holding company preclude the application of the personal holding company tax to, among others, any foreign personal holding company, most foreign corporations owned solely by nonresident alien individuals, and any PFIC (sec. 542(c)(5), (7), and (10)). Notwithstanding these exceptions, the personal holding company tax is potentially applicable to a small class of closely-held foreign corporations.

f. Accumulated earnings tax

In addition to the corporate income tax, a tax is imposed at the rate of 39.6 percent on the accumulated taxable income of a corporation formed or availed of for the purpose of avoiding income tax with respect to its shareholders (or the shareholders of any other corporation), by permitting its earnings and profits to accumulate instead of being distributed (secs. 531, 532(a)). The fact that the earnings and profits of the corporation are allowed to accumulate beyond the reasonable needs of the business generally is determinative of the required tax-avoidance motive (sec. 533). Like the personal holding company tax, the accumulated earnings tax acts as a substitute for the tax that would have been incurred by the shareholders on dividends actually distributed by the corporation.

The accumulated earnings tax does not apply to any personal holding company, foreign personal holding company, or PFIC (sec. 532(b)). These exceptions, along with the current inclusion of subpart F income in the gross incomes of the U.S. 10-percent shareholders of a CFC, result in only a very limited application of the accumulated earnings tax to foreign corporations.

g. Foreign investment companies

A foreign corporation generally is a foreign investment company if (1) the corporation is registered as a management company or as a unit investment trust, or is engaged primarily in the business of investing, reinvesting, or trading in securities or commodities or any interest in securities or commodities and (2) 50 percent or more (measured by vote or by value) of the stock of the corporation is held (directly or indirectly) by U.S. persons (sec. 1246(b)). Gain on a sale or exchange (or a distribution that is treated as an exchange) of stock in a foreign investment company generally is treated as ordinary income to the extent of the taxpayer's ratable share of the undistributed earnings and profits of the foreign investment company (sec. 1246(a)). This rule operates not to prevent deferral of U.S. tax, as do the foregoing sets of rules, but rather to prevent the use of a foreign corporation to convert ordinary income into capital gain.

4. Transfer pricing rules

In the case of a multinational enterprise that includes at least one U.S. corporation and at least one foreign corporation, the United States taxes all of the income of the U.S. corporation, but only so much of the income of the foreign corporation as is determined to have sufficient nexus to the United States. The determination of the amount that properly is the income of the U.S. member of a multinational enterprise and the amount that properly is the income of a foreign member of the same multinational enterprise thus is critical to determining the amount of income the United States may tax (as well as the amount of income other countries may tax).

Due to the variance in tax rates and tax systems among countries, a multinational enterprise may have a strong 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 setting artificial transfer prices for transactions between group members.

As a simple illustration of how transfer pricing could be used to reduce taxes, assume that a U.S. corporation has a wholly-owned foreign subsidiary. The U.S. corporation manufactures a product domestically and sells it to the foreign subsidiary. The foreign subsidiary, in turn, sells the product to unrelated third parties. Due to the U.S. parent's control of its subsidiary, the price which is charged by the parent to the subsidiary theoretically could be set independently of ordinary market forces. If the foreign subsidiary is established in a jurisdiction that subjects its profits from the sale of the product to an effective rate of tax lower than the effective U.S. tax rate, then the U.S. corporation may be inclined to undercharge the foreign subsidiary for the product. By doing so, a portion of the combined profits of the group from the manufacture and sale of the product would be shifted out of a high-tax jurisdiction (the United States) and into a lower-tax jurisdiction (the foreign corporation's home country).[10] The ultimate result of this process would be a reduced worldwide tax liability of the multinational enterprise.

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[10] By contrast, U.S. companies owning foreign subsidiaries that are located in countries with effective tax rates that are higher than the U.S. rates may have an incentive to overcharge for sales from the U.S. parent to the foreign subsidiary in order to shift profits, and the resulting tax, into the United States.

Under section 482, the Secretary of the Treasury is authorized to redetermine the income of an entity subject to U.S. taxation, when it appears that an improper shifting of income between that entity and a commonly controlled entity in another country has occurred. This authority is not limited to reallocations of income between different taxing jurisdictions; it permits reallocations in any common control situation, including reallocations between two U.S. entities. However, it has significant application to multinational enterprises due to the incentives for taxpayers to shift income to obtain the benefits of significantly different effective tax rates.

Section 482 grants the Secretary of the Treasury broad authority to allocate income, deductions, credits, or allowances between any commonly controlled organizations, trades, or businesses in order to prevent evasion of taxes or clearly to reflect income. The statute generally does not prescribe any specific reallocation rules that must be followed, other than establishing 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 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. The regulations contain complex rules governing the determination of an arm's-length charge for various types of transactions. The regulations generally attempt to prescribe methods for identifying the relevant comparable unrelated party transactions and for providing adjustments for differences between such transactions and the related party transactions in question. In some instances, the regulations also provide safe harbors.

Determinations under section 482 that result in the allocation of additional income to the United States might theoretically subject a taxpayer to double taxation, if both the United States and another country imposed tax on the same income and the other country did not agree that the income should be reallocated to the United States. Tax treaties generally provide mechanisms to attempt to resolve such disputes in a manner that may avoid double taxation if both countries agree. Such mechanisms include the designation of a "competent authority" by each country, to act as that country's representative in the negotiation attempting to resolve such disputes. However, such competent authority procedures do not guarantee that double tax may not be imposed in a particular case.

One method for addressing the issue of double taxation is through the advance pricing agreement ("APA") procedure.[11] An APA is an advance agreement establishing an approved

[11] There is ongoing litigation in the U.S. District Court between the Bureau of National Affairs, Inc. ("BNA"), a tax publisher, and the IRS involving the public release of APAs. The IRS announced on January 11, 1999, that it was conceding that APAs are subject to disclosure under section 6110. (See IR-1999-05). The continuing issues are, among other things, the process of redacting confidential information from the APAs and the schedule under which such APAs will be released.

transfer pricing methodology entered into between the taxpayer, the Internal Revenue Service, and a foreign tax authority. The taxpayer generally is required to use the approved transfer pricing methodology for the duration of the APA. The IRS and the foreign tax authority generally agree to accept the results of such approved methodology. An APA also may be negotiated between just the taxpayer and the IRS; such an APA establishes an approved transfer pricing methodology for U.S. tax purposes. The APA process may prove to be particularly useful in cases involving industries such as financial products and services for which transfer pricing determinations are especially difficult.

5. Foreign tax credit rules

a. In general

Because the United States taxes U.S. persons on their worldwide income, Congress enacted the foreign tax credit in 1918 to prevent U.S. taxpayers from being taxed twice on their foreign source income: once by the foreign country where the income is earned and again by the United States. The foreign tax credit generally allows U.S. taxpayers to reduce the U.S. income tax on their foreign income by the foreign income taxes they pay on that income. The foreign tax credit does not operate to offset U.S. income tax on U.S.-source income.

A credit against U.S. tax on foreign income is allowed for foreign taxes paid or accrued by a U.S. person (sec. 901). In addition, a credit is allowed to a U.S. corporation for foreign taxes paid by certain foreign subsidiary corporations and deemed paid by the U.S. corporation upon a dividend received by, or certain other income inclusions of, the U.S. corporation with respect to earnings of the foreign subsidiary (the "deemed-paid" or "indirect" foreign tax credit) (sec. 902).

The foreign tax credit provisions of the Code are elective on a year-by-year basis. In lieu of electing the foreign tax credit, U.S. persons generally are permitted to deduct foreign taxes (sec. 164(a)(3)). For purposes of the alternative minimum tax, foreign tax credits generally cannot be used to offset more than 90 percent of the U.S. person's pre-foreign tax credit tentative minimum tax (sec. 59(a)).[12]

A foreign tax credit limitation, which is calculated separately for various categories of income, is imposed to prevent the use of foreign tax credits to offset U.S. tax on U.S.-source

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[12] The alternative minimum tax foreign tax credit is determined under principles similar to those used in computing the regular foreign tax credit, except that (1) the numerator of the alternative minimum tax foreign tax credit limitation is foreign source alternative minimum taxable income, and (2) the denominator of that fraction is total alternative minimum taxable income. Taxpayers may elect to use as their alternative minimum tax foreign tax credit limitation fraction the ratio of foreign source <u>regular</u> taxable income to total alternative minimum taxable income (sec. 59(a)(4).

income. Detailed rules are provided for the allocation of expenses against U.S.-source and foreign-source income. Special rules apply to require the allocation of foreign losses in one category of income for a taxable year to offset foreign income in the other categories for such year and to require the recharacterization of foreign income for a year subsequent to a foreign loss year from one income category to another or from foreign source to U.S. source (sec. 904(f)).

The amount of creditable taxes paid or accrued (or deemed paid) in any taxable year which exceeds the foreign tax credit limitation is permitted to be carried back to the two immediately preceding taxable years and carried forward to the first five succeeding taxable years, and credited in such years to the extent that the taxpayer otherwise has excess foreign tax credit limitation for those years (sec. 904(c)). For purposes of determining excess foreign tax credit limitation amounts, the foreign tax credit separate limitation rules apply.

Foreign tax credits are denied for withholding taxes paid with respect to certain dividends received by a corporation or a regulated investment company, if the shareholder has not held the stock for a minimum period of time during which it is not protected from risk of loss (sec. 901(k)). An exception from this treatment is provided for foreign tax credits with respect to certain dividends received on stock by active dealers in securities (sec. 901(k)(4)).

b. Deemed-paid foreign tax credit

U.S. corporations owning at least 10 percent of the voting stock of a foreign corporation are treated as if they had paid a share of the foreign income taxes paid by the foreign corporation in the year in which that corporation's earnings and profits become subject to U.S. tax as dividend income of the U.S. shareholder (sec. 902(a)). This is the "deemed-paid" or "indirect" foreign tax credit. A U.S. corporation may also be deemed to have paid taxes paid by a second, third, fourth, fifth, or sixth tier foreign corporation, if certain requirements are satisfied (sec. 902(b)). Foreign taxes paid below the third tier are eligible for the deemed credit only with respect to taxes paid in taxable years during which the payor is a CFC. Foreign taxes paid below the sixth tier are not eligible for the deemed-paid credit. In addition, a deemed-paid credit generally is available with respect to subpart F inclusions (sec. 960(a)). Moreover, a deemed-paid credit generally is available with respect to inclusions under the PFIC provisions by U.S. corporations meeting the requisite ownership threshold (secs. 1291(g) and 1293(f)).

The amount of foreign tax eligible for the indirect credit is added to the actual dividend or inclusion (the dividend or inclusion is said to be "grossed-up") and is included in the U.S. corporate shareholder's income; accordingly, the shareholder is treated as if it had received its proportionate share of pre-tax profits of the foreign corporation and paid its proportionate share of the foreign tax paid by the foreign corporation (sec. 78)).

For purposes of computing the deemed-paid foreign tax credit, dividends (or other inclusions) are considered made first from the post-1986 pool of all the distributing foreign corporation's accumulated earnings and profits (sec. 902(c)(6)(B)).[13]Accumulated earnings and profits for this purpose include the earnings and profits of the current year undiminished by the current distribution (or other inclusion) (sec. 902(c)(1)). Dividends in excess of the accumulated pool of post-1986 undistributed earnings and profits are treated as paid out of pre-1987 accumulated profits and are subject to the ordering principles of pre-1986 Act law (sec. 902(c)(6)).

c. Foreign tax credit limitation

A premise of the foreign tax credit is that it should not reduce the U.S. tax on a taxpayer's U.S.-source income but should only reduce the U.S. tax on the taxpayer's foreign-source income. Permitting the foreign tax credit to reduce U.S. tax on U.S. income would in effect cede to foreign countries the primary right to tax income earned from U.S. sources.

In order to prevent foreign taxes from reducing U.S. tax on U.S.-source income, the foreign tax credit is subject to an overall limitation and a series of separate limitations. Under the overall limitation, the total amount of the credit may not exceed the same proportion of the taxpayer's U.S. tax which the taxpayer's foreign-source taxable income bears to the taxpayer's worldwide taxable income for the taxable year (sec. 904(a)). In addition, the foreign tax credit limitation is calculated separately for various categories of income (sec. 904(d)). Under these separate limitations, the total amount of the credit for foreign taxes on income in each category may not exceed the same proportion of the taxpayer's U.S. tax which the taxpayer's foreign-source taxable income in that category bears to the taxpayer's worldwide taxable income for the taxable year.

The separate limitation categories are passive income; high withholding tax interest income; financial services income; shipping income; certain dividends received by a corporation from noncontrolled section 902 corporations[14]; dividends from a domestic international sales

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[13] Earnings and profits computations for these purposes are to be made under U.S. concepts. Goodyear Tire & Rubber Co. v. United States, 493 U.S. 132 (1989).

[14] Dividends paid by a noncontrolled foreign corporation in taxable years beginning before January 1, 2003, are subject to a separate foreign tax credit limitation for each noncontrolled corporation. In addition, dividends paid by a noncontrolled corporation that is not a passive foreign investment company in taxable years beginning after December 31, 2002, out of earnings and profits accumulated in taxable years beginning before January 1, 2003, are subject to a single foreign tax credit limitation for all noncontrolled foreign corporations (other than passive foreign investment companies). Moreover, dividends paid by a noncontrolled foreign corporation that is a passive foreign investment company out of earnings and profits accumulated in taxable years beginning before January 1, 2003, are subject to a separate foreign tax credit limitation for each such noncontrolled foreign corporation. Finally, dividends paid by a

corporation (DISC) or former DISC; certain distributions from a foreign sales corporation (FSC) or former FSC; and taxable income of a FSC attributable to foreign trade income (sec. 904(d)). Income not in a separate limitation category is referred to in the regulations as "general limitation income." A special limitation applies to the credit for taxes imposed on foreign oil and gas extraction income (sec. 907(a)).

Dividends, interest, rents, royalties, and subpart F income inclusions received (or deemed received) from CFCs by their U.S. 10-percent shareholders generally are subject to the general limitation or to the various separate limitations (as the case may be) in accordance with look-through rules that take into account the extent to which the income of the payor is itself subject to one or more of these limitations (sec. 904(d)(3)).

6. Foreign sales corporations

Under special tax provisions that provide an export incentive, a portion of the export income of an eligible foreign sales corporation ("FSC") is exempt from U.S.income tax. In addition, a U.S. corporation is not subject to U.S. tax on dividends distributed from the FSC out of earnings attributable to certain export income. Thus, there generally is no corporate level tax imposed on a portion of the income from exports of a FSC.[15]

Typically, a FSC is owned by a U.S. corporation that produces goods in the United States. The U.S. corporation either supplies goods to the FSC for resale abroad to unrelated persons or pays the FSC a commission in connection with its sales to unrelated persons. Therefore, the income of the FSC, a portion of which is exempt from U.S. tax under the FSC

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noncontrolled foreign corporation in taxable years beginning after December 31, 2002, are subject to the general limitation or to the various other separate limitations (as the case may be) in accordance with look-through rules that take into account the extent to which the income of the payor is itself subject to one or more of these limitations.

[15] Two export incentives preceded the enactment of the FSC provisions. Under provisions enacted in 1962, CFCs that qualified as export trade corporations were permitted to reduce their subpart F income by the amount of certain export trade income (secs. 970 and 971). No CFC may qualify as an export trade corporation unless it so qualified as of 1971. Under provisions enacted in 1971, domestic international sales corporations ("DISCs") were permitted to defer U.S. tax on certain export receipts (secs. 991-997). Upon enactment of the FSC provisions in 1984, a special rule permitted any DISC to transfer its deferred earnings to a FSC. An interest charge is now imposed on the deferral of tax on the earnings of any remaining DISC (sec. 995(f)). In July 1998, the European Union requested that a World Trade Organization ("WTO") dispute panel investigate the FSC regime and its compliance with WTO rules including the Agreement on Subsidies and Countervailing Measures. A WTO dispute panel was established in September 1998 to address these issues.

rules, equals the FSC's gross markup or gross commission income, less the expenses incurred by the FSC.

A FSC must have a foreign presence, it must have economic substance, and activities that relate to its export income must be performed by the FSC outside the U.S. customs territory. Furthermore, the income of the FSC is determined according to specified transfer pricing rules.

A FSC generally is not subject to U.S. tax on its exempt foreign trade income. To achieve this result, the exempt foreign trade income of a FSC is treated as foreign-source income which is not effectively connected with the conduct of a trade or business within the United States (sec. 921(a)).

Foreign trade income other than exempt foreign trade income, as well as investment income, generally is treated as U.S.-source income effectively connected with the conduct of a trade or business conducted through a permanent establishment within the United States (sec. 921(d)). Thus, income other than exempt foreign trade income generally is subject to U.S. tax currently and is treated as U.S.-source income for purposes of the foreign tax credit limitation.

Foreign trade income of a FSC is defined as the FSC's gross income attributable to foreign trading gross receipts (sec. 923(b)). Foreign trading gross receipts generally are the gross receipts of any FSC that are attributable to the following types of transactions: the sale of export property; the lease or rental of export property; services related and subsidiary to such a sale or lease of export property; engineering and architectural services for projects outside the United States; and export management services (sec. 924(a)). Investment income and carrying charges are excluded from the definition of foreign trading gross receipts (sec. 924(f)(2)).

The term "export property" generally means property (1) which is manufactured, produced, grown or extracted in the United States by a person other than a FSC, (2) which is held primarily for sale, lease, or rental in the ordinary course of a trade or business for direct use or consumption outside the United States, and (3) not more than 50 percent of the fair market value of which is attributable to articles imported into the United States (sec. 927(a)). The term "export property" does not include property leased or rented by a FSC for use by any member of a controlled group of which the FSC is a member; patents, copyrights (other than films, tapes, records, similar reproductions, and other than computer software, whether or not patented), and other intangibles; oil or gas (or any primary product thereof); or products the export of which is prohibited. Export property also excludes property designated by the President as being in short supply.

If export property is sold to a FSC by a related person (or a commission is paid by a related person to a FSC with respect to export property), the income with respect to the export transactions must be allocated between the FSC and the related person. The taxable income of the FSC and the taxable income of the related person are computed based upon a transfer price determined under an arm's-length pricing approach or under one of two formulae which are intended to approximate arm's-length pricing.

The portion of a FSC's foreign trade income that is treated as exempt foreign trade income depends on the pricing rule used to determine the income of the FSC. If the amount of income earned by the FSC is based on arm's-length pricing between unrelated parties, or between related parties under the rules of section 482, the exempt foreign trade income generally is 30 percent of the foreign trade income the FSC derives from a transaction (secs. 923(a)(2) and (6) and 291(a)(4)). If the income earned by the FSC is determined under one of the special formulae specified in the FSC provisions, the exempt foreign trade income generally is 15/23 of the foreign trade income the FSC derives from the transaction (secs. 923(a)(3) and (6) and 291(a)(4)).

A FSC is not required or deemed to make distributions to its shareholders. Actual distributions are treated as being made first out of earnings and profits attributable to foreign trade income, and then out of any other earnings and profits (sec. 926(a)). Any distribution made by a FSC out of earnings and profits attributable to foreign trade income to a foreign shareholder is treated as U.S.-source income that is effectively connected with a business conducted through a permanent establishment of the shareholder within the United States (sec. 926(b)). Thus, the foreign shareholder is subject to U.S. tax on such a distribution.

A U.S. corporation generally is allowed a 100 percent dividends-received deduction for amounts distributed from a FSC out of earnings and profits attributable to foreign trade income (sec. 245(c)(1)(A)). Thus, there generally is no corporate level U.S. tax on exempt foreign trade income and only a single level of U.S. corporate tax (at the FSC level) on non exempt foreign trade income. However, the 100 percent dividends-received deduction is not allowed for nonexempt foreign trade income determined under arm's-length principles (sec. 245(c)(2)).

B. U.S. Taxation of Foreign Persons with U.S. Income

1. Overview

The United States imposes tax on nonresident alien individuals and foreign corporations (collectively, foreign persons) only on income that has a sufficient nexus to the United States. In contrast, the United States imposes tax on U.S. persons on all income, whether derived in the United States or in a foreign country.

Foreign persons are subject to U.S. tax on income that is "effectively connected" with the conduct of a trade or business in the United States, without regard to whether such income is derived from U.S. sources or foreign sources. Such income generally is taxed in the same manner and at the same rates as income of a U.S. person. In addition, foreign persons generally are subject to U.S. tax at a 30-percent rate on certain gross income derived from U.S. sources.

Pursuant to an applicable tax treaty, the 30-percent gross-basis tax imposed on foreign persons may be reduced or eliminated. In addition, an applicable tax treaty may limit the imposition of U.S. tax on business operations of a foreign person to cases where the business is conducted through a permanent establishment in the United States.

2. Source of income rules

The source of income for U.S. tax purposes is determined based on various factors. The relevant factors include the location or nationality of the payor, the location or nationality of the recipient, the location of the recipient's activities that generate the income, and the location of the assets that generate the income. The rules for determining the source of specific types of income are described briefly below.

Interest

Interest income generally is treated as U.S.-source income if it is from obligations of the United States or the District of Columbia or from interest-bearing obligations of U.S. residents or U.S. corporations (sec. 861(a)(1)). Under a special rule, interest paid by certain U.S. persons that conduct active foreign businesses is treated as foreign-source income in whole or in part (sec. 861(c)). Other exceptions from the general rule treating interest paid by U.S. persons as U.S.-source income apply to interest on deposits with foreign commercial banking branches of U.S. corporations or partnerships and certain other amounts paid by foreign branches of domestic financial institutions (sec. 861(a)(1)(B)).

Dividends

Dividends from U.S. corporations generally are treated as U.S.-source income (sec. 861(a)(2)(A)). Under a special rule, dividends from certain foreign corporations that conduct U.S. businesses are treated in part as U.S.-source income (sec. 861(a)(2)(B)).

Rents and royalties

Rents or royalties from property located in the United States, and rents or royalties for the use of or privilege of using intangible property in the United States, generally are treated as U.S.-source income (sec. 861(a)(4)).

Income from sales of personal property

Subject to significant exceptions, income from the sale of personal property is sourced on the basis of the residence of the seller (sec. 865(a)). For this purpose, the term "nonresident" is defined to include any foreign corporation (sec. 865(g)). The term "nonresident" also is defined to include any nonresident alien who does not have a "tax home" in the United States.

Several exceptions to the general rule result in income from sales of property by nonresidents being treated as U.S.-source income. Gain of a nonresident on the sale of inventory property may be treated as U.S.-source income if title to the property passes in the United States or if the sale is attributable to an office or other fixed place of business maintained by the nonresident in the United States (secs. 865(b) and (e) and 861(a)(6)). If the inventory property is manufactured in the United States by the person that sells the property, a portion of the income from the sale of such property in all events is treated as U.S.-source income (sec. 863(b)). Gain of a nonresident on the sale of depreciable property is treated as U.S.-source income to the extent of prior U.S. depreciation deductions (sec. 865(c)). Payments received on sales of intangible property are sourced in the same manner as royalties to the extent the payments are contingent on the productivity, use, or disposition of the intangible (sec. 865(d)).

Personal services income

Compensation for labor or personal services performed in the United States generally is treated as U.S.-source income, subject to an exception for amounts that meet certain de minimis criteria (sec. 861(a)(3)).[16]

Insurance income

Underwriting income from issuing insurance or annuity contracts generally is treated as U.S.-source income if the contract involves property in, liability arising out of an activity in, or the lives or health of residents of, the United States (sec. 861(a)(7)).

Transportation income

Generally, 50 percent of income attributable to transportation which begins or ends in the United States is treated as U.S.-source income (sec. 863(c)).

Income from space or ocean activities or international communications

In the case of a foreign person, generally no income from a space or ocean activity is treated as U.S.-source income (sec. 863(d)). The same holds true for international communications income unless the foreign person maintains an office or other fixed place of business in the United States, in which case the income attributable to such fixed place of business is treated as U.S.-source income (sec. 863(e)).

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[16] Gross income of a nonresident alien individual, who is present in the United States as a member of the regular crew of a foreign vessel, from the performance of personal services in connection with the international operation of a ship generally is treated as foreign-source income.

3. Net-basis taxation

a. Income from a U.S. business

The United States taxes on a net basis the income of foreign persons that is "effectively connected" with the conduct of a trade or business in the United States (secs. 871(b) and 882). Any gross income earned by the foreign person that is not effectively connected with the person's U.S. business is not taken into account in determining the rates of U.S. tax applicable to the person's income from such business (secs. 871(b)(2) and 882(a)(2)).

U.S. trade or business

A foreign person is subject to U.S. tax on a net basis if the person is engaged in a U.S. trade or business. In this regard, partners in a partnership and beneficiaries of an estate or trust are treated as engaged in the conduct of a trade or business within the United States if the partnership, estate, or trust is so engaged (sec. 875).

The question of whether a foreign person is engaged in a U.S. trade or business has generated a significant body of case law. Basic issues involved in the determination include whether the activity constitutes business rather than investing, whether sufficient activities in connection with the business are conducted in the United States, and whether the relationship between the foreign person and persons performing functions in the United States with respect to the business is sufficient to attribute those functions to the foreign person.

The Code contains specific rules with respect to the application of the trade or business standard to certain activities. Pursuant to section 864(b), the term "trade or business within the United States" expressly includes the performance of personal services within the United States. However, an exception is provided in the case of a nonresident alien individual's performance of services for a foreign employer, where both the total compensation received for such services during the year and the period in which the individual is present in the United States are de minimis (sec. 864(b)(1)). In addition, detailed rules govern the determination of whether trading in stocks or securities or commodities constitutes the conduct of a U.S. trade or business (sec. 864(b)(2)). Under these rules, trading in stock or securities or commodities by a foreign person through an independent agent generally is not treated as the conduct of a U.S. trade or business, if the foreign person does not have an office or other fixed place of business in the United States through which such transactions are effected. Trading in stock or securities or commodities for the foreign person's own account also generally is not treated as the conduct of a U.S. business, provided that the foreign person is not a dealer in stock or securities or commodities, as the case may be.

Effectively-connected income

A foreign person that is engaged in the conduct of a trade or business within the United States is subject to U.S. net-basis taxation on the income that is "effectively connected" with such business. Specific statutory rules govern the determination of whether income is so effectively connected (sec. 864(c)).

In the case of U.S.-source capital gain or loss and U.S.-source income of a type that would be subject to gross basis U.S. taxation, the factors taken into account in determining whether the income, gain, deduction, or loss is effectively connected with a U.S. trade or business include whether the amount is derived from assets used in or held for use in the conduct of the U.S. trade or business and whether the activities of the trade or business were a material factor in the realization of the amount (sec. 864(c)(2)). In making this determination, due regard is given to whether the asset or income, gain, deduction, or loss was accounted for through the U.S. trade or business. In the case of any other U.S.-source income, gain, deduction, or loss, such amounts are all treated as effectively connected with the conduct of the trade or business in the United States (sec. 864(c)(3)).

Foreign-source income of a foreign person that is effectively connected with the conduct of a trade or business in the United States may also be taxed by the United States, subject to a credit for any foreign income taxes (secs. 864(c)(4) and 906). However, only specific types of foreign-source income are considered to be effectively connected with a U.S. trade or business (sec. 864(c)(4)(A)). Foreign-source income of a type not specified generally is exempt from U.S. tax.

Foreign-source income, gain, deduction, or loss generally is considered to be effectively connected with a U.S. business only if the person has an office or other fixed place of business within the United States to which such income, gain, deduction, or loss is attributable and such income falls into one of the three categories described below (sec. 864(c)(4)(B)). The first category consists of rents or royalties for the use of patents, copyrights, secret processes or formulas, good will, trade-marks, trade brands, franchises, or other like intangible properties derived in the active conduct of the U.S. trade or business (sec. 864(c)(4)(B)(i)). The second category consists of interest or dividends derived in the active conduct of a banking, financing, or similar business within the United States or received by a corporation the principal business of which is trading in stocks or securities for its own account (sec. 864(c)(4)(B)(ii)). Notwithstanding the foregoing, foreign-source income consisting of dividends, interest, or royalties is not treated as effectively connected if the items are paid by a foreign corporation in which the recipient owns, directly, indirectly, or constructively, more than 50 percent of the total combined voting power of the stock (sec. 864(c)(4)(D)(i)). The third category consists of income, gain, deduction, or loss derived from the sale or exchange of inventory or property held by the taxpayer primarily for sale to customers in the ordinary course of the trade or business where the property is sold or exchanged outside the United States through the foreign person's U.S. office or other fixed place of business (sec. 864(c)(4)(B)(iii)). Such amounts are not treated as effectively connected if the property is sold or exchanged for use, consumption, or disposition outside the United States and an office or other fixed place of business of the taxpayer in a foreign country participated materially in the sale or exchange.

In determining whether a foreign person has a U.S. office or other fixed place of business, the office or other fixed place of business of an agent generally is disregarded. The place of business of an agent other than an independent agent acting in the ordinary course of business is not disregarded, however, if either the agent has the authority (regularly exercised) to negotiate and conclude contracts in the name of the foreign person or the agent has a stock of merchandise from which he regularly fills orders on behalf of the foreign person (sec. 864(c)(5)(A)). Assuming that an office or other fixed place of business does exist, income, gain, deduction, or loss is not considered attributable to such office unless the office was a material factor in the production of the income, gain, deduction, or loss and the office regularly carries on activities of the type from which the income, gain, deduction, or loss was derived (sec. 864(c)(5)(B)). Finally, in the case of any inventory property sales that are foreign-source income effectively connected with a U.S. business, the income, gain, deduction, or loss treated as attributable to the U.S. office cannot be more than the amount of U.S.-source income that would have been produced had the sale or exchange been made in the United States (sec. 864(c)(5)(C)).

Special rules apply for purposes of determining the effectively-connected income of an insurance company. The foreign-source income of a foreign corporation that is subject to tax under the insurance company provisions of the Code is treated as effectively connected, provided that such income is attributable to its United States business (sec. 864(c)(4)(C)).

Income, gain, deduction, or loss for a particular year generally is not treated as effectively connected if the foreign person is not engaged in a U.S. trade or business in that year (sec. 864(c)(1)(B)). However, if income or gain taken into account for a taxable year is attributable to the sale or exchange of property, the performance of services, or any other transaction which occurred in a prior taxable year, the determination whether such income or gain is taxable on a net basis is required to be made as if the income were taken into account in the earlier year and without regard to the requirement that the taxpayer be engaged in a trade or business within the United States during the later taxable year (sec. 864(c)(6)). Also, if any property ceases to be used or held for use in connection with the conduct of a trade or business within the United States and the property is disposed of within 10 years after the cessation, the determination of whether any income or gain attributable to the disposition of the property is taxable on a net basis is required to be made as if the disposition occurred immediately before the property ceased to be used or held for use in connection with the conduct of a trade or business in the United States and without regard to the requirement that the taxpayer be engaged in a trade or business within the United States during the taxable year for which the income or gain is taken into account (sec. 864(c)(7)).

Allowance of deductions

Effectively connected taxable income is computed taking into account deductions to the extent that they are associated with income that is effectively connected with the conduct of a U.S. trade or business. For this purpose, the issue of the proper apportionment and allocation of deductions generally is addressed in detailed regulations. The regulations applicable to deductions other than interest expense set forth general guidelines for allocating deductions among classes of income and apportioning deductions between effectively-connected and non-effectively-connected income, providing that, in appropriate cases, deductions may be allocated on the basis of units sold, gross sales or receipts, costs of goods sold, profits contributed, expenses incurred, assets used, salaries paid, space utilized, time spent, or gross income received. More specific guidelines are provided for the allocation of research and experimental expenditures, legal and accounting fees, income taxes, losses on dispositions of property, and net operating losses. Interest deductions are subject to a detailed regulatory regime for the allocation and apportionment to effectively-connected income.

b. Investments in U.S. real property

Special U.S. tax rules apply to gains of foreign persons attributable to dispositions of interests in U.S. real property. The rules governing the imposition and collection of tax on such dispositions are contained in a series of provisions that were enacted in 1980 and that are collectively referred to as the Foreign Investment in Real Property Tax Act ("FIRPTA") (secs. 897, 1445, 6039C, and 6652(f)). Prior to the enactment of the FIRPTA provisions, foreign persons could invest in U.S. real property without being subject to U.S. tax upon the eventual disposition of such property.

Imposition of tax

Section 897(a) provides that gain or loss of a foreign person from the disposition of a U.S. real property interest is taken into account for U.S. tax purposes as if such gain or loss were effectively connected with a trade or business within the United States during the taxable year. Accordingly, foreign persons generally are subject to U.S. tax on any gain from a disposition of a U.S. real property interest at the same rates that apply to similar income received by U.S. persons.

In the case of nonresident alien individuals, the alternative minimum tax applies to the lesser of the individual's alternative minimum taxable income or the individual's net real property gains (sec. 897(a)(2)(A)). Losses of nonresident alien individuals are taken into account under the FIRPTA provisions only to the extent that such losses would be taken into account under section 165(c), which limits loss deductions to business losses, losses on transactions entered into for profit, and certain casualty or theft losses (sec. 897(b)).

In the case of foreign corporations, the gain from a disposition of a U.S. real property interest may also be subject to the branch profits tax at a 30-percent rate (or a lower treaty rate). If a foreign corporation that holds a U.S. real property interest is entitled to nondiscriminatory treatment with respect to such interest under an applicable treaty, the foreign corporation may elect to be treated as a U.S. corporation for purposes of the FIRPTA provisions (sec. 897(i)). This election may be made only if all shareholders of the corporation consent to the election and specifically agree that any gain upon the disposition of the interest that would be taken into account under the FIRPTA provisions will be taxable even if such taxation would be contrary to a treaty. This election to be treated as a domestic corporation is the exclusive remedy for any person claiming treaty protection against discriminatory treatment as a result of the FIRPTA provisions.

Definition of U.S. real property interest

Under the FIRPTA provisions, U.S. tax is imposed on gains from the disposition of an interest in real property (including an interest in a mine, well, or other natural deposit) located in the United States or the U.S. Virgin Islands. The term "interest in real property" includes, with respect to both land and improvements thereon, (1) fee ownership and co-ownership, (2) leaseholds, (3) options to acquire, and (4) options to acquire leaseholds (sec. 897(c)(6)(A)). Moreover, the term includes partial interests in real property, such as life estates, remainders, and reversions. In addition, the term includes any direct or indirect right to share in the appreciation in the value of, or in the gross or net proceeds or profits generated by, U.S. real property.

Also included in the definition of a U.S. real property interest is any interest (other than an interest solely as a creditor) in any domestic corporation, unless the taxpayer establishes that the corporation was not a U.S. real property holding corporation ("USRPHC") at any time during the five-year period ending on the date of the disposition of the interest (sec. 897(c)(1)(A)(ii)). This general rule does not apply to investments in a publicly-traded USRPHC. Under a special rule, USRPHC stock of a class that is regularly traded on an established securities market is treated as a U.S. real property interest only in the case of a foreign person that, at some time during the five-year period described above, held more than 5 percent of that class of stock (sec. 897(c)(3)). Rules similar to this special rule apply to treat an interest in a publicly-traded partnership as a U.S. real property interest.

A corporation is a USRPHC if the fair market value of such corporation's U.S. real property interests equals or exceeds 50 percent of the sum of the fair market values of (1) its U.S. real property interests, (2) its interests in foreign real property, plus (3) any other of its assets which are used or held for use in a trade or business (sec. 897(c)(2)). For purposes of this asset test, a corporation that is a partner in a partnership or a beneficiary of an estate or trust generally takes into account its proportionate share of all assets of such partnership, estate, or trust (sec. 897(c)(4)(B)). Look-through rules also apply to a controlling interest (50 percent or more of the fair market value of all classes of stock) held by a corporation in another corporation, whether foreign or domestic (sec. 897(c)(5)).

Special rules applicable to certain transactions

Gain recognized by a foreign person on the disposition of an interest in a partnership, trust, or estate generally is subject to tax under the FIRPTA provisions to the extent that the gain is attributable to any appreciation in the value of any U.S. real property interests of the entity (sec. 897(g)).

As a general rule, nonrecognition provisions apply under the FIRPTA provisions only in the case of an exchange of a U.S. real property interest for an interest the sale of which would be taxable under the Code (sec. 897(e)). This rule is designed to prevent a foreign person from escaping U.S. tax by exchanging a taxable asset for a nontaxable asset in an exchange which would otherwise qualify for nonrecognition treatment under the Code. Specific rules apply to require gain recognition in certain cases. In this regard, foreign corporations are required in certain circumstances to recognize gain upon the distribution (including a distribution in liquidation or redemption) to their shareholders of appreciated U.S. real property interests (sec. 897(d)(1)). Moreover, gain generally is recognized by a foreign person under the FIRPTA provisions on the transfer of a U.S. real property interest to a foreign corporation if the transfer is made as paid-in surplus or as a contribution to capital.

Withholding on dispositions by foreign persons of U.S. real property interests

The Code generally imposes a withholding obligation when a U.S. real property interest is acquired from a foreign person (sec. 1445). The withholding obligation generally is imposed on the transferee; however, in certain limited circumstances, an agent of the transferor or transferee is required to withhold. Any tax imposed on a foreign person under the FIRPTA provisions in excess of the amount withheld remains the liability of the foreign person.

The amount required to be withheld on the sale by a foreign person of a U.S. real property interest generally is 10 percent of the amount realized on the transaction (i.e., the gross sales price) (sec. 1445(a)). However, a certificate for reduced withholding may be issued by the IRS such that the amount required to be withheld will not exceed the transferor's maximum tax liability (sec. 1445(c)(1)).

There are several exemptions from the obligation to withhold on a disposition of a U.S. real property interest. First, withholding by the transferee generally is not required if the transferor furnishes to the transferee an affidavit stating, under penalty of perjury, that the transferor is not a foreign person and providing the transferor's taxpayer identification number (sec. 1445(b)(2)). Second, withholding is not required on the disposition of an interest in a domestic corporation if the corporation furnishes an affidavit to the transferee stating, under penalty of perjury, that the corporation is not a USRPHC and has not been a USRPHC during the five-year period ending on the date of disposition (sec. 1445(b)(3)). Third, withholding may be reduced or eliminated if the transferee receives a qualifying statement issued by the IRS that the transferor is exempt from tax or either the transferor or the transferee has provided adequate security (or has made other arrangements for payment of the tax) (sec. 1445(b)(4)). Fourth, withholding is not required if the transferee intends to use the transferred real property as a residence, and the amount realized by the transferor on the disposition of the property is $300,000 or less (sec. 1445(b)(5)). Fifth, withholding is not required on a disposition of stock of a class that is regularly traded on an established securities market (sec. 1445(b)(6)).

Special withholding rules apply in the case of certain dispositions of U.S. real property interests by partnerships, trusts, and estates; certain distributions by foreign or domestic corporations, partnerships, trusts, and estates; and certain dispositions of interests in partnerships, trusts, and estates.

4. Gross-basis taxation

a. Withholding tax

In the case of U.S.-source interest, dividends, rents, royalties, or other similar types of income (known as fixed or determinable, annual or periodical gains, profits and income), the United States generally imposes a flat 30-percent tax on the gross amount paid to a foreign person if such income or gain is not effectively connected with the conduct of a U.S. trade or business (secs. 871(a) and 881). This tax generally is collected by means of withholding by the person making the payment to the foreign person receiving the income (secs. 1441 and 1442). Accordingly, the 30-percent gross-basis tax generally is referred to as a withholding tax. In most instances, the amount withheld by the U.S. payor is the final tax liability of the foreign recipient and, thus, the foreign recipient files no U.S. tax return with respect to this income.

The United States generally does not tax capital gains of a foreign corporation that are not connected with a U.S. trade or business. Capital gains of a nonresident alien individual that are not connected with a U.S. business generally are subject to the 30-percent gross-basis tax only if the individual was present in the United States for 183 days or more during the year (sec. 871(a)(2)). Also subject to tax at a flat rate of 30 percent are any foreign person's gains from the sale or exchange of patents, copyrights, trademarks, and other like property, or of any interest in such property, to the extent the gains are from payments that are contingent on the productivity, use, or disposition of the property or interest sold or exchanged (secs. 871(a)(1)(D) and 881(a)(4)).

Gains of a foreign individual or corporation on the disposition of U.S. real property interests are taxed on a net basis under FIRPTA, even if they are not otherwise effectively connected with a U.S. trade or business. Similarly, rental and other income from U.S. real property may be taxed, at the election of the taxpayer, on a net basis at graduated rates (secs. 871(d) and 882(d)).

Although payments of U.S.-source interest that is not effectively connected with a U.S. trade or business generally are subject to the 30-percent withholding tax, there are significant exceptions to that rule. For example, interest from certain deposits with banks and other financial institutions is exempt from tax (secs. 871(i)(2)(A) and 881(d)). Original issue discount on obligations maturing in six months or less is also exempt from tax (sec. 871(g)(1)(B)(i)). An additional exception is provided for certain interest paid on portfolio obligations (secs. 871(h) and 881(c)). Portfolio interest generally is defined as any U.S.-source interest (including original issue discount), not effectively connected with the conduct of a U.S. trade or business, (1) on an obligation that satisfies certain registration requirements or specified exceptions thereto, and (2) that is not received by a 10-percent shareholder (sec. 871(h)). This exception is not available for any interest received either by a bank on a loan extended in the ordinary course of its business (except in the case of interest paid on an obligation of the United States), or by a controlled foreign corporation from a related person (sec. 881(c)(3)). Moreover, this exception is not available for certain contingent interest payments (sec. 871(h)(4)).

Pursuant to an applicable tax treaty, the 30-percent gross-basis tax imposed on foreign persons may be reduced or eliminated. However, a foreign person is not entitled to a reduced rate of withholding tax under a treaty on an item of income derived through an entity that is treated as a partnership (or is otherwise fiscally transparent) for U.S. tax purposes if (1) such item is not treated for purposes of the taxation laws of such foreign country as an item of income of such person, (2) the foreign country does not impose tax on an actual distribution of such item of income from such entity to such person, and (3) the treaty itself does not contain a provision addressing the applicability of the treaty in the case of income derived through a partnership or other fiscally transparent entity (sec. 894(c)). Temporary and proposed regulations address the application of reduced rates of withholding tax provided under a treaty in cases involving a hybrid entity (e.g., an entity that is treated as a partnership or is otherwise fiscally transparent for U.S. tax purposes but is treated as fiscally non-transparent for purposes of the tax laws of the jurisdiction of residence of the taxpayer) (Temp. Treas. Reg. sec. 1.894-1T).

b. Excise tax on insurance premiums paid to foreign insurers

The United States imposes an excise tax on policies of insurance, indemnity bonds, annuity contracts, and policies of reinsurance issued by a foreign insurer or reinsurer (1) to or for (or in the name of) a domestic corporation or partnership or a U.S. resident individual with respect to risks wholly or partly within the United States, or (2) to or for (or in the name of) any foreign person engaged in business within the United States with respect to risks within the United States (secs. 4371 and 4372). The excise tax is 4 percent of the premiums paid on a policy of casualty insurance or an indemnity bond, and generally 1 percent on all other premiums (sec. 4371). The excise tax does not apply to an amount effectively connected with the conduct of a trade or business in the United States (unless such amount is exempt from net basis U.S. tax under a treaty) (sec. 4373).

c. Branch level taxes

A U.S. corporation owned by foreign persons is subject to U.S. income tax on its net income. In addition, the earnings of the U.S. corporation are subject to a second tax, this time at the shareholder level, when dividends are paid. As discussed above, when the shareholders are foreign, the second-level tax is imposed at a flat rate and collected by withholding. Similarly, as discussed above, interest payments made by a U.S. corporation to foreign creditors are subject to a U.S. withholding tax in certain circumstances. Pursuant to the branch tax provisions, the United States taxes foreign corporations engaged in a U.S. trade or business on amounts of U.S. earnings and profits that are shifted out of, or amounts of interest deducted by, the U.S. branch of the foreign corporation. The branch level taxes are comparable to these second-level taxes. In addition, where a foreign corporation is not subject to the branch profits tax as the result of a treaty, it may be liable for withholding tax on actual dividends it pays to foreign shareholders.

The United States imposes a tax of 30 percent on a foreign corporation's "dividend equivalent amount" (sec. 884(a)). The "dividend equivalent amount" generally is the earnings and profits of a U.S. branch of a foreign corporation attributable to its income effectively connected with a U.S. trade or business (sec. 884(b)). The following earnings and profits attributable to income effectively connected with a U.S. trade or business are excluded from the imposition of branch profits tax: (1) certain earnings derived by FSC; (2) certain foreign transportation earnings; (3) earnings derived from the sale of any interest in U.S. real property holding corporations; (4) earnings derived by certain corporations organized in a U.S. possession; and (5) earnings derived by certain captive insurance companies (sec. 884(d)(2)).

In arriving at the dividend equivalent amount, a branch's effectively connected earnings and profits are adjusted to reflect changes in a branch's U.S. net equity (i.e., the excess of the branch's assets over its liabilities, taking into account only amounts treated as connected with its U.S. trade or business) (sec. 884(b)). The first adjustment reduces the dividend equivalent amount to the extent the branch's earnings are reinvested in trade or business assets in the United States (or reduce U.S. trade or business liabilities). The second adjustment increases the dividend equivalent amount to the extent prior reinvested earnings are considered remitted to the home office of the foreign corporation.

Interest paid by a U.S. trade or business of a foreign corporation generally is treated as if paid by a U.S. corporation and therefore is subject to U.S. 30-percent withholding tax (if the interest is paid to a foreign person) (sec. 884(f)(1)(A)). Certain "excess interest" of a U.S. trade or business of a foreign corporation is treated as if paid by a U.S. corporation to a foreign parent and, therefore, is subject to U.S. 30-percent withholding tax (sec. 884(f)(1)(B)). For this purpose, excess interest is the excess of the interest deduction allowed with respect to the U.S. trade or business over the amount of interest paid by such trade or business.

C. Income Tax Treaties

1. In general

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. Treaties also contain provisions governing the creditability of taxes imposed by the treaty country in which income was earned in computing the amount of tax owed to the other country by its residents with respect to such income. Treaties further provide procedures under which inconsistent positions taken by the treaty countries with respect to a single item of income or deduction may be mutually resolved by the two countries.

The preferred tax treaty policies of the United States have been expressed from time to time in model treaties and agreements. The Organization for Economic Cooperation and Development (the "OECD") also has published model tax treaties. In addition, the United Nations has published a model treaty for use between developed and developing countries. The Treasury Department, which together with the State Department is responsible for negotiating tax treaties, last published a proposed model income tax treaty in September 1996 (the "U.S. model"). The OECD last published a model income tax treaty in 1992 ("the OECD model"). The United Nations last published a model income tax treaty in 1980 ("the U.N. model").

Many U.S. income tax treaties currently in effect diverge in one or more respects from the U.S. model. These divergences may reflect the age of a particular treaty or the particular balance of interests between the United States and the treaty partner. Other countries' preferred tax treaty policies may differ from those of the United States, depending on their internal tax laws and depending upon the balance of investment and trade flows between those countries and their potential treaty partners. For example, certain capital importing countries may be interested in imposing relatively high tax rates on interest, royalties, and personal property rents paid to residents of the other treaty country. Consequently, treaties with such countries may have higher withholding rates on dividends, interest, royalties, and personal property rents. As another example, the other country may demand other concessions in exchange for agreeing to requested U.S. terms. Countries that impose income tax on certain local business operations at a relatively low rate (or a zero rate) in order to attract manufacturing capital may seek to enter into "tax-sparing" treaties with capital exporting countries. In other words, the country may seek to enter into treaties under which the capital exporting country gives up its tax on the income of its residents derived from sources in the first country, regardless of the extent to which the first country has imposed tax with respect to that income. While other capital exporting countries have agreed to such treaties, the United States has rejected proposals by certain foreign countries to enter into such tax-sparing arrangements.

The OECD, the U.N., and the U.S. models reflect a standardization of terms that serves as a useful starting point in treaty negotiations. However, issues may arise between the United

States and a particular country that of necessity cannot be addressed with a model provision. Because a treaty functions as a bridge between two actual tax systems, one or both of the parties to the negotiations may seek to diverge from the models to account for specific features of a particular tax system.

2. Model income tax treaty provisions

Significant features of the model income tax treaties are described briefly below.

Residence

The U.S. model generally treats as a resident of a treaty country any person who, under the laws of that country, is liable to tax therein by reason of its domicile, residence, citizenship, place of management, place of incorporation, or any other similar criterion. However, the concept of resident excludes any person who is liable to tax in a country solely in respect of income from sources in that country or of profits attributable to a permanent establishment in that country.

Business profits attributable to a permanent establishment

Under the U.S. model, one treaty country may not tax the business profits of an enterprise of a qualified resident of the other treaty country, unless the enterprise carries on business in the first country through a permanent establishment situated there. In that case, the business profits of the enterprise may be taxed in the first country on profits that are attributable to that permanent establishment. The U.S. model describes in detail the characteristics relevant to determine whether a place of business is a permanent establishment. The term includes a place of management, a branch, an office, a factory, a workshop, a mine, an oil or gas well, a quarry, or any other place of extraction of natural resources.

The U.S. model provides that the business profits to be attributed to the permanent establishment include only the profits derived from the assets or activities of the permanent establishment. The U.N. model adds a limited "force of attraction rule" which would allow the country in which the permanent establishment is located to attribute to the permanent establishment sales in that country of goods or merchandise of the same or similar kind as those sold through the permanent establishment, and to attribute to the permanent establishment other business activities carried on in that country of the same or similar kind as those effected through the permanent establishment.

The U.S., OECD, and U.N. models expressly provide for the allocation of worldwide executive and general administrative expenses in determining business profits attributable to a permanent establishment. The U.S. model also provides for the allocation of research and development expenses, interest, and other expenses incurred for the purposes of the enterprise as a whole (or the part of the enterprise that includes the permanent establishment).

Dividends

The U.S. model permits taxation of dividends by the residence country of the payor, but limits the rate of such tax in cases in which the dividends are beneficially owned by a resident of the other treaty country. In such cases, the U.S. model allows not more than a 5-percent gross-basis tax if the beneficial owner is a company that owns directly at least 10 percent of the payor's voting stock, and not more than a 15-percent gross-basis tax in any other case. Under the OECD model, the 5-percent rate is not available unless the beneficial owner of the dividends is a company other than a partnership that holds directly at least 25 percent of the capital of the dividend payor. The U.N. model expressly leaves to case-by-case bilateral negotiation the particular percentage limit to be imposed on source-country taxation of dividends.

Interest and royalties

The U.S. model generally allows no tax to be imposed by a treaty country on interest or royalties arising in that country and beneficially owned by a resident of the other treaty country. By contrast, the OECD model would permit up to 10-percent gross-basis taxation of interest by the treaty country in which the interest arises. The U.N. model expressly leaves to case-by-case bilateral negotiation the particular percentage limit to be imposed on source-country taxation of interest or royalties.

Other income

The U.S. model provides that items of income beneficially owned by a resident of a treaty country, wherever arising, that are not dealt with in the articles of the treaty are taxable only by the recipient's country of residence. By contrast, the U.N. model states that items of income of a resident of a treaty country not dealt with in the other treaty articles and arising in the other treaty country may also be taxed in that other country.

Relief from double taxation

The U.S. model obligates the United States to allow its residents and citizens as a credit against U.S. income tax: (a) income taxes paid or accrued to the treaty country by the U.S. person, and (b) in the case of a U.S. company owning at least 10 percent of the voting stock of a company resident in the treaty country, and from which the U.S. company receives dividends, the treaty country income tax paid or accrued by or on behalf of the payor company with respect to the profits out of which the dividends are paid. However, the U.S. model preserves U.S. internal law by subjecting this right to the foreign tax credit to the provisions and limitations of U.S. law as it may be amended from time to time without changing the general principle of the model provision.

A standard article in treaties specifies the U.S. and foreign taxes covered by the treaty. The U.S. model provides that such covered taxes shall be considered income taxes for purposes of the credit article, and contemplates the possibility that such a tax might be creditable solely by reason of the treaty.

Nondiscrimination

The U.S. model provides that nationals of a treaty country, wherever they may reside, shall not be subjected in the other country to any taxation (or any requirement connected therewith) that is more burdensome than the taxation and connected requirements to which nationals of that other country in the same circumstances, particularly with respect to taxation on worldwide income, are or may be subjected. Similarly, the taxation of a permanent establishment or fixed base that an enterprise or resident of a treaty country has in the other country generally shall not be less favorably levied in the source country than the taxation levied on enterprises or residents of the source country carrying on the same activities. Further, an enterprise of a source country, the capital of which is wholly or partly owned or controlled by one or more residents of the other country, shall not be subjected in the source country to any taxation (or any requirement connected therewith) that is more burdensome than the taxation and connected requirements to which other similar source-country enterprises are or may be subjected. Finally, the U.S. model generally provides (subject to certain arm's length standards) that interest, royalties, and other disbursements paid by a treaty country resident to a resident of the other country shall, for the purposes of determining the taxable profits of the payor, be deductible under the same conditions as if they had been paid to a resident of the source country.

Mutual agreement procedures

The U.S. model provides for a treaty country resident or national to obtain relief, from the competent authority of either treaty country, from actions of either or both countries that are considered to result in taxation in violation of the treaty. The U.S. model requires the competent authorities to endeavor to resolve such a case by mutual agreement where the home country authority cannot do so unilaterally.

D. Tax Treatment of U.S. Persons Living Abroad

1. General exclusion

A U.S. citizen or resident generally is taxed on his or her worldwide income, with the allowance of a foreign tax credit for foreign taxes paid on the foreign income. An individual who has his or her tax home in a foreign country and who meets either of two eligibility requirements, however, generally can elect to exclude an amount of foreign earned income from gross income (sec. 911(a)). The maximum exclusion is $70,000 per year, increased in increments of $2,000 per year beginning in 1998. The exclusion is $74,000 for 1999. The exclusion is indexed for inflation beginning in 2008 (for inflation after 2006).

An individual meeting the eligibility requirements generally may also elect to exclude (or deduct, in certain cases) certain housing costs (sec. 911(a)(2)). Housing costs available for exclusion are the excess of the individual's housing expenses for the year over an amount equal to the product of 16 percent of the daily salary of an employee of the United States who is compensated at a rate equal to the annual rate paid for step 1 of GS-14, multiplied by the number of days during the taxable year that the person meets the exclusion's qualification requirements (sec. 911(c)(1)). For this purpose, housing expenses generally are the reasonable expenses, other than deductible interest or taxes, paid or incurred during the taxable year by (or on behalf of) the individual for his or her housing (and housing of his spouse and dependents) in a foreign country (sec. 911(c)(2)).[17] Generally, the taxpayer is permitted an exclusion for the expenses of the abode that bears the closest relationship to the tax home of the individual.[18]

To qualify for the foreign earned income exclusion, an individual must satisfy either a bona fide residence test or a physical presence test.[19] Under the bona fide residence test, a citizen of the United States must establish to the satisfaction of the Treasury Secretary that he or she has been a bona fide resident of a foreign country for an uninterrupted period which includes an entire taxable year (sec. 911(d)(1)). In order to satisfy the physical presence test, the individual must be present overseas for 330 days out of any 12 consecutive month period (sec. 911(d)(2)). In either case, the taxpayer must have a tax home in a foreign country.[20]

The combined earned income exclusion and housing amount exclusion may not exceed the taxpayer's total foreign earned income for the taxable year (sec. 911(d)(7)). Foreign earned

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[17] Housing expenses are not considered reasonable to the extent they are lavish or extravagant under the individual's circumstances.

[18] Under a special rule, however, those expenses may also include the costs of maintaining a separate household outside of the United States for his or her spouse and dependents if that household is maintained due to dangerous, unhealthful, or otherwise adverse living conditions in the location of the household where the taxpayer resides.

[19] Note that whereas the physical presence test applies to both U.S. citizens and non-citizen U.S. residents (as defined under section 7701(b)), the statutory bona fide residence test applies only to U.S. citizens.

[20] For this purpose, the term "tax home" means the taxpayer's home for purposes of determining the deductibility of traveling expenses while away from home under section 162(a)(2). A taxpayer is not treated as having a tax home in a foreign country for any period during which he has an abode in the United States (sec. 911(d)(3)).

income generally means income earned from sources outside the United States as compensation for personal services actually rendered by the taxpayer (sec. 911(d)(2)).[21]

The foreign earned income provision contains a denial of double benefits by reducing such items as the foreign tax credit by the amount attributable to excluded income (sec. 911(d)(6)).

Individuals who are present in a country with respect to which restrictions relating to travel or travel-related transactions are in effect lose certain tax benefits (sec. 911(d)(8)).[22] An individual who is present in such a country does not lose tax benefits unless that individual's engaging in travel-related transactions is in violation of law. An individual is not treated as a bona fide resident of, or as present in, a foreign country for any day during which the individual is present in a country in violation of law. Foreign earned income, otherwise eligible for the exclusion, does not include any income from sources within such a country attributable to services performed therein. Housing expenses eligible for tax benefits do not include any expenses (allocable to a period in which presence was prohibited) for housing in such a country or for housing of the spouse or dependents of the taxpayer in another country while the taxpayer is present in such a country.

2. Income from sources within U.S. possessions

The Code provides special rules for the taxation of certain persons residing in, and earning income from sources within, U.S. possessions.

<u>Guam, American Samoa, and the Northern Mariana Islands</u>

As a general rule, section 931 provides that an individual who is a bona fide resident of Guam, American Samoa, or the Northern Mariana Islands is permitted to exclude from his or her gross income any income derived from sources within those possessions, as well as any income that is effectively connected with the conduct of a trade or business by that individual within

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[21] Foreign earned income does not include amounts (1) received as a pension or an annuity, (2) paid by the United States Government (or governmental agency to an employee thereof), (3) included in gross income by reason of section 402(b) (taxation of beneficiaries of nonexempt trusts) or section 403(c) (taxation of beneficiaries of nonqualified annuities), or (4) received after the close of the taxable year following the taxable year in which the services to which the amounts are attributable were performed (sec. 911(b)(1)(B)).

[22] For this purpose, the restrictions must have been adopted pursuant to the Trading With the Enemy Act (50 U.S.C. App. 1 et seq.), or the International Emergency Economic Powers Act (50 U.S.C. 1701 et seq.).

those possessions.[23] In order to eliminate such a person's ability to receive a double benefit from this provision, neither a deduction (other than the deduction for personal exemptions) nor a credit is permitted to be taken if it is properly allocable to amounts excluded from gross income.

The rules of section 931 apply to bona fide residents of American Samoa, but do not yet apply to bona fide residents of Guam and the Northern Mariana Islands. In order for those rules to apply to Guam and the Northern Mariana Islands, certain requirements must be satisfied, including, among other things, that the possession and the United States enter into an implementation agreement that provides for the elimination of double taxation by the possession and the United States; the establishment of rules that prevent or inhibit U.S. income tax evasion or avoidance; exchange of information between the possession and the United States for tax administration purposes; and resolution of other problems arising in connection with the administration of the tax laws of the possession or the United States.[24] Guam and the United States entered into such an implementation agreement, intended to be effective January 1, 1991. However, the implementation agreement was indefinitely delayed, such that no agreement currently is in effect with Guam. The Northern Mariana Islands and the United States have not yet entered into an implementation agreement.[25] Until the applicable requirements are satisfied, the tax code of Guam and the Northern Mariana Islands is identical to that of the United States (i.e., a mirror code).

U.S. Virgin Islands

The tax code of the Virgin Islands is identical to that of the United States (i.e., a mirror code). An individual who is a U.S. citizen or resident and has Virgin Island-source income or income derived from the conduct of a trade or business in the Virgin Islands for the taxable year generally is required to file income tax returns with both the United States and the Virgin Islands (sec. 932(a)). The individual's tax liability is pro-rated based on a specified formula. Under the formula, the amount of tax due to the Virgin Islands is equal to the total tax liability multiplied by the proportion of adjusted gross income from Virgin Islands sources to total adjusted gross income (sec. 932(b)). The remainder of the tax is paid to the United States.

The rule specified in the preceding paragraph does not apply to a person who is a bona fide resident of the Virgin Islands at the close of the taxable year. Such a person is required to file an income tax return with the Virgin Islands. If the return so filed reports income from all sources and identifies the source of each item shown on the return, and the full tax liability on

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[23] No exclusion is permitted for amounts received for services rendered as an employee of the United States Government.

[24] Tax Reform Act of 1986, section 1271.

[25] American Samoa and the United States entered into an implementation agreement, effective January 1, 1988.

such income is remitted to the Virgin Island Government, then gross income shown on the Virgin Islands return is excluded from gross income for purposes of computing the person's U.S. income tax liability (i.e., the person will have no gross income for U.S. tax purposes) (sec. 932(c)).

<u>Puerto Rico</u>

A person born in Puerto Rico typically is a U.S. citizen and, thus, a U.S. person for U.S. tax purposes. However, income derived from sources within Puerto Rico by an individual who is a bona fide resident of Puerto Rico during the entire taxable year generally is excluded from gross income and exempt from U.S. taxation, even if such resident is a U.S. citizen (sec. 933).[26] Such income generally is subject to taxation by Puerto Rico. In order to eliminate such a person's ability to receive a double benefit from this provision, neither a deduction (other than the deduction for personal exemptions) nor a credit is permitted to be taken if it is properly allocable to amounts excluded from gross income.

Items of income earned from sources outside of Puerto Rico by U.S. persons who reside in Puerto Rico generally are subject to U.S. taxation.

[26] No exclusion is permitted for amounts received for services rendered as an employee of the United States Government.

III. 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 capital account (U.S. investment abroad and foreign investment in the United States).

A. Trade Deficits and Cross Border Capital Flows

<u>National income accounting</u>

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.[27]

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[27] 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 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,

$$(1)\ GNP = C + I + G + (X\text{-}M) + NI.$$

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

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 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

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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.

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):

$$\text{Net Foreign Borrowing} = \text{Investment} - \text{Saving}$$

or,

$$\text{Net Foreign Borrowing} = (\text{Imports} - \text{Exports}) - \text{Net Investment Income}$$

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.[28] 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.[29] If the economy currently does not have enough domestic

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[28] This equation in the text can be seen from equation (3) in footnote 27 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, then net foreign borrowing must be greater.

[29] 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.

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 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.

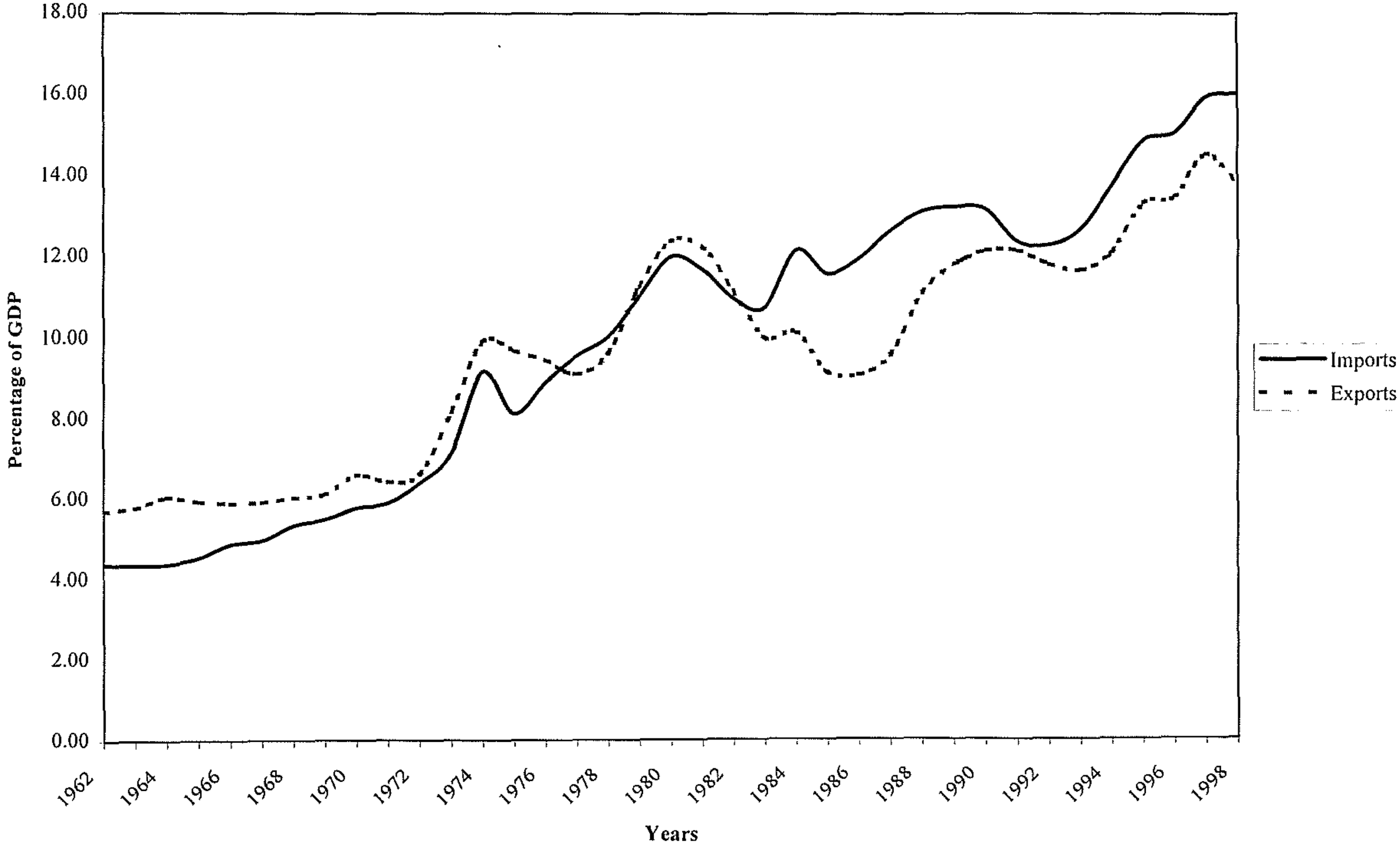
The above observations support the argument that the trade deficit does not in itself provide a useful measure of international competitiveness, since trade deficits and trade surpluses can be either good or bad for the United States. The example of oil discovery discussed above shows that even increases 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.

B. Trends in the United States' Balance of Payments

Foreign trade has become increasingly important to the United States economy. Figure 1 presents the value of exports from the United States and imports into the United States as a percentage of GDP for the period 1962-1998.[30] As depicted in Figure 1, exports and imports each have risen from less than six percent of GDP in 1962 to more than 13.5 percent in 1998. Figure 1 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.

[30] Data for Figure 1 are from the U.S. Commerce Department, Bureau of Economic Analysis and are reprinted in Appendix Tables A.1. and A.2.

Figure 1.-- Exports and Imports as a Percentage of United States GDP, 1962-1998



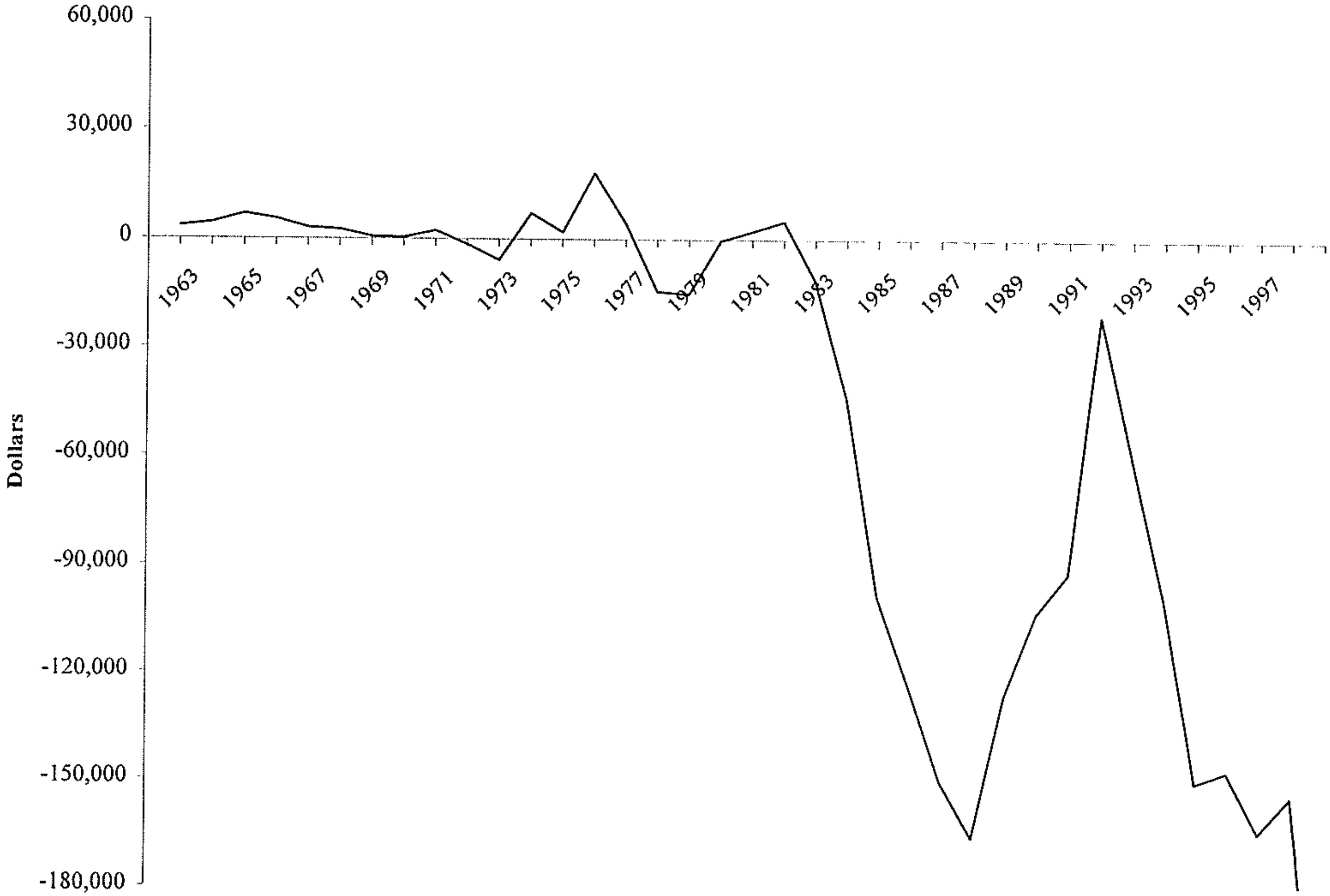
Source: Department of Commerce, Bureau of Economic Analysis

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), was positive as recently as 1981, but generally has been in deficit by over $90 billion per year nine times since 1984. Figure 2 reports the current account balance of the United States for the period 1963 through 1998 in nominal (non-inflation-adjusted) dollars.[31] Figure 2, like Figure 1, shows the United States' change in status from net exporter to net importer since the early 1980s. Figure 2 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.

[31] Data for Figure 2 are from the U.S. Commerce Department, Bureau of Economic Analysis and are reprinted in Appendix Table A.1.

Figure 2.--United States Current Account Balance, 1963-1998

[millions nominal dollars]



Source: Department of Commerce, Bureau of Economic Analysis

The aggregate data reported in Figures 1 and 2 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. Figures 3, 4, and 5 separately chart the nominal dollar value of exported and imported goods (Figure 3), exported and imported services (Figure 4), and investment income earned by U.S. and foreign persons (Figure 5).[32] The sum of the export curves in Figures 3, 4, and 5 less the sum of the import curves (plus unilateral remittances) equals the current account balance curve of Figure 2.

Figures 3, 4, and 5 reveal different trends. As has been widely reported, the merchandise (goods only) trade deficit has been over $100 billion per year since 1984. On the other hand, the United States has been a net exporter of services since the mid-1970s (Figure 4). Only since 1994 have payments of income to foreign persons on their U.S. investments exceeded U.S. receipts of income on investments abroad (Figure 5).

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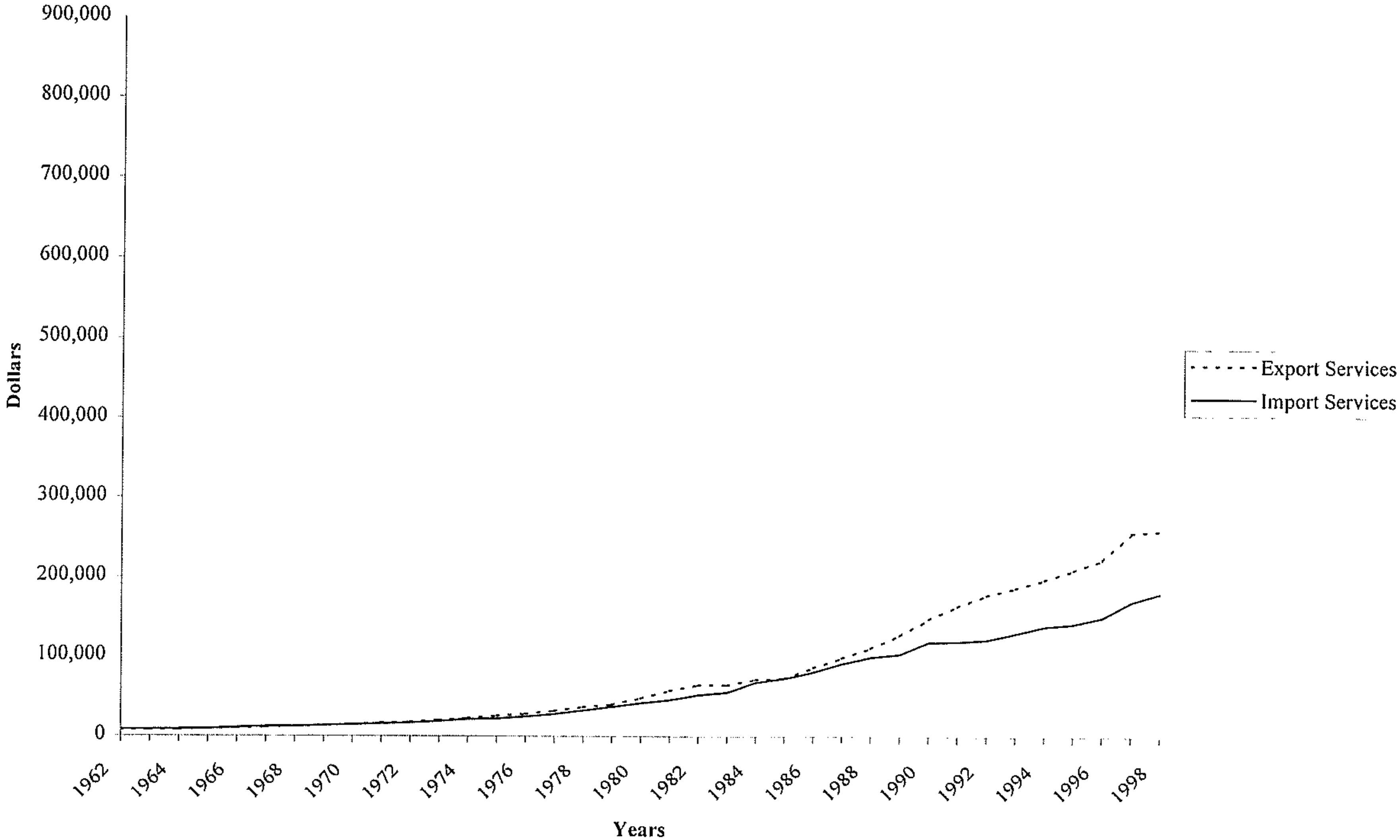
[32] Data for Figures 3, 4, and 5 are from the U.S. Commerce Department, Bureau of Economic Analysis and are reprinted in Appendix Table A.1.

Figure 3.--U.S. Merchandise Trade, 1962-1998
[millions nominal dollars]

Source: Department of Commerce, Bureau of Economic Analysis

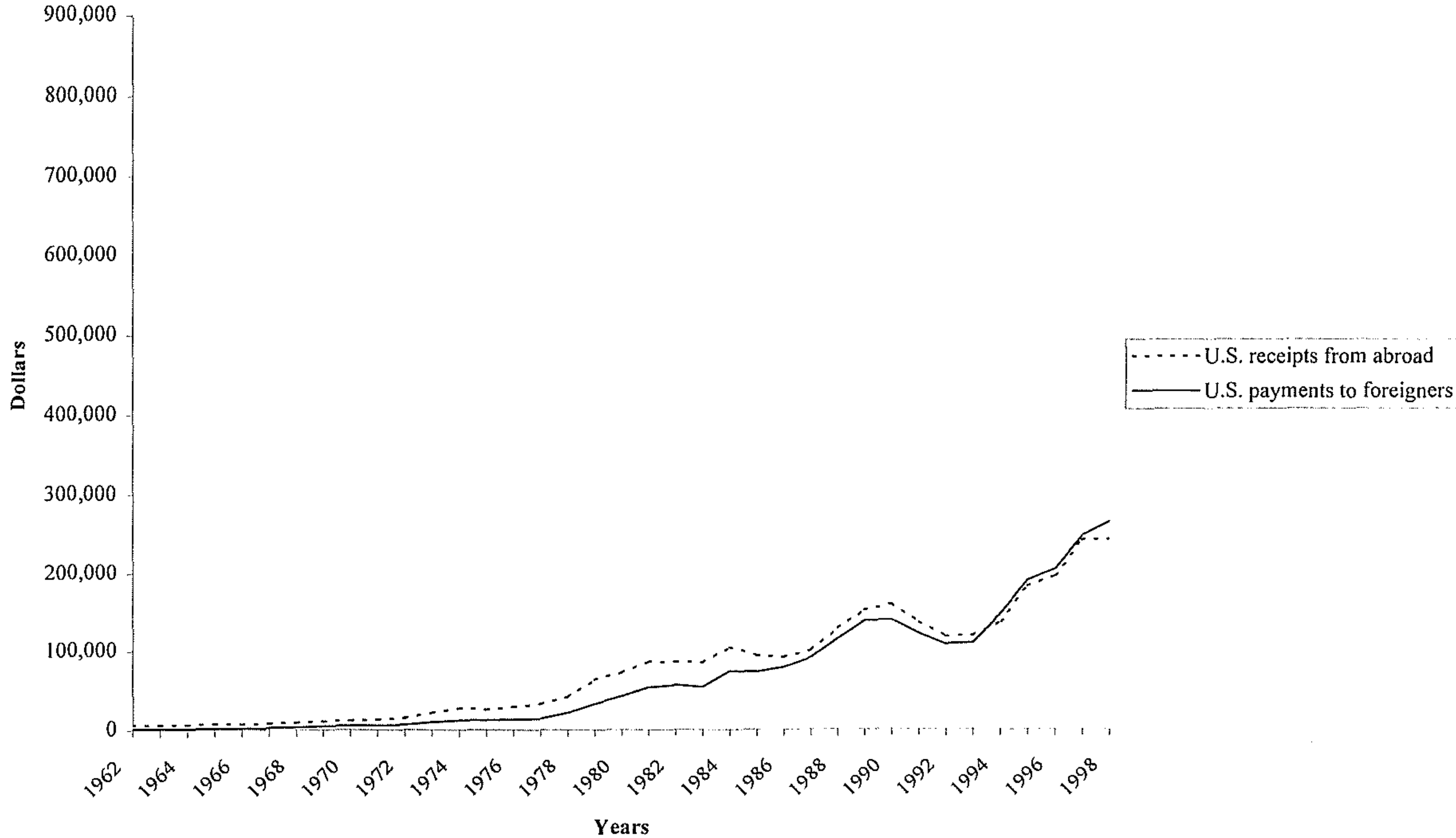
Figure 4.--Trade in Services, 1962-1998
[millions nominal dollars]



Source: Department of Commerce, Bureau of Economic Analysis

Figure 5.--U.S. Receipts of Income from Abroad and U.S. Payments to Foreign Persons, 1962-1998

[millions nominal dollars]



Source: Department of Commerce, Bureau of Economic Analysis

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.

The preceding paragraph suggests that intra-firm trade involves the shipment of components across borders. Other intra-firm trade may involve the shipment of raw materials abroad for manufacture abroad or shipment of finished goods to a foreign sales affiliate. The data do not permit such distinctions to be drawn. Nevertheless, the extent of this intra-firm cross-border trade is large and growing. In 1994, large foreign-owned domestic corporations reported sales of tangible goods to related foreign persons (exports) of $70.5 billion, a figure representing 14 percent of total U.S. merchandise exports in 1994. Large foreign-owned domestic corporations reported purchases of tangible goods from related foreign persons (imports) of $180.6 billion, a figure representing 27 percent of total U.S. merchandise imports in 1994.[33] Similarly, in 1994, U.S. multinational enterprises shipped $136.1 billion of goods to their foreign affiliates, a figure representing 26 percent of U.S. merchandise exports in 1994. Foreign affiliates of U.S. multinational enterprises shipped $113.4 billion of goods to their U.S. parent enterprise, a figure representing 17 percent of U.S. merchandise imports in 1994.[34] Thus, in total, in 1994 intra-firm trade accounted for at least 40 percent of U.S. merchandise exports and 44 percent of U.S. merchandise imports.

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 in Part III.A. above, the current account balance, which consists primarily of the trade balance, should be exactly offset by the capital account balance, which measures the net inflow or outflow of capital to or from the United States. The difference between the current account surplus or

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[33] Michael G. Seiders, "Transactions Between Large Foreign-Owned Domestic Corporations and Related-Foreign Persons, 1994," *SOI Bulletin*, 17, Winter 1997-1998, pp. 123-140. The figures reported in the text are the sum of reported "sales of stock in trade" and "sales of other tangible property." See Figure B. In 1991, such inter-affiliate trade by large foreign-owned domestic corporations represented 11 percent of merchandise exports and 24 percent of merchandise exports.

[34] Raymond J. Mataloni, Jr., "U.S. Multinational Companies: Operations in 1995," *Survey of Current Business*, 77, October 1997, p. 50.

deficit and the capital account deficit or surplus is recorded as a statistical discrepancy. Serious problems of measurement cause the accounts to be somewhat mismatched in practice, but basic patterns are unlikely to be significantly distorted by these problems.

Table 1.–International Transactions of the United States, Selected Years, 1975-1998
($ Billions nominal)

	1975	1980	1985	1990	1995	1998
Current Account Balance	**18.1**	**2.3**	**-124.2**	**-92.7**	**-152.9**	**-233.4**
Exports of Goods and Services	157.9	344.4	382.7	697.4	965.0	1,174.1
Merchandise	107.1	244.3	215.9	389.3	574.9	671.1
Services	25.5	47.6	73.2	147.8	208.8	260.4
Receipts from U.S. assets abroad	25.4	72.6	93.7	160.3	181.3	242.6
Imports of Goods and Services	132.7	333.8	484.0	756.7	1,087.8	1,365.6
Merchandise	98.2	249.8	338.1	498.3	749.3	919.0
Services	22.0	41.5	72.9	118.8	145.8	181.5
Payments on foreign-owned U.S. assets	12.6	42.5	73.1	139.6	192.7	265.1
Unilateral Transfers	7.1	8.3	23.0	33.4	30.1	41.9
Capital Account Balance	**-24.0**	**-27.7**	**101.3**	**48.2**	**146.2**	**237.1**
Foreign Investment in the United States	15.7	58.1	141.2	122.2	426.3	542.5
Direct Investment	2.6	16.9	20.0	47.9	74.7	196.2
Private non-direct investment	6.0	25.7	122.3	40.4	241.1	368.4
Official	7.0	15.5	-1.1	33.9	110.5	-22.1
U.S. Investment Abroad	39.7	87.0	39.9	74.0	280.1	305.4
Direct investment	14.2	19.2	14.1	30.0	96.9	131.9
Private non-direct investment	21.1	54.4	19.1	44.2	173.1	165.8
Increase in government assets	4.3	13.3	6.7	-0.1	10.1	6.7
Allocation of Special Drawing Rights	----	1.2	----	----	----	----
Statistical Discrepancy	**5.9**	**25.4**	**23.0**	**44.5**	**6.7**	**-3.6**

Source: Christopher L. Bach, "U.S. International Transactions, Fourth Quarter and Year 1998," *Survey of Current Business,* U.S. Department of Commerce, Bureau of Economic Analysis, April 1999, pp. 18-65, and selected earlier issues of the *Survey of Current Business.* Data for 1998 are preliminary.

C. Trends in the United States' Capital Account

Overview of the United States' capital account

As explained in Part III.A., 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 2 and Table 1 document the United States' current account has been in deficit since the early 1980s. Figure 6 plots gross (before depreciation) U.S. investment and gross U.S. saving as a percentage of GDP for the period 1959-1998.[35] Figure 6 also plots net foreign investment as a percentage of GDP. In Figure 6, when the United States is a net exporter of capital, net foreign investment is measured as a positive number and when the United States is a net importer of foreign capital net foreign investment is measured as a negative number. 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 1998, gross investment in the United States was $1,392 billion and net foreign investment was $213 billion, or 15.3 percent of gross domestic investment. In 1993, net foreign investment comprised 8.9 percent of gross domestic investment.

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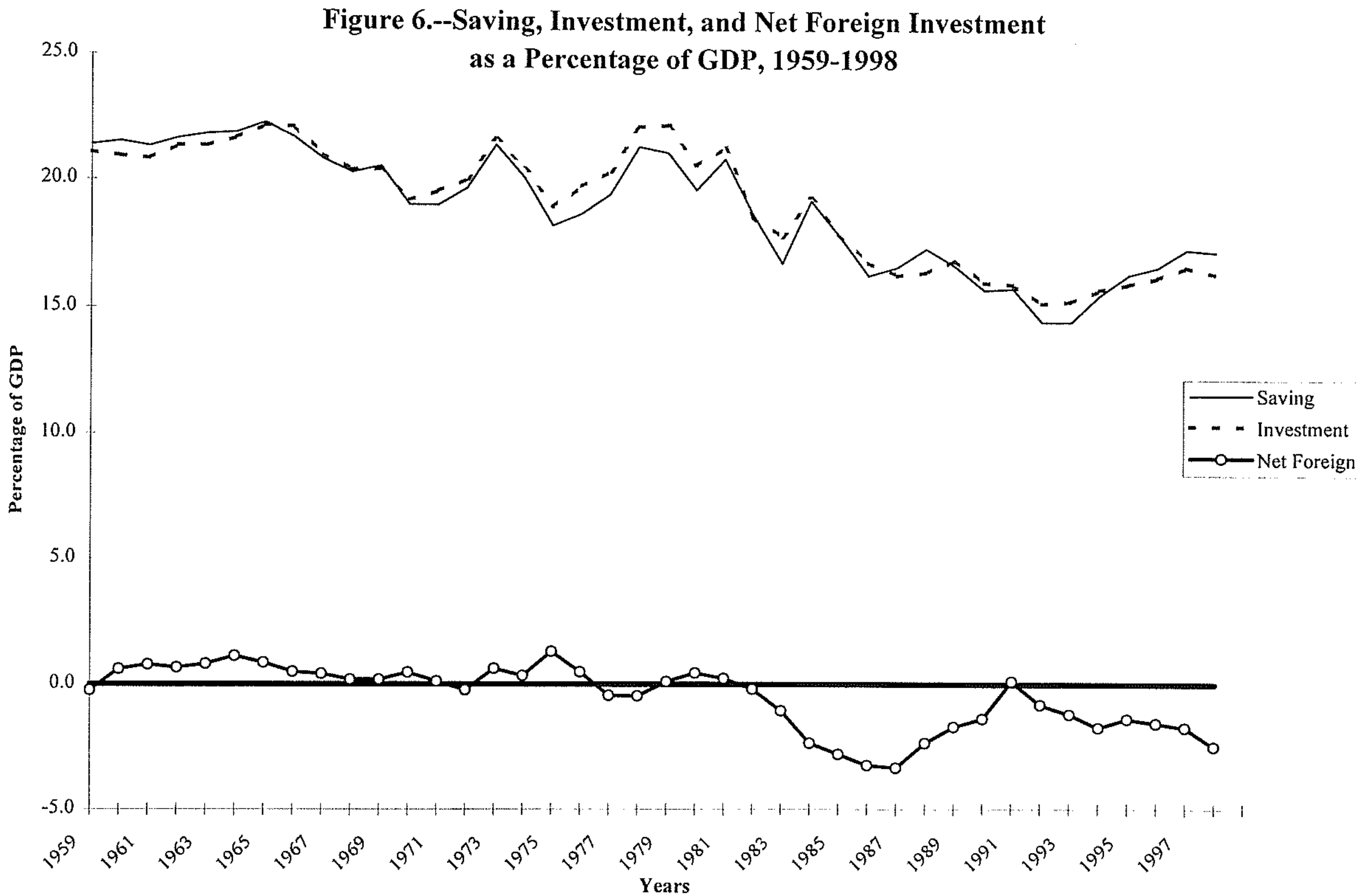
[35] Data for Figure 6 are from the U.S. Department of Commerce, Bureau of Economic Analysis and are reprinted in Appendix Table A.2.

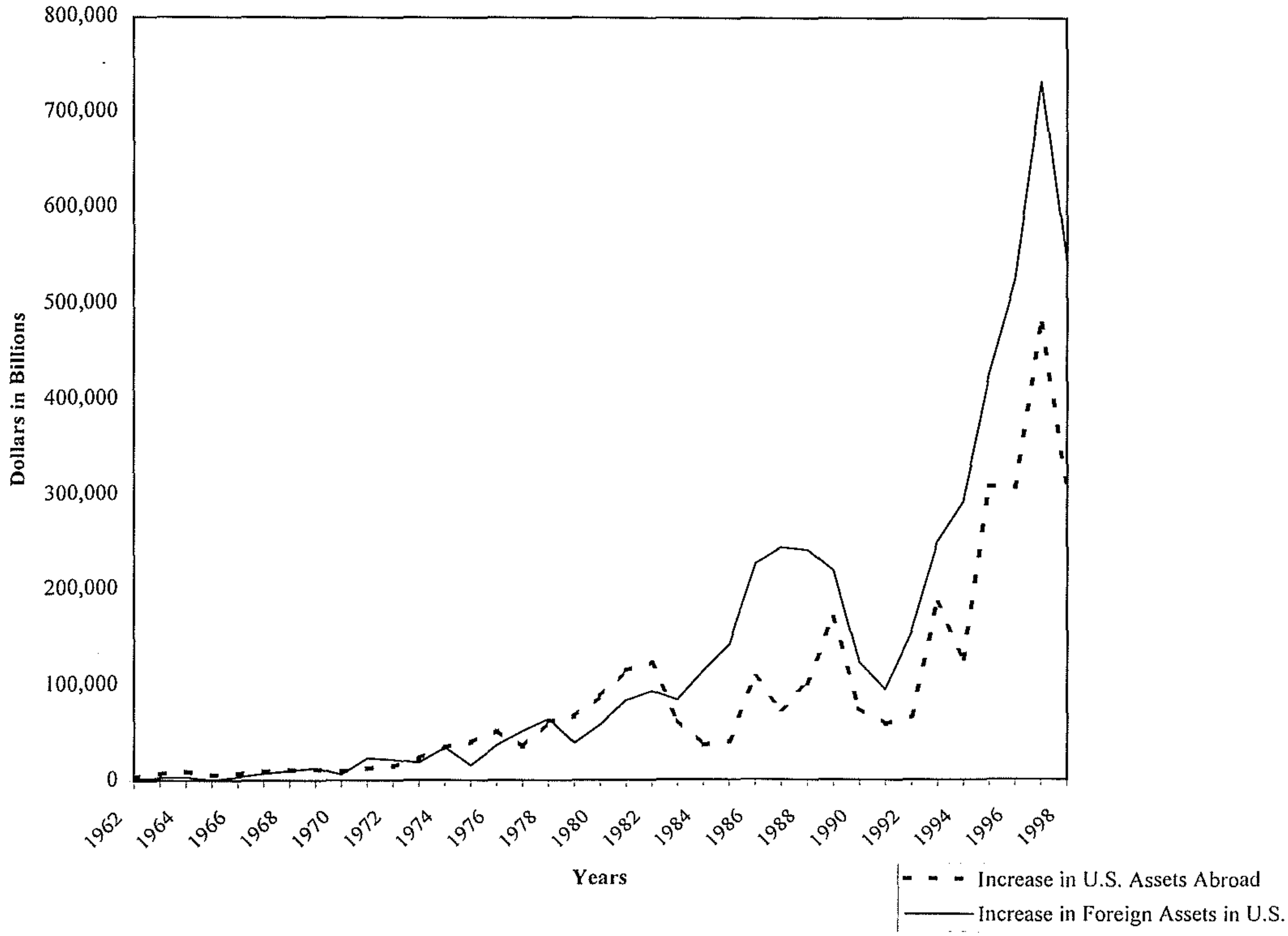


Source: Department of Commerce, of Economic Analysis

The net foreign investment in the United States is measured by the United States' capital account. The capital account measures the increase in U.S. assets abroad compared to the increase in foreign assets in the United States. Figure 7 plots the annual increase of U.S. assets abroad and of foreign assets in the United States in nominal dollars for the period 1962-1998.[36]

[36] Data for Figure 7 are from the U.S. Department of Commerce, Bureau of Economic Analysis and are reprinted in Appendix Table A.3.

Figure 7.--Annual Increases in U.S. Assets Abroad and in Foreign Assets in U.S., 1962-1998



Source: Department of Commerce, Bureau of Economic Analysis

Growth in foreign-owned assets in the United States[37]

The amount of foreign-owned assets in the United States grew more than 700 percent between 1975 and 1988 and more than 300 percent between 1980 and 1988.[38] The total amount of foreign-owned assets in the United States exceeded $5.4 trillion by the end of 1997.[39] 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 1997, the amount of foreign-owned assets in the United States exceeded U.S.-owned assets abroad by $1.22 trillion.[40] These investments are measured by their book value. 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.[41] Figures 8 and 9 display the value of U.S.-owned assets abroad and foreign-owned assets in the United States for selected years measured under both current (or book) 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 7.

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[37] For a more complete discussion of issues relating to foreign investment in the United States, see Joint Committee on Taxation, *Background and Issues Relating to the Taxation of Foreign Investment in the United States* (JCS-1-90), January 23, 1990.

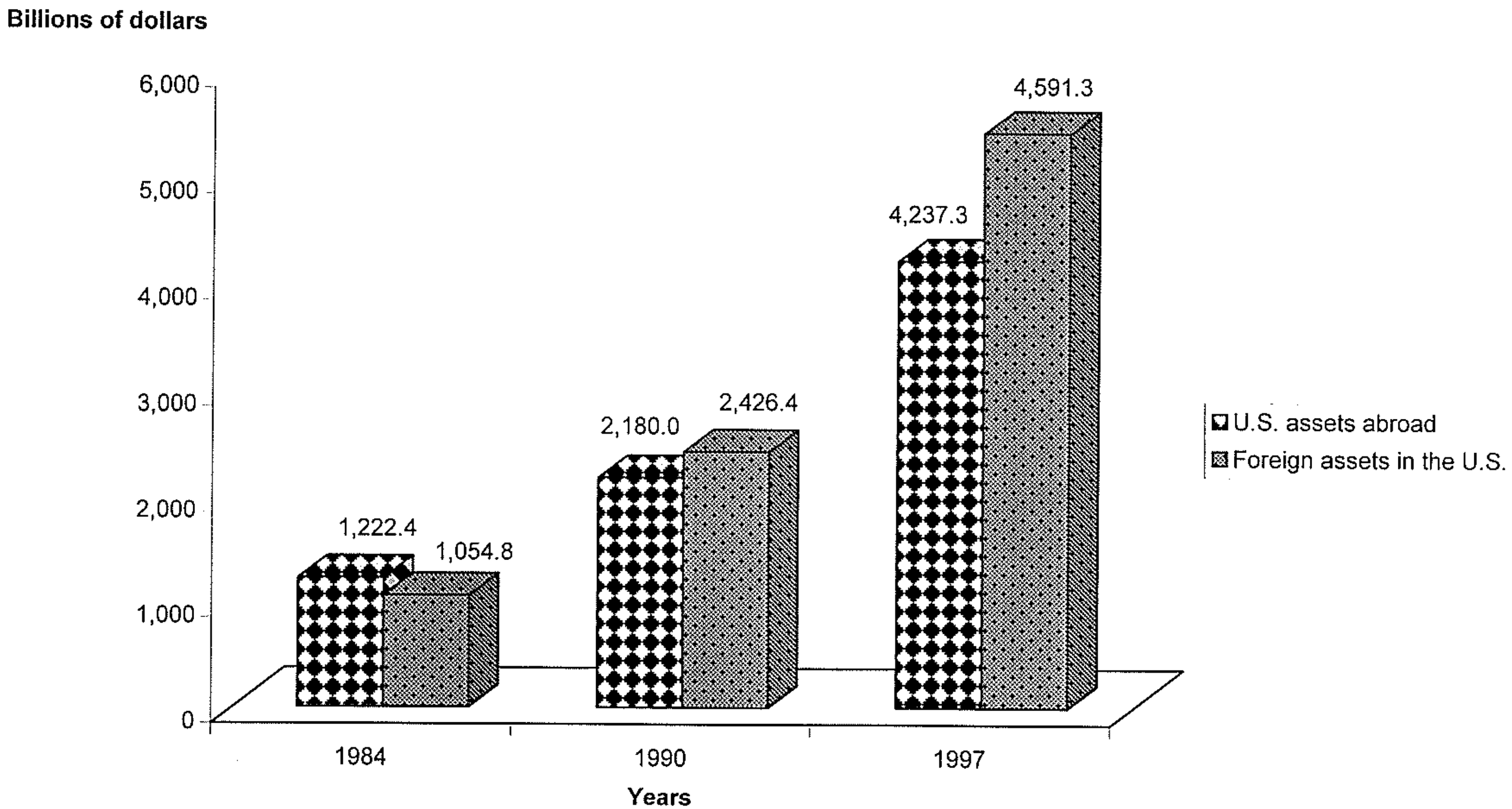
[38] Russell B. Scholl, "The International Investment Position of the United States in 1988," *Survey of Current Business*, U.S. Department of Commerce, Bureau of Economic Analysis, June 1989, p. 43.

[39] Russell B. Scholl, "The International Investment Position of the United States in 1997," *Survey of Current Business*, 78, U.S. Department of Commerce, Bureau of Economic Analysis, July 1998 pp. 24-34.

[40] *Ibid.*

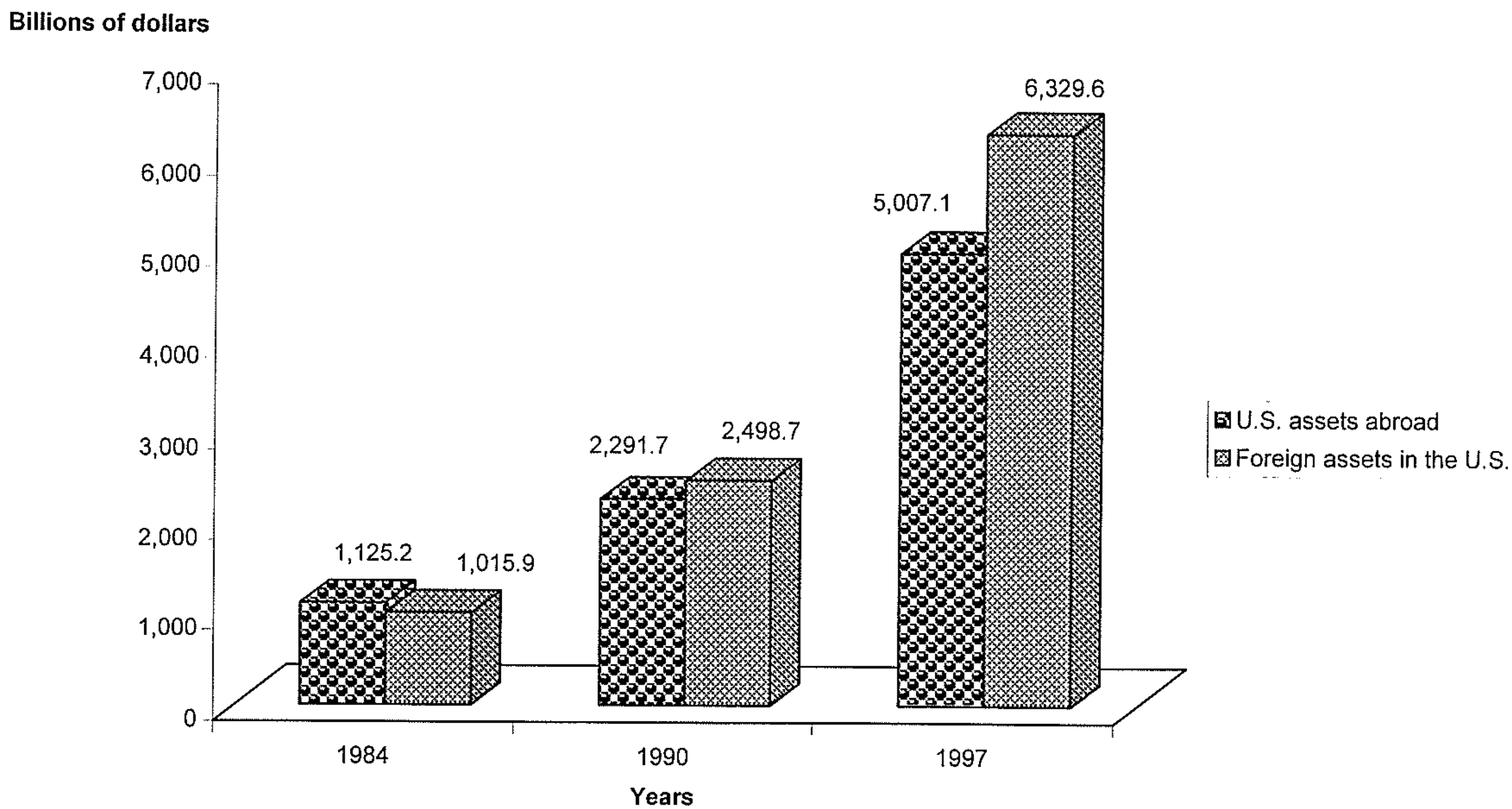
[41] Some commentators also have observed that the statistical discrepancies in the trade data are becoming large enough to question any conclusions which might be drawn from such data. See "Statistical Discrepancy" in Table 1 above. The distinction between book valuation and market valuation is only 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 8.--International Investment Position of the United States, 1984, 1990, and 1997 (direct investment at current cost)



Source: Department of Commerce, Bureau of Economic Analysis.

Figure 9.--International Investment Position of the United States, 1984, 1990, 1997 (direct investment at market value)



Source: Department of Commerce, Bureau of Economic Analysis.

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 $752 billion in the United States in 1997, having grown from $83 billion in 1980.[42]

The largest category of investment is non-direct investment held by private (non-governmental) foreign investors, commonly referred to as portfolio investment. This category 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 1997, portfolio assets of foreign persons in the United States were more than five times the recorded value of direct investment, $3,875 billion compared to $752 billion, respectively.[43] Bank deposits account for approximately one-fifth of this total, and reflect, in part, the increasingly global nature of banking activities. Figure 10 reports the dollar value of foreign holdings of selected U.S. assets, both portfolio investment and direct investment, for 1984, 1990, and 1997. 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 by private U.S. persons abroad has grown from $295.1 billion in 1980 to $4,237 billion in 1997.[44] This growth has not been as rapid as the growth in the value of investments by foreign persons in the United States.

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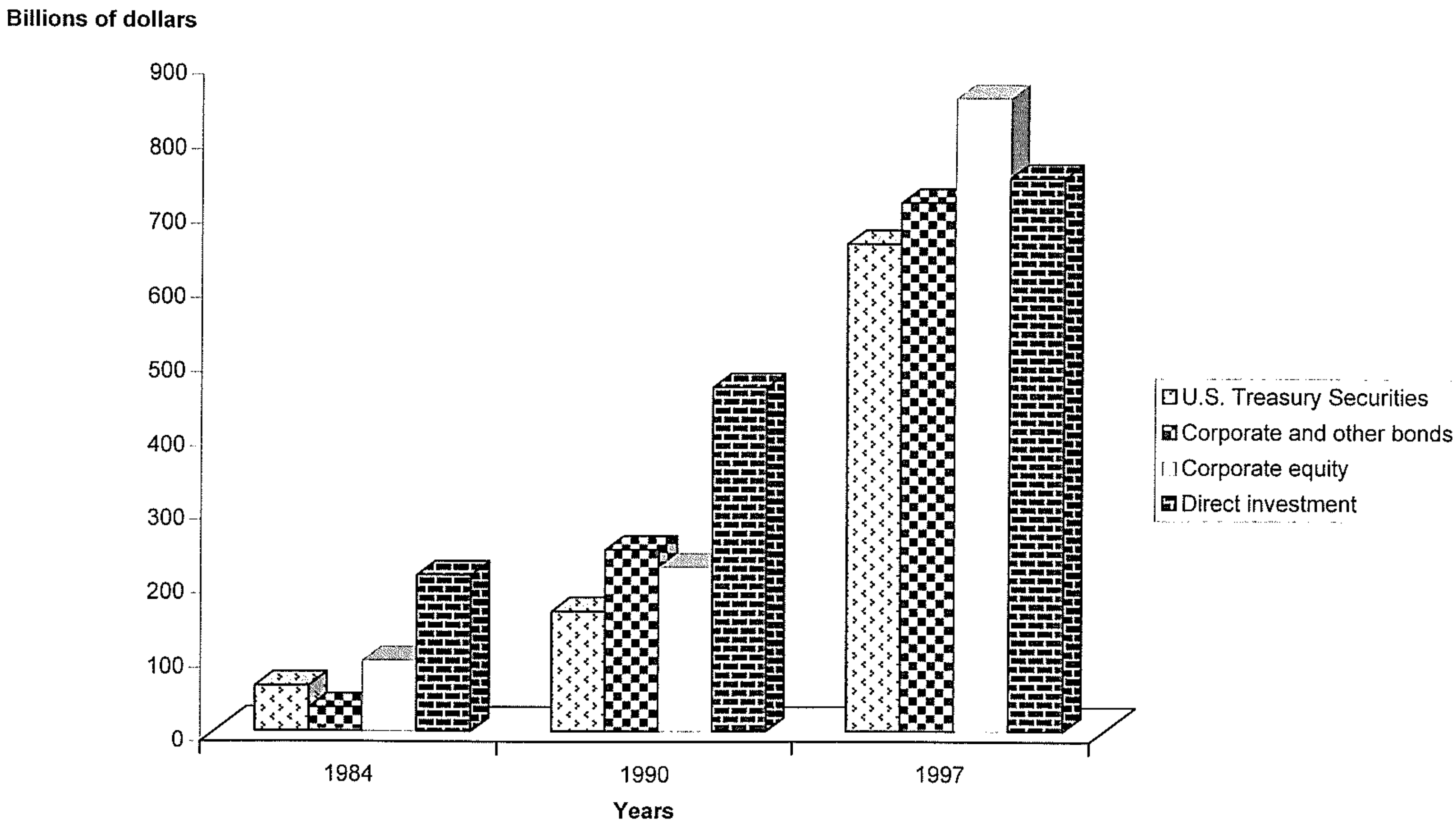
[42] Russell B. Scholl, "The International Investment Position of the United States in 1994," *Survey of Current Business*, U.S. Department of Commerce, Bureau of Economic Analysis, June 1995, pp. 52-60, and Scholl, "The International Investment Position of the United States in 1997."

[43] If direct investments are measured at market value, foreign persons' portfolio holdings are approximately 2.4 times greater than foreign persons' direct investments. Scholl, "The International Investment Position of the United States in 1997."

[44] Scholl, "The International Investment Position of the United States in 1994," and Scholl, "The International Investment Position of the United States in 1997."

Figure 10.--Selected Nongovernmental Foreign Holdings of United States' Assets, Both Portfolio and Direct Investments, 1984, 1990, 1997 (direct investment at current cost)



Source: Department of Commerce, Bureau of Economic Analysis.

IV. ANALYSIS OF ISSUES RELATING TO INTERNATIONAL INVESTMENT

A. Capital Export Neutrality, Capital Import Neutrality, and National Neutrality

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,[45] 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.

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

Capital export neutrality.--Capital export neutrality refers to a system where 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 of international taxation where income from investment located in each country is taxed at the same rate regardless of the residence of the investor.

Chart 1 below, compares capital import neutrality with capital export 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 under 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 subject to the domestic tax rate regardless of the residence of the taxpayer. Foreign investment income 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

Under capital export neutrality, decisions on the location of investment are not distorted by taxes. 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.

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.

Some commentators refer to the principle of capital import neutrality as promoting "competitiveness." This notion of competitiveness[46] refers to the ability of U.S. multinationals (firms 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. 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 export 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

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[46] The term "competitiveness" encompasses different concepts. In the present context it might be better labeled "multinational competitiveness." Multinational competitiveness refers to the competitiveness of certain types of firms or industries relative to other types of firms or industries. The term "competitiveness" also is used in the context of measuring 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. In that context, competitiveness might be better labeled "trade competitiveness." Trade competitiveness often is measured by the U.S. trade deficit. Competitiveness also is used to describe comparisons of the current U.S. living standard and the prospects for future U.S. living standards with those of other countries. This notion of competitiveness focuses on the productivity growth of U.S. labor and the saving rate of the United States, because both of these factors affect future living standards.

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.[47]

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

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[47] 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.

further.[48] 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.[49]

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[48] 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.

[49] For a discussion of the positive effects of outbound U.S. investment, see Council of Economic Advisers, *Economic Report of the President*, Washington, D.C.: U.S. Government Printing Office, February 1991, pp. 258-261. The discussion on outbound investment concludes (p. 259): "On a net basis, it is highly doubtful that U.S. direct investment abroad reduces U.S. exports or displaces U.S. jobs." 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. Robert E. Lipsey reports that, on average, studies find one dollar of overseas production by U.S. affiliates generates $0.16 of exports from the United States. Robert E. Lipsey, "Outward Direct Investment 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. There is no definitive conclusion about the effect of outbound investment on U.S. employment. Lipsey 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...." *Ibid.* p. 31. However, most of the evidence Lipsey reviews examines individual industries rather than aggregate economic effects.

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. Since national neutrality is less generous to taxpayers than capital export neutrality, deviations from capital export neutrality that increase tax 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.

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, many provisions work at cross purposes. Some provisions of current law favor outbound investment, while others discourage it.

B. Departures From Capital Export Neutrality in Current U.S. Tax Rules

1. 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 1994, the largest 7,500 CFCs of U.S. multinationals had $98.4 billion of earnings and profits and paid $23.3 billion of foreign income taxes.[50] Foreign branches of U.S. multinationals had $60.3 billion of branch income and paid $4.2 billion of foreign income taxes.[51]

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,

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[50] Internal Revenue Service, "Controlled Foreign Corporations, 1994," *Statistics of Income Bulletin,* 18, Summer 1998, pp. 109-130.

[51] Robin A. Robison and Sarah E. Nutter, "Corporate Foreign Tax Credit, 1994: "*Statistics of Income Bulletin*, 18, Fall 1998, pp. 172-230.

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.[52] The benefit from the deferral of tax until foreign earnings are repatriated may be viewed as similar to the benefit enjoyed from 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 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.[53] In addition, the interest allocation rules, by precluding full worldwide fungibility of interest among commonly controlled domestic <u>and foreign</u> 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.

2. 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

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[52] This second benefit is in some degree limited by the less generous foreign tax credit carryover periods (back 2 years and forward 5 years) as compared to the net operating loss carryover periods (back 2 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 carryforward, usable only over the next 5 years. Thus, while deferral makes it possible for the taxpayer to choose the year in which the tax will be deemed paid, the reduced carryforward period prevents the taxpayer from also enjoying the flexibility to use its excess credits over the full 20 years accorded to losses.

[53] E.g., Tillinghast, "International Tax Simplification," 8 *American Journal of Tax Policy* 187, 190 (1990).

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 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.[54] 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.

3. 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."[55] This tax reform proposal addressed the use of high foreign taxes imposed by one country (i.e., taxes in excess of the U.S.

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

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

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 1986 Act reduced in a different way the ability on U.S. taxpayers to average foreign tax liability on highly taxed foreign income against the foreign tax liability on lightly taxed 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 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.

4. 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.

5. Export incentives

A fundamental decision facing any U.S. business is whether to locate some portion of production overseas. In the case of a business that sells products overseas, the investment location decision to invest abroad or domestically can be influenced by the availability of tax incentives for exports. Export incentives, like tariffs that penalize imports, reduce global economic welfare. Furthermore, although they undoubtedly improve the lot of the favored export sector, they generally can be expected to reduce the overall economic welfare of the nation providing the subsidy. Nevertheless, tax and other export incentives may reduce the incentive of U.S. businesses to locate production abroad. One of the tax incentives providing favorable treatment to the taxation of income from exports is contained in the provisions available to exporters who make use of FSCs.

C. Tax Treaties

1. In general

Treaties involve trade-offs between the tax benefits they provide to inbound and outbound investments. Policy issues are implicated by the trade-offs. For example, treaties might be seen as benefitting U.S. outbound investment at the cost of reducing U.S. revenues from tax on inbound investment.[56] Treaties might be seen as benefitting the United States by increasing the inflow of investment at the cost of increasing investment outflows and reducing the U.S. tax take from the inflow. Or treaties might be seen as benefitting the United States simply by reducing barriers to the free flow of resources at the cost of reducing U.S. tax revenues. In each case, treaties raise the issue of whether their perceived benefits are in fact benefits, whether they are worth the costs, and whether more efficient approaches would be superior.

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[56] For a discussion of the impact of treaties on the taxation of inbound investments see Joint Committee on Taxation, *Background and Issues Relating to the Taxation of Foreign Investment in the United States* (JCS-1-90), January 23, 1990, pp. 43-54.

The discussion that follows will concentrate on the policy issues arising from the tax benefits achieved from applying treaty rules to outbound investment. It is worth remembering, however, that every such benefit is connected, to a greater or lesser degree, to benefits the residents of the other treaty country achieve vis-a-vis their own U.S. tax liabilities.

An overarching treaty issue regarding outbound investment is whether the reduction in foreign tax benefits the U.S. Treasury, U.S. taxpayers or the United States as a whole. For example, a U.S. taxpayer with excess foreign tax credit limitation generally will not benefit from a treaty reduction in foreign tax on income currently includable in U.S. taxable income. That is, U.S. tax liability will replace the reduced foreign tax liability. In this case, the treaty directly benefits the U.S. Treasury. A taxpayer with excess foreign tax credits would find that a treaty reduction in foreign tax is not offset by an equal increase in U.S. tax. Thus, the treaty directly benefits the taxpayer, not the Treasury. The issue becomes whether this net tax savings of the U.S. taxpayer on its foreign income is also a net benefit to the United States. The conclusion reached becomes more significant to treaty policy the more U.S. taxpayers are likely to be in an excess credit position.

A related issue is the degree to which treaties are desirable from a U.S. policy perspective simply because foreign tax reductions of any amount are achieved, and the degree to which the amount of foreign tax reduction sought in negotiations should rightfully be measured by the degree to which they eliminate aspects of foreign laws that discriminate against foreign investors or foreign income of domestic investors.

2. Tax sparing

One treaty issue particularly affecting the treatment of outbound investment concerns the U.S. negotiating position with respect to tax sparing. Tax sparing would require the reduction or elimination of U.S. tax on income from activities in the source country, for example by allowing a credit for foreign taxes even though the taxes are not actually paid due to a tax holiday or other local tax incentive program. Tax sparing generally is sought by countries seeking, for their own policy reasons, to encourage inbound foreign investment through tax incentives.

Proponents of tax sparing have argued that U.S. multinationals are <u>prevented</u> by the absence of tax sparing from receiving the benefit of foreign tax incentives to investment in the foreign country. It is asserted, therefore, that if the United States spared the right to levy home country tax on foreign income, U.S.-based multinationals could tap low cost labor and raw material markets in developing countries at an after-tax cost "far below" that currently available to them. Thus, proponents of tax sparing argue that current U.S. policy not to enter into tax-sparing agreements hinders U.S. companies from access to the low cost labor and raw materials necessary to compete equally in world trade.[57]

Opponents of tax sparing argue that if the goal of tax sparing were to relieve U.S. tax burdens that might otherwise deter active foreign investment, then under present law, tax sparing is actually unnecessary, given the deferral permitted on active foreign income earned by a U.S. person through a foreign subsidiary. Industries that historically have not taken advantage of deferral--i.e., that have operated abroad in branch form--include natural resources industries which, it is argued, must base their operations where the resources are located, regardless of local tax incentives. It may also be argued that these industries paying sufficient amounts of foreign tax have found themselves to be exempt, in effect, from bearing any additional U.S. tax burden on that income.

It is further argued that tax sparing interacts with the foreign government's internal tax policy to the detriment of tax policy for all concerned. Given a certain level of government expenditures and a certain level of debt-financing of those expenditures, a country choosing to impose an income tax has a choice of imposing a relatively low income tax rate on a broad income base, or of imposing a higher rate accompanied by tax incentives. It has been argued that the latter type of system is inefficient because of its "uneven playing field." In many cases, the government concerned is also dependent on foreign loans or foreign aid to finance the shortfall in revenues caused by the allowance of inefficient tax incentives. Thus, allowance of tax concessions by countries seeking to further their economic development increases pressure on international financial markets and institutions, as well as on foreign aid budgets. It is argued that a treaty device which encourages U.S. investors abroad to bring pressure on foreign countries to grant tax concessions interferes with the development of foreign tax systems.[58] It is further argued that because in return for United States agreement to provide tax sparing, the treaty country grants to U.S. residents reduced local taxes on payments such as interest, royalties, and dividends, the pressures on the treaty country government that are fostered by tax sparing are increased further by reduced local revenues.

3. Integration of corporate/shareholder taxation

U.S. treaty policy toward integration benefits for cross-border dividends seems to be based on a view that U.S. investors in corporations resident in countries with integrated corporate/shareholder taxation systems should receive source country tax reductions on their

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[57] Arthur Young & Co., *The Competitive Burden: Tax Treatment of U.S. Multinationals* (1988).

[58] *Double Taxation Convention with Pakistan: Hearing before the Senate Comm. on Foreign Relations*, 85th Cong., 1st Sess., 1-32 (1954) (testimony of Professor Stanley Surrey).

dividends from such corporations, and may fairly take a credit under U.S. law based on an amount of tax imposed by the foreign country not on the shareholders, but the corporations.

The treaty issue is not only whether the United States will seek foreign tax reductions for the benefit of U.S. investors in the treaty country, and will forgo some U.S. tax that might otherwise take the place (under U.S. statutory law) of the reduced foreign taxes; the issue also involves arriving at a view as to what level of foreign tax reduction is to be sought and what degree of U.S. tax reduction is believed tolerable.

For example, between the time Germany enacted its imputation system (1977) and the time the 1989 treaty was signed, the Treasury Department expressed the view that the most appropriate adjustment to German tax on U.S. investment in German companies would be for Germany to grant U.S. shareholders refunds of the full 36-percent German federal corporate tax on distributed profits.[59] The treaty that was actually signed generally provides U.S. direct investors no imputation benefit, and provides U.S. portfolio investors in German resident companies with a 5-percent rate reduction relative to the generally applicable 15-percent source country treaty withholding rate for dividends paid by German resident companies. German shareholders, by contrast, receive a credit under internal German law for the full 36-percent "distribution burden" that German corporate earnings bear at the corporate level. Thus, U.S. portfolio investors in German resident companies receive the benefit of the German split-rate system, but receive a smaller imputation-related benefit than German shareholders in German resident companies receive for dividends paid by the companies.

Only under the U.K. treaty does the U.S. direct investor receive source country rate reductions to account for integration. The U.K. treaty does afford U.S. portfolio investors integration benefits analogous to those of domestic investors.[60]

The issue is the degree of integration benefit that the United States will consider acceptable in its treaties. The outcome of the German treaty negotiation demonstrated that the United States was willing to accept less than full parity for its investors in Germany. Some may argue that this bargain falls short of what is acceptable. Others may argue that the benefits actually achieved in the German treaty constituted a reasonable compromise with German internal policy.

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[59] Treasury Department News Release B-1703 (July 2, 1979).

[60] The U.K. recently has made changes which affect the taxation of distributions from U.K. resident companies. These changes may affect the treaty benefits of U.S. investors.

Moreover, it has been a well-established principle of international taxation that the country in which income-producing activity occurs is entitled to collect tax on the income from the activity. Therefore, any treaty system of dividend taxation would likely be designed to permit the source country to retain an adequate percentage of the tax that would have been imposed had the shareholder been domestic.

V. SUMMARY OF TAXATION OF FOREIGN INCOME IN THE UNITED KINGDOM, GERMANY, AND JAPAN

This part provides for purposes of comparison a brief summary of the income tax treatment of foreign-source income under the tax laws of the United Kingdom, Germany, and Japan. The summary is not intended as an authoritative representation of the laws of these countries. The staff of the Joint Committee on Taxation prepared this summary with the assistance of the staff of the Law Library of the Library of Congress.[61]

A. Treatment of Foreign Income in the United Kingdom

1. Foreign tax credit

The worldwide income and gains of U.K. resident individuals and corporations generally are subject to current U.K. tax.[62] In order to prevent an item of non-U.K. source income from being taxed by the source country and again by the United Kingdom, U.K. tax law provides a foreign tax credit (i.e., a credit against U.K. tax on that income to the extent of foreign taxes incurred on that income).

Certain limitations are placed on the ability of taxpayers to utilize foreign tax credits. The foreign tax credit is available only on a source-by-source (i.e., country-by-country) basis. Thus, excess foreign taxes attributable to one source generally may not offset the residual U.K. tax on untaxed or low-taxed foreign income from a different source. However, taxpayers are able to achieve some degree of averaging of foreign taxes through the use of so-called "mixing" corporations. Finally, there is no allowance for a carryback or carryforward of unused foreign tax credits. In cases where credits would go unused, taxpayers may elect to forgo the foreign tax credit and instead claim a deduction for foreign taxes.

U.K. law also provides for an indirect foreign tax credit in the case of certain dividend income earned by a U.K. resident company. Where the dividend is from a non-resident company, the foreign tax credit applies to any tax directly withheld from the dividend, as well as to a portion of the foreign taxes incurred by the payor corporation with respect to the profits so distributed. In order to qualify for the indirect foreign tax credit, the U.K. company (or its parent

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[61] The text summarizes the laws of the United Kingdom, Germany, and Japan as in effect on January 1, 1999.

[62] The income of a U.K. resident, not ordinarily resident or domiciled in the United Kingdom, that is derived from a trade or profession carried on wholly outside the United Kingdom, is subject to U.K. tax only if such income is remitted to the United Kingdom. However, if the earnings of a foreign branch cannot be remitted to the United Kingdom as a result of foreign restrictions, deferral of payment of U.K. tax on that income is allowed.

company) must directly or indirectly own at least 10 percent of the foreign company's voting stock.

For dividends paid by such non-resident companies to U.K. companies after November 25, 1996, the foreign tax credit may be denied if the companies have artificially increased the amount of the underlying foreign tax. The restriction applies when the underlying foreign tax payable by the non-resident company is at a high rate, i.e., in excess of the rate of U.K. corporation tax, and the high rate is included because of an avoidance scheme that has the claiming of double taxation relief as its only or main purpose.

A 1998 law restricts the foreign tax credit when a bank or other lender receives interest or dividends and there is a related "financial expenditure" incurred either by the lender or an associated company. The financial expenditure must be deducted from the interest or dividend such that the foreign tax credit is computed based upon the net amount of the interest or dividend. Further, the amount of foreign withholding tax that may be credited is limited to 15 percent of the gross amount of the interest or dividends concerned.

2. Income earned through foreign subsidiaries

Income earned by non-U.K. subsidiaries (except to the extent they are connected to business operations in the United Kingdom) is not subject to U.K. tax until it is repatriated in the form of dividends. In 1984, special legislation covering controlled foreign companies was introduced. This legislation eliminated the deferral of U.K. tax on certain earnings of foreign subsidiaries.[63] It mainly applies to operations located in tax haven countries.

3. Incentives for outbound investment

Generally, the internal tax laws of the United Kingdom provide no tax incentives for outbound investment other than the allowance of deferral on certain earnings of foreign subsidiaries. However, in certain cases where foreign countries have provided "tax sparing" relief to encourage inbound investment, the United Kingdom has agreed in tax treaties with those countries to allow a credit against U.K. tax for the foreign tax so spared. For foreign-source interest or dividends paid after March 17, 1998, if the foreign tax includes spared tax, the excess of the spared tax over the amount qualifying for the credit is disallowed.

The United Kingdom has an extensive network of tax treaties that include provisions addressing relief from double taxation. This treaty network does not extend to several countries

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[63] The loss of deferral is accomplished by the Inland Revenue's treatment of the relevant earnings of the controlled foreign corporation as having been deemed distributed to its U.K.-resident corporate shareholders, who are in turn subject to U.K. tax on the deemed distributions. Individual shareholders are not subject to this anti-deferral regime.

in Central and South America. In the absence of a treaty, as stated above, a U.K. resident may nonetheless obtain unilateral relief from double taxation through foreign tax credits.

Relief for U.S. State taxes, as opposed to U.S. Federal taxes, also is given unilaterally (i.e., through foreign tax credits). Finally, unilateral relief is granted to dual resident companies which under the United States-United Kingdom income tax treaty are denied the benefit of most of the provisions of that treaty.

B. Treatment of Foreign Income in Germany

1. Foreign tax credit

Germany taxes the worldwide income of German resident individuals and corporations. This leads to potential double taxation of foreign income if the source country taxes such income as well. Germany grants relief from this double taxation either through treaties on double taxation, or unilaterally through a credit or deduction for the foreign tax.

A direct foreign tax credit is available to German resident taxpayers[64] for the foreign income taxes paid on foreign-source income if the country imposing the tax does not have a double taxation treaty with Germany. In addition, the foreign tax credit of German law also is applied if there is a double taxation treaty that calls for its application or if the treaty does not provide relief. For purposes of the foreign tax credit, German law defines taxable foreign-source income according to the German tax rules for domestic income. Under these rules, business income is taxable foreign-source income if realized through a foreign permanent establishment of the German resident taxpayer, or through his foreign permanent representative.

The foreign tax credit can be claimed only for foreign taxes that correspond to the German income tax. However, it can also be claimed for the income taxes of the States or local subdivisions of a foreign country. The foreign tax credit can only be used to reduce the German individual or corporate income tax. It cannot be credited against other taxes such as the German trade tax.

The foreign tax credit is computed separately for each country that imposed foreign taxes. This per-country limitation benefits taxpayers who incur a loss in one country while obtaining a profit elsewhere. On the other hand, the limitation is disadvantageous where high and low profits are achieved in different countries.

Foreign tax credits cannot be carried over to future tax years. Credited foreign tax cannot exceed the amount of German tax attributable to the foreign-source net income. In sum, these rules work to the effect that the taxpayer is burdened with the higher of the German or foreign income tax.

A deduction of foreign tax is available to the German resident taxpayer, as an option, instead of claiming of a credit. However, if the deduction is taken, it must be applied to all income from one country.

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[64] The direct foreign tax credit is also available to certain non-resident taxpayers for foreign source income attributable to a permanent business establishment located in Germany.

When German resident corporations receive dividends from their foreign subsidiaries, they are, under certain circumstances, entitled to apply for an indirect foreign tax credit for a pro-rata share of foreign income taxes paid by the foreign subsidiary. This benefit is granted to mitigate the multiple taxation of corporate income. The indirect foreign tax credit is available for German resident shareholders owning at least 10 percent of the stock of a first tier foreign subsidiary, provided the subsidiary is engaged in an active business (and not in passive investments). In addition, an indirect foreign tax credit can be claimed under certain circumstances for foreign income taxes paid by a second-tier foreign subsidiary. Indirect foreign tax credits below the second tier are not allowed.

For dividends distributed by subsidiaries in certain specified developing countries, a paid foreign tax credit is available. The credit is granted for the total amount of the German income tax due on the dividends, regardless of the actual foreign taxes paid. This credit, however, is available only for certain pre-existing investments.[65]

2. Treatment of foreign income in treaties

Germany has concluded double taxation treaties for income taxes with more than 70 countries. These countries use different methods to avoid double taxation. Many of the treaties follow the Model Convention of the Organization for Economic Cooperation and Development. They primarily use the exemption method under which the income of a permanent business establishment is taxed only in the source country and exempted from taxation in the country of residence of the owner of the foreign establishment. However, some treaties also use the foreign tax credit as the primary means of eliminating double taxation; yet others use the exemption method for Germany and the foreign tax credit method for the other country (as is the case in the Germany-United States double taxation treaty).

When the foreign tax credit method is used, Germany computes the foreign tax credit in accordance with German domestic rules, as described above. When the exemption method is used, losses resulting from a permanent establishment in a treaty country generally are not deductible from the German income tax of the resident German taxpayer who owns the establishment.

When dividends of foreign corporations are distributed to a German resident shareholder, their tax treatment depends on a governing tax treaty or the absence thereof. Under most German tax treaties, shareholders who own at least 10 percent of the stock of a foreign corporation are exempt from German income taxation. However, on the basis of domestic legislation, this exemption is reduced to 85 percent of the income. The remaining 15 percent of such income is subject to German taxation because they are deemed to be non-deductible business expenses.

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[65] The credit is available for certain investments made before 1981 or based on contracts made at that time.

3. Income earned through foreign subsidiaries

In general, income of foreign corporations is taxed by Germany as foreign-source income only if there is a distribution to a German resident shareholder. Thus, generally, the corporate identity of the foreign corporation is respected, particularly if the foreign corporation is engaged in an active business.

However, there are certain instances under which the income of foreign subsidiaries of German resident shareholders is taxed by Germany as foreign-source income. In this regard, certain undistributed income of foreign corporations is attributed to the German controlling shareholder as though it had been distributed and is taxed essentially as domestic income. This includes undistributed income of a foreign corporation controlled at least 50 percent by one or more German shareholders. The income of such corporations is taxed in Germany as though it was domestic income,[66] even if the corporation is an active foreign subsidiary (being engaged in a business other than investing). In addition, passive income (e.g., investment income) of a foreign corporation is attributed to a German shareholder who owns at least 10 percent of the stock of the corporation, if the corporation resides in a low tax country.[67]

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[66] The taxation of controlled foreign companies was introduced in 1972, in the Foreign Transactions Tax Act, based on the subpart F provisions of the U.S. Internal Revenue Code.

[67] Such tainted foreign investment income is taxable for resident German shareholders beginning in 1992.

C. Treatment of Foreign Income in Japan

1. General rule of deferral

Japanese taxpayers are subject to income tax on their worldwide income, including income derived by foreign branch operations that is not remitted to Japan. Japanese taxpayers generally are not subject to taxation in Japan on the earnings of foreign corporations in which they own interests until the profits are repatriated to Japan (in the form of dividend or liquidating distributions, or upon sale of the interests). This general rule of deferral, however, does not apply to certain tax-haven subsidiaries.

Certain Japanese taxpayers are taxable currently on their pro rata shares of the undistributed profits of Japanese-controlled corporations established in designated tax havens. Japanese taxpayers subject to this treatment are those owning (directly, indirectly, or constructively) five percent[68] or more of the stock in a tax-haven subsidiary that is owned (directly, indirectly, or constructively) more than 50 percent by Japanese taxpayers. Tax-haven countries include any country where the effective rate of tax applicable to the Japanese-controlled corporation in question is "substantially low," which is defined in a Cabinet order as 25 percent or less. The effective rate of tax generally is computed under principles of Japanese law, and includes not only local taxes actually paid but also local taxes that are exempted or reduced to the extent that the exemption or reduction qualifies for a tax-sparing credit under the local country's tax treaty with Japan.

Actual distributions of previously taxed tax-haven profits are free of additional income tax if distributed within the next five years after the undistributed profits are taxed.

2. Foreign tax credit

Japanese corporations may credit certain foreign taxes against income taxes payable to Japan on foreign-source income. Both direct and deemed-paid taxes are eligible for the credit, with 25-percent ownership in the foreign corporation generally required for deemed-paid credits. Deemed-paid credits are allowed for only first-tier and second-tier foreign corporations.[69] The ownership threshold is waived for purposes of deemed-paid credits with respect to certain shareholders in designated tax-haven subsidiaries. The ownership threshold also is reduced in certain tax treaties. For example, under the United States-Japan tax treaty, Japanese shareholders in U.S. corporations may claim deemed-paid credits with respect to as little as 10-percent ownership.

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[68] Prior to the 1992 tax law amendments, this ownership threshold was 10 percent.

[69] Deemed-paid credits for second-tier foreign corporations have been allowed only since Japan's 1992 tax amendments.

The foreign tax credit is subject to a limitation computed on an overall (as opposed to a per-country) basis. The limitation is computed on the basis of the national income tax only, although excess credits may be used, to a limited extent, against the corporation's local inhabitants income tax. Excess credits may be carried forward (but not back) for up to three years, and excess limitation may be carried forward three years (in effect, yielding a result similar to a carryback).

For purposes of determining the foreign tax credit limitation fraction, only one third of a taxpayer's foreign-source income that is not subject to any foreign tax may be included in the numerator as foreign-source income (although all of such income is included in the denominator as worldwide income), and the numerator (foreign-source income) may not exceed 90 percent of the denominator (worldwide income). In addition, export sales from Japan are treated as foreign source-income only if they are sold through a fixed place of business in a foreign country, or if the income from the export sales is subject to tax in a foreign jurisdiction.

3. Tax sparing

Japan has entered into a number of tax treaties that provide "tax sparing" benefits with respect to tax holidays or other incentives granted by developing countries to foreign investors. Under tax sparing, Japanese investors in business operations in the other treaty country may claim foreign tax credits against their Japanese tax liability as if they had actually paid the foreign taxes that were "spared" pursuant to the tax holidays. Japan currently offers tax sparing in its treaties with Bangladesh, Brazil, Bulgaria, China, India, Indonesia, Ireland, Korea, Malaysia, Mexico, Pakistan, the Philippines, Singapore, Spain, Sri Lanka, Thailand, Turkey, Vietnam, and Zambia.

APPENDIX: DATA ON U.S. INTERNATIONAL TRANSACTIONS

Appendix Table A.1.--U.S. International Transactions, 1962-1998

($ millions)

Years	Exports of goods, services and income	Exports of merchandise adjusted (excluding military)	Exports of services	Income receipts on U.S. assets abroad	Imports of goods, services and income	Imports of merchandise adjusted (excluding military)	Imports of services	Income payments on foreign assets in the U.S.	Unilateral transfers (Net)
1962	33,340	20,781	6,941	5,618	25,676	16,260	8,092	1,324	4,277
1963	35,776	22,272	7,348	6,157	26,970	17,048	8,362	1,560	4,392
1964	40,165	25,501	7,840	6,824	29,102	18,700	8,619	1,783	4,240
1965	42,722	26,461	8,824	7,437	32,708	21,510	9,111	2,088	4,583
1966	46,454	29,310	9,616	7,528	38,468	25,493	10,494	2,481	4,955
1967	49,353	30,666	10,667	8,021	41,476	26,866	11,863	2,747	5,294
1968	54,911	33,626	11,917	9,367	48,671	32,991	12,302	3,378	5,629
1969	60,132	36,414	12,806	10,913	53,998	35,807	13,322	4,869	5,735
1970	68,387	42,469	14,171	11,748	59,901	39,866	14,520	5,515	6,156
1971	72,384	43,319	16,358	12,707	66,414	45,579	15,400	5,435	7,402
1972	81,986	49,381	17,841	14,765	79,237	55,797	16,868	6,572	8,544
1973	113,050	71,410	19,832	21,808	98,997	70,499	18,843	9,655	6,913
1974	148,484	98,306	22,591	27,587	137,274	103,811	21,379	12,084	9,249
1975	157,936	107,088	25,497	25,351	132,745	98,185	21,996	12,564	7,075
1976	172,090	114,745	27,971	29,375	162,109	124,228	24,570	13,311	5,686
1977	184,655	120,816	31,485	32,354	193,764	151,907	27,640	14,217	5,226
1978	220,516	142,075	36,353	42,088	229,870	176,002	32,189	21,680	5,788
1979	287,965	184,439	39,692	63,834	281,657	212,007	36,689	32,961	6,593
1980	344,440	224,250	47,584	72,606	333,774	249,750	41,491	42,532	8,349
1981	380,928	237,044	57,354	86,529	364,196	265,067	45,503	53,626	11,702
1982	361,436	211,157	64,079	86,200	355,804	247,642	51,749	56,412	17,075
1983	351,306	201,799	64,307	85,200	377,573	268,901	54,973	53,700	17,718
1984	395,850	219,926	71,168	104,756	474,203	332,418	67,748	74,036	20,598

Years	Exports of goods, services and income	Exports of merchandise adjusted (excluding military)	Exports of services	Income receipts on U.S. assets abroad	Imports of goods, services and income	Imports of merchandise adjusted (excluding military)	Imports of services	Income payments on foreign assets in the U.S.	Unilateral transfers (Net)
1985	382,747	215,915	73,155	93,677	484,037	338,088	72,862	73,087	22,954
1986	401,843	223,344	86,523	91,976	528,513	368,425	80,992	79,095	24,189
1987	449,514	250,208	98,539	100,767	592,745	409,765	91,678	91,302	23,107
1988	560,426	320,230	111,126	129,070	662,487	447,189	99,491	115,806	25,023
1989	642,025	362,120	127,387	152,517	719,758	477,365	103,535	138,858	26,106
1990	697,426	389,307	147,819	160,300	756,694	498,337	118,783	139,574	33,393
1991	718,194	416,913	164,278	137,003	732,486	490,981	119,614	121,892	6,869
1992	737,394	440,352	178,617	118,425	766,796	536,458	121,991	108,346	32,148
1993	763,826	456,823	187,755	119,248	829,668	589,441	129,979	110,248	34,084
1994	838,820	502,485	198,716	137,619	954,304	668,584	138,829	146,891	35,761
1995	969,189	575,940	210,590	182,659	1,082,268	749,364	142,230	190,674	35,075
1996	1,032,478	611,669	223,907	196,902	1,155,101	799,343	150,440	205,318	42,472
1997	1,179,380	679,325	258,268	241,787	1,294,904	877,279	170,520	247,105	39,691
1998	1,174,055	671,055	260,385	242,615	1,365,648	919,040	181,514	265,094	41,855

Source: U.S. Department of Commerce, Bureau of Economic Analysis, Survey of Current Business, June 1995, pp. 84-85; June 1997, p. D-58; and April 1999, p. D-52.
Note: Data for 1998 are preliminary.

Appendix Table A.2--U.S. Gross Domestic Product, Gross Saving, Gross Investment, and Net Foreign Investment, 1959-1998

($ billions)

Year	GDP	Gross saving	Gross investment	Net foreign investment
1959	507.2	108.5	106.9	-1.2
1960	526.6	113.9	110.2	3.2
1961	544.8	116.8	113.5	4.3
1962	585.2	127.4	125.0	3.9
1963	617.4	135.4	131.9	5.0
1964	663.0	145.8	143.8	7.5
1965	719.1	161.0	159.6	6.2
1966	787.8	171.7	174.4	3.9
1967	833.6	174.4	175.1	3.5
1968	910.6	185.8	186.0	1.7
1969	982.2	202.9	200.7	1.8
1970	1,035.6	198.2	199.1	4.9
1971	1,125.4	215.3	220.4	1.3
1972	1,237.3	244.9	248.1	-2.9
1973	1,382.6	297.5	299.9	8.7
1974	1,496.9	302.3	306.7	5.1
1975	1,630.6	298.3	309.5	21.4
1976	1,819.0	340.9	359.9	8.9
1977	2,026.9	395.5	413.0	-9.0
1978	2,231.4	477.4	494.9	-10.4
1979	2,557.5	540.9	568.7	2.6
1980	2,784.2	547.4	574.8	12.5
1981	3,115.9	651.1	665.7	7.4
1982	3,242.1	604.7	601.8	-6.1
1983	3,514.5	589.6	626.2	-37.3
1984	3,902.4	751.5	755.7	-91.5
1985	4,180.7	746.7	748.0	-116.9
1986	4,422.2	721.0	743.1	-142.9
1987	4,692.3	780.9	764.2	-156.4
1988	5,049.6	877.2	828.7	-118.1
1989	5,438.7	907.9	919.5	-92.4
1990	5,743.8	904.4	920.5	-78.6
1991	5,916.7	935.3	944.0	7.3
1992	6,244.4	905.4	949.1	-50.5
1993	6,550.2	938.4	993.5	-88.2
1994	6,931.4	1,055.9	1,087.2	-139.6
1995	7,269.6	1,187.4	1,160.9	-100.6
1996	7,661.6	1,274.5	1,242.3	-119.2
1997	8,110.9	1,406.3	1,350.5	-140.9
1998 1/	8,511.0	1,468.0	1,391.5	-212.6

Source: U.S. Department of Commerce, Bureau of Economic Analysis.

Appendix Table A.3.--Increase in U.S. Assets Abroad and Foreign Assets in the United States, 1962-1998

($ millions)

Years	Increase in U.S. assets abroad	Increase in foreign assets in U.S.
1962	4,174	1,911
1963	7,270	3,217
1964	9,560	3,643
1965	5,716	742
1966	7,321	3,661
1967	9,757	7,379
1968	10,977	9,928
1969	11,585	12,702
1970	9,337	6,359
1971	12,475	22,970
1972	14,497	21,461
1973	22,874	18,388
1974	34,745	34,241
1975	39,703	15,670
1976	51,269	36,518
1977	34,785	51,319
1978	61,130	64,036
1979	66,054	38,752
1980	86,967	58,112
1981	114,147	83,032
1982	122,335	92,418
1983	61,573	83,380
1984	36,313	113,932
1985	39,889	141,183
1986	106,753	226,111
1987	72,617	242,983
1988	100,087	240,265
1989	168,744	218,490
1990	74,011	122,192
1991	57,881	94,241
1992	65,875	153,823
1993	184,589	248,529
1994	125,851	291,365
1995	307,856	424,462
1996	306,830	525,046
1997	478,502	733,441
1998 1/	305,385	542,482

Source: U.S. Department of Commerce, Bureau of Economic Analysis, Survey of Current Business, June 1995, pp. 84-85; June 1997, p. D-58; May 1999, p. D-52.

1/ preliminary data.

Appendix Table A.4--Selected Nongovernmental Foreign Holdings of U.S. Assets, Both Portfolio and Direct Investment, 1982-1997

($ billions)

Year	U.S. Treasury securities	Corporate and other bonds	Corporate equity	Direct investment
1982	25.8	16.7	76.3	176.9
1984	62.1	32.4	96.1	211.2
1986	96.1	140.9	168.9	265.8
1988	100.9	191.3	201.0	375.2
1990	152.4	238.9	221.7	467.3
1992	197.7	299.3	300.2	500.5
1994	235.7	368.1	371.6	561.2
1996	504.8	588.0	611.4	667.0
1997	662.0	718.1	859.9	751.8

Source: Russell B. Scholl, "The International Investment Position of the United States, in 1996," Survey of Current Business, 77 July 1997, pp. 24-33, and Russell B. Scholl, "The International Investment Position of the United States in 1997," Survey of Current Business, 78, July 1998, pp. 24-34.

Note: Direct investment at current cost.