OVERVIEW OF PRESENT-LAW RULES RELATING TO INTERNATIONAL TAXATION AND DESCRIPTION OF H.R. 2018, THE INTERNATIONAL TAX SIMPLIFICATION FOR AMERICAN COMPETITIVENESS ACT OF 1999

Scheduled for a Public Hearing

Before the

SUBCOMMITTEE ON OVERSIGHT
of the
HOUSE COMMITTEE ON WAYS AND MEANS

on June 22, 1999

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of the

JOINT COMMITTEE ON TAXATION

June 18, 1999

JCX-30-99

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INTRODUCTION

The Subcommittee on Oversight of the House Committee on Ways and Means has scheduled a public hearing on June 22, 1999, on issues relating to international tax simplification and competitiveness. This document,[1] prepared by the staff of the Joint Committee on Taxation, provides an overview of certain aspects of present law and a description of H.R. 2018, the International Tax Simplification for American Competitiveness Act of 1999, introduced by Messrs. Houghton, Levin, Sam Johnson, Herger, Matsui, Crane, and English on June 7, 1999.[2]

Part I of the document provides an overview 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 II is a description of the provisions of H.R. 2018.

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[1] This document may be cited as follows: Joint Committee on Taxation, *Overview of Present-Law Rules Relating to International Taxation and Description of H.R. 2018, the International Tax Simplification for American Competitiveness Act of 1999* (JCX-30-99), June 18, 1999.

[2] An identical bill, S. 1164, was introduced by Senators Hatch, Baucus and Mack on May 27, 1999.

I. PRESENT LAW

A. Summary

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.

B. 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 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 such 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. Thus, the income from the U.S. person's foreign operations is subject to current U.S. tax. However, a foreign tax credit may reduce or eliminate the U.S. tax on such income.

3. Foreign operations conducted through a foreign corporation

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. A 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 a U.S. shareholder of a foreign corporation with respect to income earned by the foreign corporation. The main anti-deferral regimes set forth in the Code (in order of enactment) are the foreign personal holding company rules (secs. 551-558), the controlled foreign corporation rules of subpart F (secs. 951-964), and the passive foreign investment company rules (secs. 1291-1298). Additional anti-deferral regimes set forth in the Code are the personal holding company rules (secs. 541-547), the accumulated earnings tax (secs. 531-537), and the foreign investment company and electing foreign investment company rules (secs. 1246 and 1247).

Foreign personal holding companies.--The Revenue Act of 1937 established an anti-deferral regime for foreign personal holding companies ("FPHCs"). A FPHC generally is defined as any foreign corporation if five or fewer U.S. individual citizens or residents own (directly, indirectly, or constructively) more than 50 percent of the corporation's stock (measured by vote or value), and at least 60 percent of the corporation's gross income consists of certain types of passive income (such as dividends, interest, certain royalties and certain rents).[3] If a foreign corporation is a FPHC, 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.

Controlled foreign corporations.--The Revenue Act of 1962 established an anti-deferral regime for controlled foreign corporations ("CFCs") under subpart F of the Code. A CFC generally is defined as any foreign corporation if U.S. persons own (directly, indirectly, or constructively) more than 50 percent of the corporation's stock (measured by vote or value), taking into account only those U.S. persons that own at least 10 percent of the stock (measured by vote only). Under the subpart F rules, the United States generally taxes the U.S. 10-percent shareholders of a CFC on their pro rata shares of certain income of the CFC (referred to as "subpart F income"), without regard to whether the income is distributed to the shareholders. Subpart F income typically is passive income or income that is relatively movable from one

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[3] Once the corporation qualifies as a FPHC, the gross income threshold for each subsequent year generally is 50 percent.

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)). Foreign base company income, in turn, includes 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. For example, foreign personal holding company income includes, among other items, dividends, interest, rents and royalties (subject to certain exceptions). In effect, the United States treats the U.S. 10-percent shareholders of a CFC as having received a current distribution out of the CFC's subpart F income. In addition, the U.S. 10-percent shareholders of a CFC are required to include currently in income for U.S. tax purposes their pro rata shares of the CFC's earnings invested in U.S. property. The U.S. tax on such amounts may be reduced through foreign tax credits.

Passive foreign investment companies.--The Tax Reform Act of 1986 established an anti-deferral regime for passive foreign investment companies ("PFICs"). A PFIC generally is defined as any foreign corporation if 75 percent or more of its gross income for the taxable year consists of passive income, or 50 percent or more of its assets consists of assets that produce, or are held for the production of, passive income.[4] Alternative sets of income inclusion rules apply to U.S. persons that are shareholders in a PFIC, regardless of their percentage ownership in the PFIC. One set of rules applies to PFICs that are "qualified electing funds," under which electing U.S. shareholders currently include in gross income their respective shares of the PFIC's earnings, with a separate election to defer payment of tax, subject to an interest charge, on income not currently received. A second set of rules applies to PFICs that are not qualified electing funds, under which U.S. shareholders pay tax on certain income or gain realized through the PFIC, plus an interest charge that is attributable to the value of deferral. A third set of rules applies to PFIC stock that is marketable, under which electing U.S. shareholders currently take into account as income (or loss) the difference between the fair market value of their PFIC stock as of the close of the taxable year and their adjusted basis in such stock (subject to certain limitations).

Detailed rules for coordination among the anti-deferral regimes are provided to prevent U.S. persons from being subject to U.S. tax on the same item of income under multiple regimes. For example, the PFIC rules generally do not apply to U.S. shareholders that are subject to the subpart F rules.

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[4] For purposes of applying the PFIC asset test, a foreign corporation that is publicly traded measures its assets using fair market value, a CFC that is not publicly traded measures its assets using adjusted tax basis, and any other foreign corporation that is not publicly traded measures its assets using fair market value unless the corporation elects to use adjusted tax basis.

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 establishing artificial transfer prices for transactions between group members.

Under section 482, the Secretary of the Treasury is authorized to redetermine the income of an entity subject to U.S. taxation when it appears that an improper shifting of income between that entity and a commonly controlled entity has occurred. This authority is not limited to reallocations of income between different countries; 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 to clearly 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 a relevant comparable unrelated party transaction 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 theoretically might subject a taxpayer to double taxation if, for example, 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 that 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. Such competent authority procedures, however, do not guarantee that double tax will not be imposed in a particular case.

One method for addressing the issue of double taxation is through the advance pricing agreement ("APA") procedures. An APA is an advance agreement establishing an approved transfer pricing methodology entered into between the taxpayer, the Internal Revenue Service ("IRS"), 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 only 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]

5. Foreign tax credit rules

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-source income by the foreign income taxes they pay on that income. The foreign tax credit, however, does not operate to offset U.S. income tax on U.S.-source income.

A credit against U.S. tax on foreign-source income is allowed for foreign taxes directly paid or accrued by a U.S. person (the "direct" foreign tax credit). 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).

The foreign tax credit provisions 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. For purposes

[5] 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.

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.

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 income. Under this limitation, the credit for foreign taxes on income in a particular category may not exceed the same proportion of the taxpayer's U.S. tax liability which the taxpayer's foreign-source taxable income in that category bears to the taxpayer's worldwide taxable income for the taxable year. Detailed rules are provided for the allocation of expenses against foreign-source income. Special rules apply to require the recharacterization of foreign-source income for a year subsequent to a foreign loss year as U.S.-source income.

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. For purposes of determining excess foreign tax credit limitation amounts, the foreign tax credit separate limitation rules apply.

6. Foreign sales corporations

A foreign sales corporation ("FSC") typically 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. Under special tax provisions, a portion of the export income of an eligible FSC is exempt from U.S. income tax (secs. 921-927). 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.[6]

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[6] Two export-related provisions 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). The FSC rules generally were enacted to replace the DISC rules to address concerns with General Agreement on Tariffs and Trade subsidy rules. 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. 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.

C. 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. 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.

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.

The source of income for U.S. tax purposes is determined based on various factors, including the location or nationality of the payor, the location or nationality of the recipient, the location of the activities that generate the income, and the location of the assets that generate the income. For example, income from the sale or exchange of inventory property that is produced (in whole or in part) within the United States and sold or exchanged outside the United States, or produced (in whole or in part) outside the United States and sold or exchanged within the United States, is treated as partly from U.S. sources and partly from foreign sources. In general, 50 percent of such income is treated as attributable to production activities and is sourced based on the location of the production assets; the other 50 percent of such income is treated as attributable to sales activities and generally is sourced where the sale occurs.

2. Net-basis taxation

The United States taxes on a net basis and at the generally applicable U.S. tax rates the income of foreign persons that is "effectively connected" with the conduct of a trade or business in the United States. 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.

The determination of whether a foreign person is engaged in a U.S. trade or business is based on the facts and circumstances. 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 factors taken into account in determining whether income, gain or loss is effectively connected with a U.S. trade or business include, for example, in the case of U.S.-source capital gains and certain U.S.-source passive income, whether the amount is derived from assets used 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 such amount. In the case of any other U.S.-source income, gain, or loss, such amounts are all treated as effectively connected with the conduct of the trade or business in the United States. Only specific types of foreign-source income are considered to be effectively connected with a U.S. trade or business (sec. 864(c)(4)). Foreign-source income of a type not specified generally is exempt from U.S. tax.

3. Gross-basis taxation

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. This tax generally is collected by means of withholding by the person making the payment to the foreign person receiving the income. Accordingly, the 30-percent gross-basis tax is generally 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.

Certain exclusions or exceptions from the withholding tax apply. For example, 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)). In addition, certain types of interest (for example, interest from certain bank deposits and from certain portfolio obligations) are not subject to the withholding tax.

D. Income Tax Treaties

In addition to the U.S. and foreign statutory rules for the taxation of foreign income of U.S. persons and U.S. income of foreign persons, bilateral income tax treaties limit the amount of income tax that may be imposed by one treaty partner on residents of the other treaty partner. For example, treaties often reduce or exempt withholding taxes imposed by a treaty country on certain types of income (e.g., dividends, interest and royalties) paid to residents of the other treaty country. 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.

II. DESCRIPTION OF H.R. 2018

A. Treatment of Controlled Foreign Corporations

1. Permanent subpart F exemption for active financing income (sec. 101 of the bill)

Present Law

Under the subpart F rules, U.S. 10-percent shareholders of a controlled foreign corporation ("CFC") are subject to U.S. tax currently on certain income earned by the CFC, whether or not such income is distributed to the shareholders (referred to as "subpart F income"). Subpart F income includes, among other things, foreign personal holding company income and insurance income. 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. The U.S. 10-percent shareholders of a CFC also are subject to current inclusion with respect to their shares of the CFC's foreign base company services income (i.e., income derived from services performed for a related person outside the country in which the CFC is organized).

Temporary exceptions from foreign personal holding company income and 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"). These exceptions are applicable only for taxable years beginning in 1999.[7]

With respect to income derived in the active conduct of a banking, financing, or similar business, a CFC is required to be predominantly engaged in such business and to conduct substantial activity with respect to such business in order to qualify for the exceptions. In addition, certain nexus 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 exceptions apply to income derived from certain cross border transactions, provided that certain requirements are met. Additional exceptions from foreign personal holding

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[7] Temporary exceptions from the subpart F provisions for certain active financing income applied only for taxable years beginning in 1998. Those exceptions were extended and modified as part of the present-law provision.

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.

In the case of insurance, in addition to a temporary exception from foreign personal holding company income for certain income of a qualifying insurance company with respect to risks located within the CFC's country of creation or organization, certain temporary exceptions from insurance income and from foreign personal holding company income apply for certain income of a qualifying branch of a qualifying insurance company with respect to risks located within the home country of the branch, provided certain requirements are met under each of the exceptions. Further, additional temporary exceptions from insurance income and from foreign personal holding company income apply for certain income of certain CFCs or branches with respect to risks located in a country other than the United States, provided that the requirements for these exceptions are met.

Description of Proposal

The proposal would make permanent the exceptions from subpart F for active financing income.

Effective Date

The proposal would be effective for taxable years of a foreign corporation beginning after December 31, 1999, and taxable years of U.S. shareholders with or within which such taxable years of such foreign corporation end.

2. Study of proper treatment of European Union under same country exceptions (sec. 102 of the bill)

Present Law

In general, U.S. 10-percent shareholders of a controlled foreign corporation ("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. 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)). In general, 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).

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)).

Income of a CFC may be excepted from the subpart F provisions under various same country exceptions. For example, a major category of foreign base company income is foreign personal holding company income which generally includes, among other things, certain dividends, interest, rents and royalties (sec. 954(c)). Same country exceptions from treatment as foreign personal holding company income generally are provided for dividends and interest received by the CFC from a related person which (1) is a corporation organized under the laws of the same foreign country in which the CFC is created or organized and (2) has a substantial part of its assets used in a trade or business located in such same foreign country. Similarly, same country exceptions from foreign personal holding income generally are provided for rents and royalties received by the CFC from a related corporation for the use of property within the country in which the CFC is created or organized (sec. 954(c)(3)).

Description of Proposal

The proposal would direct the Secretary of Treasury to conduct a study of the feasibility of treating all countries included in the European Union as one country for purposes of applying same country exceptions under subpart F. The proposal would require that the study include consideration of methods to ensure that taxpayers would be subject to a substantial effective rate of foreign tax in such countries if the European Union were treated as one country for subpart F purposes.

The proposal would require the results of the study to be reported to the House Committee on Ways and Means and the Senate Committee on Finance, along with any legislative recommendations, no later than 6 months after the date of enactment.

3. Expansion of de minimis rule under subpart F (sec. 103 of the bill)

Present Law

Under the rules of subpart F, U.S. 10-percent shareholders of a controlled foreign corporation ("CFC") are required to include in income currently for U.S. tax purposes certain types of income of the CFC, whether or not such income is actually distributed currently to the shareholders (referred to as "subpart F income"). Subpart F income includes foreign base company income and certain insurance 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)). Under a de minimis rule, if the gross amount of a CFC's foreign base company income and insurance income for a taxable year is less than the lesser of 5 percent of the CFC's gross income or $1 million, then no part of the CFC's gross income is treated as foreign base company income or insurance income (sec. 954(b)(3)(A)).

Description of Proposal

The proposal would expand the subpart F de minimis exception to the lesser of 10 percent of gross income or $2 million. Accordingly, under the proposal, if the gross amount of a CFC's foreign base company income and insurance income for the taxable year is less than the lesser of 10 percent of the CFC's gross income or $2 million, then no part of the CFC's gross income would be treated as foreign base company income or insurance income subject to current inclusion by the U.S. shareholders of the CFC.

Effective Date

The proposal would be effective for taxable years of CFCs beginning after December 31, 1999, and taxable years of U.S. shareholders with or within which such taxable years of CFCs end.

4. Subpart F earnings and profits determined under generally accepted accounting principles (sec. 104 of the bill)

Present Law

For purposes of subpart F, the earnings and profits of any foreign corporation, and the deficit in earnings and profits of any foreign corporation, for any taxable year are to be determined, under regulations prescribed by the Secretary, through the application of rules substantially similar to those applicable to domestic corporations (sec. 964(a)). Several adjustments must be made to convert the foreign corporation's income for financial reporting purposes into earnings and profits for tax purposes.[8]

The determination of earnings and profits is relevant for foreign corporations for a variety of reasons. For example, subpart F income of a CFC for any taxable year may not exceed the earnings and profits of the CFC (sec. 952(c)(1)(A)). Certain prior year deficits in earnings and profits can be carried forward to reduce a shareholder's subpart F inclusion (sec. 952(c)(1)(B)). Additionally, distributions from a foreign corporation's earnings and profits may carry deemed paid foreign tax credits to a U.S. shareholder of the foreign corporation (sec. 902).

[8] See Treas. Reg. sec. 1.964-1.

Description of Proposal

The proposal would require foreign corporations to determine their earnings and profits for purposes of subpart F using U.S. generally accepted accounting principles.

Effective Date

The proposal would be effective for distributions during, and the determination of inclusions under subpart F with respect to, taxable years of a foreign corporation beginning after December 31, 1999.

5. Clarification of treatment of pipeline transportation income (sec. 105 of the bill)

Present Law

Under the subpart F rules, U.S. 10-percent shareholders of a controlled foreign corporation ("CFC") are subject to U.S. tax currently on their shares of certain income earned by the foreign corporation, whether or not such income is distributed to the shareholders (referred to as "subpart F income"). Subpart F income includes, among other things, foreign base company oil related income (sec. 954(g)). Foreign base company oil related income is income derived outside the United States from the processing of minerals extracted from oil or gas wells into their primary products; the transportation, distribution, or sale of such minerals or primary products; the disposition of assets used by the taxpayer in a trade or business involving the foregoing; or the performance of any related services. However, foreign base company oil related income does not include income derived from a source within a foreign country in connection with: (1) oil or gas which was extracted from a well located in such foreign country or, (2), oil, gas, or a primary product of oil or gas which is sold by the CFC or a related person for use or consumption within such foreign country or is loaded in such country as fuel on a vessel or aircraft. An exclusion also is provided for income of a CFC that is a small producer (i.e., a corporation whose average daily oil and natural gas production, including production by related corporations, is less than 1,000 barrels).

Description of Proposal

The proposal would provide an additional exception to the definition of foreign base company oil related income. Under the proposal, foreign base company oil related income would not include income derived from a source within a foreign country in connection with the pipeline transportation of oil or gas within such foreign country. Thus, the proposed exception would apply whether or not the CFC which owns the pipeline also owns any interest in the oil or gas transported. In addition, the proposed exception would apply to income earned from the transportation of oil or gas by pipeline in a country in which the oil or gas was neither extracted nor consumed within such foreign country.

Effective Date

The proposal would be effective for taxable years of CFCs beginning after December 31, 1999 and taxable years of U.S. shareholders with or within which such taxable years of CFCs end.

6. Subpart F treatment of income from transmission of high voltage electricity (sec. 106 of the bill)

Present Law

Under the rules of subpart F, U.S. 10-percent shareholders of a controlled foreign corporation ("CFC") are required to include in income currently for U.S. tax purposes certain types of income of the CFC, whether or not such income is actually distributed currently to the shareholders (referred to as "subpart F income"). Subpart F income includes foreign base company income, which in turn 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)).

Foreign base company services income includes income from services performed (1) for or on behalf of a related party and (2) outside the country of the CFC's incorporation (sec. 954(e)). Treasury regulations provide that the services of the foreign corporation will be treated as performed for or on behalf of the related party if, for example, a party related to the foreign corporation furnishes substantial assistance to the foreign corporation in connection with the provision of services (Treas. Reg. sec. 1.954-4(b)(1)(iv)).

Description of Proposal

The proposal would exempt income derived from the transmission of high voltage electricity from the definition of foreign base company services income. Thus, the income of a CFC that owns a high voltage transmission line for the purpose of providing electricity generated by a related party to a third party outside the CFC's country of incorporation would not constitute foreign base company services income. No inference would be intended as to the treatment of such income under present law.

Effective Date

The proposal would be effective for taxable years of CFCs beginning after December 31, 1999, and taxable years of U.S. shareholders with or within which such taxable years of CFCs end.

7. Look-through treatment for sales of partnership interests (sec. 107 of the bill)

Present Law

Under the rules of subpart F, U.S. 10-percent shareholders of a controlled foreign corporation ("CFC") are required to include in income currently for U.S. tax purposes certain types of income of the CFC, whether or not such income is actually distributed currently to the shareholders (referred to as "subpart F income"). Subpart F income includes foreign personal holding company income. 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. Thus, if a CFC sells a partnership interest at a gain, the gain generally constitutes foreign personal holding company income and is included in the income of 10-percent U.S. shareholders of the CFC as subpart F income.

Description of Proposal

The proposal would treat the sale by a CFC of a partnership interest as a sale of the proportionate share of partnership assets attributable to such interest for purposes of determining subpart F foreign personal holding company income. This rule would apply only to partners owning directly, indirectly, or constructively at least 10 percent of a capital or profits interest in the partnership. Thus, the sale of a 10-percent or greater partnership interest by a CFC would constitute subpart F income only to the extent that a proportionate sale of the underlying partnership assets attributable to the partnership interest would constitute subpart F income.

Effective Date

The proposal would be effective for taxable years of CFCs beginning after December 31, 1999, and taxable years of U.S. shareholders with or within which such taxable years of CFCs end.

B. Provisions Relating to Foreign Tax Credit

1. Extension of period to which excess foreign taxes may be carried (sec. 201 of the bill)

Present Law

The foreign tax credit is subject to an overall limitation. That is, 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. In addition, the foreign tax credit limitation is calculated separately for various categories of income, generally referred to as "separate limitation categories." The total amount of the credit for foreign taxes on income in each separate limitation 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 its worldwide taxable income.

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 (not deducted) to the extent that the taxpayer otherwise has excess foreign tax credit limitation for those years. For purposes of determining excess foreign tax credit amounts, the foreign tax credit separate limitation rules apply. Thus, if a taxpayer has excess foreign tax credits in one separate limitation category for a taxable year, those excess credits are carried back and forward only as taxes allocable to that category notwithstanding the fact that the taxpayer may have excess foreign tax credit limitation in another category for that year.

Description of Proposal

The proposal would extend the excess foreign tax credit carryforward period from 5 to 10 years.

Effective Date

The proposal would be effective for excess foreign tax credits arising in taxable years beginning after December 31, 1999.

2. Recharacterization of overall domestic loss (sec. 202 of the bill)

Present Law

A premise of the foreign tax credit is that it should not reduce a taxpayer's U.S. tax on its U.S. source income; rather, it should only reduce U.S. tax on foreign source income. An overall foreign tax credit limitation prevents taxpayers from using foreign tax credits to offset U.S. tax on U.S. source income. The overall limitation is calculated by prorating a taxpayer's pre-credit

U.S. tax on its worldwide income between its U.S. source and foreign source taxable income. The ratio (not exceeding 100 percent) of the taxpayer's foreign source taxable income to worldwide taxable income is multiplied by its pre-credit U.S. tax to establish the amount of U.S. tax allocable to the taxpayer's foreign source income and, thus, the upper limit on the foreign tax credit for the year. If the taxpayer's foreign source taxable income exceeds worldwide taxable income (because of a domestic source loss), then the full amount of pre-credit U.S. tax may be offset by the foreign tax credit.

If a taxpayer's losses from foreign sources exceed its foreign source income, the excess ("overall foreign loss" or "OFL") may offset U.S. source income. Such an offset reduces the effective rate of U.S. tax on U.S. source income. To eliminate a double benefit (that is, the reduction of U.S. tax previously noted and, later, full allowance of a foreign tax credit with respect to foreign source income), an OFL recapture rule was enacted in 1976. Under this rule, a portion of foreign source taxable income earned after an OFL year is recharacterized as U.S. source taxable income for foreign tax credit purposes (and for purposes of the possessions tax credit) (sec. 904(f)(1)). Foreign source taxable income up to the amount of the unrecaptured OFL may be so treated. Unless a taxpayer elects a higher percentage, however, generally no more than 50 percent of the foreign source taxable income earned in any particular taxable year is recharacterized as U.S. source taxable income.[9] The effect of the recapture is to reduce the foreign tax credit limitation in one or more years following an OFL year and, therefore, the amount of U.S. tax that can be offset by foreign tax credits in the later year or years.

An overall U.S. source loss reduces pre-credit U.S. tax on worldwide income to an amount less than the hypothetical tax that would apply to the taxpayer's foreign source income if viewed in isolation. The existence of foreign source taxable income in the year of the U.S. loss reduces or eliminates any net operating loss carryover that the U.S. loss would otherwise have generated absent the foreign income. In addition, as the pre-credit U.S. tax on worldwide income is reduced, so is the foreign tax credit limitation. As a result, some foreign tax credits in the year of the U.S. loss must be credited, if at all, in a carryover year. Tax on domestic source taxable income in a subsequent year may be offset by a net operating loss carryforward, but not by a foreign tax credit carryforward. There is presently no mechanism for resourcing such subsequent U.S. source income as foreign.

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[9] If a taxpayer with an OFL disposes of property that was used predominantly outside the United States in a trade or business, the taxpayer generally is deemed to have received and recognized foreign source taxable income as the result of a disposition in an amount at least equal to the lesser of the gain actually realized on the disposition or the remaining amount of the unrecaptured OFL. Furthermore, the annual 50-percent limit on the resourcing of foreign source income does not apply to that amount of foreign source income realized by reason of the disposition.

Description of Proposal

The proposal would apply a resourcing rule to U.S. source income where the taxpayer has suffered a reduction in the amount of its foreign tax credit limitation due to a prior overall domestic loss. Under the proposal, in the case of a taxpayer that has incurred an overall domestic loss, that portion of the taxpayer's U.S. source taxable income for each succeeding taxable year, which is equal to the lesser of (1) the amount of the unrecharacterized overall domestic loss, or (2) 50 percent of the taxpayer's U.S. source taxable income for such succeeding taxable year, would be recharacterized as foreign source taxable income.

The proposal would define an overall domestic loss for this purpose as any domestic loss to the extent it offsets foreign source taxable income for the current taxable year or for any preceding taxable year by reason of a loss carryback. For this purpose, a domestic loss means the amount by which the U.S. source gross income for the taxable year is exceeded by the sum of the deductions properly apportioned or allocated thereto, determined without regard to any loss carried back from a subsequent taxable year. Under the proposal, an overall domestic loss would not include any loss for any taxable year unless the taxpayer elected the use of the foreign tax credit for such taxable year.

Any U.S. source income resourced under the proposal would be allocated among and would increase the various foreign tax credit separate limitation categories in the same proportion that those categories were reduced by the prior overall domestic loss.

It is anticipated that situations could arise where a taxpayer would generate an overall domestic loss in a year following a year in which it had an overall foreign loss, or vice versa. In such a case, it would be necessary for ordering and other coordination rules to be developed for purposes of computing the foreign tax credit limitation in subsequent taxable years. The proposal would grant the Secretary of Treasury authority to prescribe such regulations as may be necessary to coordinate the operation of the OFL recapture rules with the operation of the overall domestic loss recapture rules that would be added by the proposal.

Effective Date

The proposal would apply to losses incurred in taxable years beginning after December 31, 1999.

3. Special rules relating to financial services income (sec. 203 of the bill)

Present Law

U.S. persons generally are subject to U.S. income tax on their worldwide 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) (secs. 902, 960).

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 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.[10]

The separate limitation categories include, among other things, limitation categories for high withholding tax interest and financial services income (sec. 904(d)). "High withholding tax interest" generally means any interest that is subject to a withholding tax of a foreign country or possession of the United States (or other tax determined on a gross basis) at a rate of at least 5 percent (sec. 904(d)(2)(B)). "Financial services income" generally means certain passive and business income received or accrued by a person predominantly engaged in the active conduct of a banking, insurance, financing or similar business (sec. 904(d)(2)(C)).

In order to prevent the conversion to foreign-source income of certain U.S.-source income such as to increase a taxpayer's overall limitation, certain amounts that otherwise would be foreign-source income that are derived from a U.S.-owned foreign corporation are treated for foreign tax credit limitation purposes as U.S.-source income (sec. 904(g)). Income inclusions under subpart F and the foreign personal holding company provisions, and certain income inclusions for qualified electing funds under the passive foreign investment company rules, are treated as U.S.-source income to the extent attributable to U.S.-source income of the foreign corporation from which the inclusions are required. In addition, interest paid or accrued by a U.S.-owned foreign corporation to a 10-percent U.S. shareholder (or a related person) that is properly allocable to U.S.-source income of the foreign corporation generally is treated as U.S.-source income. Moreover, a pro rata portion of dividends paid by a U.S.-owned foreign corporation out of its U.S.-source earnings and profits generally is treated as U.S.-source income. Certain exceptions apply where the foreign corporation has earnings and profits and less than 10 percent of such earnings and profits is attributable to U.S. sources.

[10] 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 two years and carried forward five years (sec. 904(c)).

Description of Proposal

The proposal would except from the separate limitation category for "high withholding tax interest" any interest received or accrued on a security by a person that holds the security in connection with its activities as a dealer in securities.

The proposal also would modify the separate limitation category for "financial services income" to provide that if the financial services income of a person exceeds 80 percent of gross income, the entire gross income for the taxable year will be treated as financial services income for foreign tax credit limitation purposes.

Further, the proposal would provide that foreign-source income derived from a U.S.-owned foreign corporation that is derived from income which is received or accrued on a security by a person that holds the security in connection with its activities as a dealer in securities is excepted from the resourcing rule of section 904(g).

Effective Date

In general, the proposal would be effective for taxable years beginning after December 31, 1999. In the case of any "deemed-paid" credits, the proposal would apply to taxable years of foreign corporations beginning after December 31, 1999, and to taxable years of U.S. shareholders in such corporations with or within which such taxable year of the foreign corporation ends.

4. Look-through rules to apply to dividends from noncontrolled section 902 corporations (sec. 204 of the bill)

Present Law

U.S. persons may credit foreign taxes against U.S. tax on foreign-source income. The amount of foreign tax credits that may be claimed in a year is subject to a limitation that prevents taxpayers from using foreign tax credits to offset U.S. tax on U.S.-source income. Separate limitations are applied to specific categories of income.

Special foreign tax credit limitations apply in the case of dividends received from a foreign corporation in which the taxpayer owns at least 10 percent of the stock by vote and which is not a controlled foreign corporation (a so-called "10/50 company").[11] Dividends paid by a 10/50 company in taxable years beginning before January 1, 2003 are subject to a separate

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[11] A controlled foreign corporation in which the taxpayer owns at least 10 percent of the stock by vote is treated as a 10/50 company with respect to any distribution out of earnings and profits for periods when it was not a controlled foreign corporation.

foreign tax credit limitation for each 10/50 company. Dividends paid by a 10/50 company 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 10/50 companies (other than passive foreign investment companies). Dividends paid by a 10/50 company that is a passive foreign investment company out of earnings and profits accumulated in taxable years beginning before January 1, 2003, continue to be subject to a separate foreign tax credit limitation for each such 10/50 company. Dividends paid by a 10/50 company in taxable years beginning after December 31, 2002, out of earnings and profits accumulated in taxable years after December 31, 2002, are treated as income in a foreign tax credit limitation category in proportion to the ratio of the earnings and profits attributable to income in such foreign tax credit limitation category to the total earnings and profits (a so-called "look-through" approach). For these purposes, distributions are treated as made from the most recently accumulated earnings and profits. Regulatory authority is granted to provide rules regarding the treatment of distributions out of earnings and profits for periods prior to the taxpayer's acquisition of such stock.

Description of Proposal

The proposal would simplify the application of the foreign tax credit limitation by applying the look-through approach immediately to all dividends paid by a 10/50 company, regardless of the year in which the earnings and profits out of which the dividend is paid were accumulated.

Effective Date

The proposal would be effective for taxable years beginning after December 31, 1999.

5. Application of look-through rules to foreign tax credit (sec. 205 of the bill)

Present Law

U.S. persons may credit foreign taxes against U.S. tax on foreign-source income. The amount of foreign tax credits that may be claimed in a year is subject to a limitation that prevents taxpayers from using foreign tax credits to offset U.S. tax on U.S.-source income. Separate limitations are applied to specific categories of income.

Certain look-through rules apply for foreign tax credit limitation purposes. For example, dividends, interest, rents, royalties, and subpart F inclusions received (or deemed received) from controlled foreign corporations ("CFCs") by their U.S. 10-percent shareholders generally are subject to the general limitation or 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 itself is subject to one or more of these limitations (sec. 904(d)(3)). The Code provides regulatory authority to apply similar look-through rules for interest, rents, and royalties received or accrued from entities which would be CFCs if they were foreign corporations (sec. 904(d)(6)(C)). Regulations generally provide look-through rules for distributive shares of partnership income received by partners with a 10-percent or greater interest in the partnership (Treas. Reg. sec. 1.904-5(h)).

In addition, for foreign tax credit limitation purposes, look-through rules apply to certain dividends received from a foreign corporation in which the taxpayer owns at least 10 percent of the stock by vote and which is not a controlled foreign corporation (a so-called "10/50 company").[12] In this regard, dividends paid by a 10/50 company in taxable years beginning after December 31, 2002, out of earnings and profits accumulated in taxable years after December 31, 2002, are treated as income in a foreign tax credit limitation category in proportion to the ratio of the earnings and profits attributable to income in such foreign tax credit limitation category to the total earnings and profits.[13]

Description of Proposal

The proposal would apply look-through rules, for foreign tax credit limitation purposes, to interest, rents, or royalties received or accrued from a 10/50 company by a U.S. shareholder. Thus, such amounts would be treated as subject to the various separate limitations to the extent the amounts are properly allocable (under regulations prescribed by the Secretary) to the income of the payor.

Effective Date

The proposal would be effective for taxable years beginning after December 31, 1999.

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[12] A CFC in which the taxpayer owns at least 10 percent of the stock by vote is treated as a 10/50 company with respect to any distribution out of earnings and profits for periods when it was not a controlled foreign corporation.

[13] Dividends paid by a 10/50 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 10/50 companies (other than passive foreign investment companies). Dividends paid by a 10/50 company in taxable years beginning before January 1, 2003, are subject to a separate foreign tax credit limitation for each 10/50 company.

6. Ordering rules for foreign tax credit carryovers (sec. 206 of the bill)

Present Law

The ability to claim the benefits of a foreign tax credit is subject to an overall limitation (sec. 904(a)). The total amount of the credit may not exceed the same proportion of the taxpayer's U.S. income tax that the taxpayer's foreign source taxable income bears to the taxpayer's worldwide taxable income for the taxable year. In addition, the foreign tax credit limitation is calculated separately for various categories of income, generally referred to as "separate limitation categories" (sec. 904(d)). The total amount of the credit for foreign taxes on income in each separate limitation category may not exceed the same proportion of the taxpayer's U.S. tax that the taxpayer's foreign source taxable income in that category bears to its worldwide taxable income.

The amount of creditable taxes paid or accrued (or deemed paid) in any taxable year that exceeds the foreign tax credit limitation may be carried back to the two immediately preceding taxable years and carried forward to the first five succeeding taxable years, and credited 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 amounts, the foreign tax credit separate limitation rules apply. Thus, if a taxpayer has excess foreign tax credits in one separate limitation category for a taxable year, those excess credits are carried back and forward only as taxes allocable to that category notwithstanding the fact that the taxpayer may have excess foreign tax credit limitation in another category for that year.

Foreign taxes that are paid or accrued (or deemed paid) during the taxable year in which a foreign tax credit is being claimed are considered to be used prior to any foreign tax credit carryforwards or carrybacks. Excess foreign tax credits for the year are carried back to the second preceding year followed by the first preceding year and then forward to the first, second, third, fourth, and fifth succeeding years, in that order.

Description of Proposal

The proposal would modify the ordering rules for foreign tax credits to provide that foreign tax credits are considered utilized first from carryforwards, then from the current year, and finally from carrybacks. The proposal also would extend the excess foreign tax credit carryforward period from 5 to 10 years.

Effective Date

The proposal would apply to taxable years beginning after December 31, 1999.

7. Repeal of limitation of foreign tax credit under alternative minimum tax (sec. 207 of the bill)

Present Law

Under present law, taxpayers are subject to an alternative minimum tax ("AMT"), which is payable, in addition to all other tax liabilities, to the extent that it exceeds the taxpayer's regular income tax liability. The tax is imposed at a flat rate of 20 percent, in the case of corporate taxpayers, on alternative minimum taxable income ("AMTI") in excess of a phased-out exemption amount. The maximum rate for noncorporate taxpayers is 28 percent. AMTI is the taxpayer's taxable income increased for certain tax preferences and adjusted by determining the tax treatment of certain items in a manner which negates the exclusion or deferral of income resulting from the regular tax treatment of those items.

Taxpayers are permitted to reduce their AMT liability by an AMT foreign tax credit. The AMT foreign tax credit for a taxable year is determined under principles similar to those used in computing the regular tax foreign tax credit, except that (1) the numerator of the AMT foreign tax credit limitation fraction is foreign source AMTI and (2) the denominator of that fraction is total AMTI.[14] Taxpayers may elect to use as their AMT foreign tax credit limitation fraction the ratio of foreign source *regular* taxable income to total AMTI (sec. 59(a)(4)).

The AMT foreign tax credit for any taxable year generally may not offset a taxpayer's entire pre-credit AMT. Rather, the AMT foreign tax credit is limited to 90 percent of AMT computed without an AMT net operating loss deduction, an AMT energy preference deduction, or an AMT foreign tax credit. For example, assume that a corporation has $10 million of AMTI, has no AMT net operating loss or energy preference deductions, and is subject to the AMT. In the absence of the AMT foreign tax credit, the corporation's tax liability would be $2 million. Accordingly, the AMT foreign tax credit cannot be applied to reduce the taxpayer's tax liability below $200,000. Any unused AMT foreign tax credit may be carried back 2 years and carried forward 5 years for use against AMT in those years under the principles of the foreign tax credit carryback and carryforward set forth in section 904(c).

Description of Proposal

The proposal would repeal the 90-percent limitation on the utilization of the AMT foreign tax credit.

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[14] Similar to the regular tax foreign tax credit, the AMT foreign tax credit is subject to the separate limitation categories set forth in section 904(d). Under the AMT foreign tax credit, however, the determination of whether any income is high taxed for purposes of the high-tax-kick-out rules (sec. 904(d)(2)) is made on the basis of the applicable AMT rate rather than the highest applicable rate of regular tax.

Effective Date

The proposal would be effective for taxable years beginning after December 31, 1999.

8. Repeal of special rules for applying foreign tax credit in case of foreign oil and gas income (sec. 208 of the bill)

Present Law

U.S. persons are subject to U.S. income tax on their worldwide income. A credit against U.S. tax on foreign-source income is allowed for foreign taxes paid or accrued (or deemed paid) (secs. 901, 902).

The amount of foreign tax credits that a taxpayer may claim in a year is subject to a limitation that prevents taxpayers from using foreign tax credits to offset U.S. tax on U.S.-source income (sec. 904). The foreign tax credit limitation is calculated on an overall basis and separately for specific categories of income. 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 two years and carried forward five years (sec. 904(c)).

Special rules apply with respect to the foreign tax credit in the case of foreign oil and gas income (sec. 907). Under a special limitation, taxes on foreign oil and gas extraction income are creditable only to the extent that they do not exceed a specified amount (e.g., 35 percent of such income in the case of a corporation) (sec. 907(a)). For this purpose, foreign oil and gas extraction income is income derived from foreign sources from the extraction of minerals from oil or gas wells or the sale or exchange of assets used by the taxpayer in such extraction. A taxpayer must have excess limitation under the special rules applicable to foreign extraction taxes and excess limitation under the general foreign tax credit provisions in order to utilize excess foreign oil and gas extraction taxes in a carryback or carryforward year. A recapture rule applicable to foreign oil and gas extraction losses treats income that otherwise would be foreign oil and gas extraction income as foreign-source income that is not considered oil and gas extraction income; the taxes on such income retain their character as foreign oil and gas extraction taxes and continue to be subject to the special limitation imposed on such taxes.

In the case of taxes paid or accrued to any foreign country with respect to foreign oil related income, discriminatory foreign taxes are not treated as creditable foreign taxes (sec. 907(b)). Foreign taxes are discriminatory for this purpose to the extent that the Treasury Secretary determines that the foreign law imposing the tax is structured, or in facts operates, so that the amount of tax imposed with respect to foreign oil related income will be materially greater, over a reasonable period of time, than the amount imposed on non-oil related and non-extraction income. Foreign oil related income is income derived from foreign sources from the processing of mineral extracted from oil or gas wells into their primary products, the transportation, distribution or sale of such minerals or primary products, the disposition of assets used by the taxpayer in one of the foregoing businesses, or the performance of any related service. To the extent that such taxes are treated as not creditable, the amount is treated as a deduction under foreign law (i.e., the amount is treated as a deductible business expense for purposes of computing an appropriate level of foreign income tax and for U.S. tax purposes).

Description of Proposal

The proposal would repeal the special rules of section 907 for applying the foreign tax credit in the case of foreign oil and gas income. Thus, taxes attributable to foreign oil and gas extraction income would no longer be subject to a special limitation, but rather would be subject to the general limitation rules of section 904. Additionally, the special rules of section 907 with respect to discriminatory taxes on foreign oil related income would no longer apply.

Effective Date

The proposal would be effective for taxable years beginning after December 31, 1999.

C. Other Provisions

1. Deduction for dividends received from certain foreign corporations (sec. 301 of the bill)

Present Law

A dividends received deduction generally is available to U.S. corporations that receive dividends from another U.S. corporation. The amount of the dividends received deduction is calculated as a percentage of the dividend received. The dividends received deduction percentage is based on the amount of stock that the recipient corporation owns in the paying corporation, as follows: (1) 70 percent if the ownership is less than 20 percent; (2) 80 percent if the ownership is at least 20 percent and less than 80 percent; and (3) 100 percent if the ownership is at least 80 percent (sec. 243).

In certain cases, a U.S. corporation that receives a dividend from a foreign corporation may be eligible for a dividends received deduction (sec. 245). For example, a U.S. corporation may claim a dividends received deduction with respect to dividends received from a foreign corporation (other than a foreign personal holding company or passive foreign investment company) in which the U.S. corporation owns at least 10 percent of the stock of the foreign corporation, measured by either vote or value (a "10-percent owned foreign corporation") (sec. 245(a)).

The amount of the dividend from a foreign corporation that is eligible for the dividends received deduction is based on the U.S.-source portion of such dividend, which is defined as the ratio of the 10-percent owned foreign corporation's post-1986 undistributed U.S.-source earnings and profits to its post-1986 total undistributed earnings and profits.[15] For these purposes, post-1986 undistributed U.S.-source earnings and profits includes: (1) income that is effectively connected with a U.S. trade or business (and that is subject to U.S. taxation), or (2) dividends received (directly or through a wholly-owned foreign corporation) from a U.S. corporation in which 80 percent or more of the stock of such corporation is owned by the 10-percent owned foreign corporation, directly or through a wholly-owned foreign corporation (the "80-percent ownership requirement").[16]

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[15] U.S. corporations that receive dividends from foreign corporations generally may be eligible for foreign tax credits with respect to such dividends. However, foreign tax credits generally may not be claimed with respect to the U.S.-source portion of any dividend from a 10-percent owned foreign corporation (sec. 245(a)(8) and (9)).

[16] The dividends received deduction on the eligible portion of the dividend is based on the percentage of stock ownership of the foreign corporation, as described in section 243.

Under the rules of subpart F, U.S. 10-percent shareholders of a controlled foreign corporation ("CFC") are required to include in income currently for U.S. tax purposes certain types of income of the CFC, whether or not such income is actually distributed currently to the shareholders (referred to as a "subpart F income inclusion"). A CFC generally is defined as any foreign corporation if U.S. persons own (directly, indirectly, or constructively) more than 50 percent of the corporation's stock (measured by vote or value), taking into account only those U.S. persons that own at least 10 percent of the stock (measured by vote only).

Description of Proposal

The proposal would treat a subpart F income inclusion as a "dividend" for purposes of section 245(a). Thus, deemed dividends from a 10-percent owned foreign corporation that is a CFC may be eligible for the dividends received deduction.

The proposal also would apply the attribution rules under section 318(a) in determining whether the 80-percent ownership requirement (i.e., 80-percent ownership in a U.S. corporation directly or through a wholly-owned foreign corporation) is satisfied for purposes of determining the undistributed U.S.-source earnings and profits of a 10-percent owned foreign corporation. Thus, the 80-percent ownership requirement could be satisfied not only through direct ownership or through wholly-owned foreign corporations, but also by application of general indirect and constructive ownership rules.

Effective Date

The proposal would apply to taxable years beginning after December 31, 1999.

2. Application of uniform capitalization rules to foreign persons (sec. 302 of the bill)

Present Law

In general

For purposes of computing a taxpayer's taxable income and earnings and profits ("E&P"), certain costs reduce net income as they are incurred (e.g., ordinary and necessary business expenses); other costs reduce net income only to the extent that the income-producing assets with which those costs are associated generate income. Generally accepted accounting principles ("GAAP") guide businesses in determining which costs to expense and which costs to capitalize into the basis of property (or include in inventory) in preparing financial statements. Pursuant to the Code, Treasury Regulations prescribe a different set of rules for this purpose (the "uniform capitalization rules"), which tend to allow less costs to be expensed, and require more costs--including both direct and indirect costs allocable to property--to be capitalized or included in inventories, than do GAAP (sec. 263A(a)). In general, the uniform capitalization rules apply to property produced by a taxpayer or acquired by a taxpayer for resale. Property produced for a taxpayer under contract with the taxpayer is treated as being produced by the taxpayer.

In the case of interest expense, the uniform capitalization rules apply only to interest paid or incurred during the property's production period [17] and that is allocable to property produced by the taxpayer or acquired for resale which (1) is either real property or property with a class life of at least 20 years, (2) has an estimated production period exceeding 2 years, or (3) has an estimated production period exceeding 1 year and a cost exceeding $1,000,000 (sec. 263A(f)).

Application to foreign persons

In general

The uniform capitalization rules apply to foreign persons, whether or not engaged in business in the United States. In the case of a foreign corporation carrying on a U.S. trade or business, for example, the uniform capitalization rules apply for purposes of computing the corporation's U.S. effectively connected taxable income, as well as computing its effectively connected earnings and profits for purposes of the branch profits tax.

When a foreign corporation is not engaged in business in the United States, its taxable income and earnings and profits may nonetheless be relevant under the Code. For example, the subpart F income of a controlled foreign corporation may be currently includible on the return of a U.S. shareholder of the controlled foreign corporation. Regardless of whether or not a foreign corporation is U.S.-controlled, its accumulated E&P must be computed in order to determine the amount of taxable dividend and the indirect foreign tax credit carried by distributions from the foreign corporation to any domestic corporation that owns at least 10 percent of its voting stock.

The E&P surplus or deficit of any foreign corporation, for any taxable year, is generally determined according to rules substantially similar to those applicable to domestic corporations. The temporary regulations under the uniform capitalization rules included the following statement:

> The provisions of section 263A (including the effective dates thereof) are applicable to all persons engaging in the production of property, or the acquisition of property for resale, including, for example, certain foreign persons which may be organized and operated exclusively outside the United States.[18]

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[17] The production period with respect to a property is the period beginning on the date on which production of the property begins and ending on the date on which the property is ready to be placed in service or to be held for sale.

[18] 52 Fed. Reg. 10059 (March 30, 1987).

Furthermore, Treas. Reg. sec. 1.263A-1(a)(3)(vii) provides that the uniform capitalization rules generally apply to property produced or property acquired for resale by foreign persons.

However, Prop. Treas. Reg. sec. 1.964-1(c)(1)(ii)(B) provides that, for purposes of computing a foreign corporation's E&P, the amount of expenses that must be capitalized into inventory may not exceed the amount required to be capitalized under generally accepted accounting principles (and reflected in the foreign corporation's financial statements). The Preamble to this proposed regulation states that taxpayers have suggested that maintaining separate inventory accounts for U.S. tax and financial accounting purposes is unduly burdensome and that use of a single set of accounts would reduce compliance burdens.[19] This proposed regulation would apply only for purposes of determining a foreign corporation's E&P and would not apply for purposes of determining subpart F income or income effectively connected with a U.S. trade or business of a foreign corporation.

U.S. ratio election

In 1988, the IRS issued Notice 88-104[20] to inform taxpayers of forthcoming guidance designed to provide an elective, simplified method of accounting for the costs required to be capitalized in connection with foreign businesses of foreign or U.S. persons under the uniform capitalization rules. The notice stated that the guidance will provide a simplified "U.S. ratio" method of accounting for costs other than interest that are required to be capitalized.

To apply the U.S. ratio method, there must be a U.S. trade or business carried on by the person carrying on the foreign business, or by a related party. The U.S. business so carried on that is the same or most similar to the foreign business must distinguish between costs capitalized in the basis of its relevant property before application of the uniform capitalization rules, and costs capitalized only as a result of those rules, and compute the ratio of the latter to the former ("the U.S. ratio"). The foreign business multiplies this U.S. ratio by the amount of its costs capitalized (without regard to the uniform capitalization rules) in the basis of its relevant property. The product of this multiplication yields the amount of additional costs (other than interest) required to be capitalized by a foreign person under the uniform capitalization rules.[21]

All expenses that the foreign person otherwise treats as deductible are decreased ratably, to equal the amount of the increase in costs capitalized under the U.S. ratio method for the taxable year. The appropriate ratio is applied to the costs of property produced or property

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[19] 57 Fed. Reg. 29246 (July 1, 1992).

[20] 1988-2 C.B. 443.

[21] "Additional section 263A costs" as defined in Temp. Treas. Reg. sec. 1.263A-1T(b)(5)(iii).

acquired for resale incurred by the foreign person for each taxable year. A separate ratio is required to be computed for each taxable year for properties related to each separate trade or business.

An election to use the U.S. ratio method was originally limited by Notice 88-104 to taxable years beginning before January 1, 1988. However, the IRS subsequently extended the provisions of that Notice to taxable years beginning after 1987 and acknowledged that those provisions would remain in effect until further guidance under the uniform capitalization rules is issued.[22] The IRS further provided in Notice 89-67 that if a taxpayer failed to elect the use of the U.S. ratio method for its first taxable year for which the uniform capitalization rules applied, it could so elect (1) on an amended tax return for such first taxable year, or (2) on its tax return for the second taxable year for which the uniform capitalization rules were effective, if and only if the method used by the taxpayer for the prior taxable year was a correct method of accounting under the uniform capitalization guidelines. In addition, the Notice provided that it is anticipated that forthcoming regulations will permit a taxpayer to elect the U.S. ratio method regardless of whether it had made the election for previous taxable years.

Capitalization of interest expense

The IRS has also provided advance guidance on the application of the interest capitalization rules of section 263A(f).[23] Under the interest capitalization rules, taxpayers must first capitalize debt which is directly attributable to the production expenditures of a property specified in section 263A(f)(1)(B) (i.e., "traced debt"). Debt generally is allocated to a particular expenditure by tracing disbursements of the debt proceeds to that expenditure. Traced debt includes only amounts of the taxpayer's eligible debt that do not exceed the property's accumulated production expenditures.

After determining the amount of traced debt directly attributable to the property's production expenditures, taxpayers then must assign any other eligible debt to any remaining production expenditures and interest on such debt must be capitalized, to the extent that the taxpayer's interest costs could have been reduced if such production expenditures had not been incurred (i.e., "avoided cost debt").[24] The determination of whether the taxpayer's interest costs could have been reduced if such production expenditures had not been incurred is made by assuming that the amounts expended for production had instead been used to repay the taxpayer's debt, thus reducing the principal balance of such debt and the interest costs thereon. The

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[22] Notice 89-67, 1989-1 C.B. 723.

[23] Notice 88-99, 1988-2 C.B. 422.

[24] Notice 88-99 allows taxpayers to elect to forego the debt tracing step by treating all of its debt that would be traced debt as avoided cost debt.

operation of the avoided cost concept does not depend on whether, in fact, the taxpayer actually would have used the amounts otherwise expended for production to repay debt.

Capitalization of the interest of parties related to producers of property

The interest costs of parties (including foreign corporations) related to the taxpayer producing qualified property can also be subjected to capitalization requirements (and avoided cost rules).[25] In the case of related parties to which the avoided cost rules apply, a deferred asset method generally is used to comply with the interest capitalization requirements. Under this method, the related party is required to capitalize interest equal to an amount that the producing taxpayer would have capitalized, using the avoided cost principles, had the producing taxpayer itself incurred the interest on the eligible debt of the related party.[26]

Under the deferred asset method, the related party accounts for capitalized interest as an asset in the same manner (and at the same time) as the producing taxpayer would have accounted for such interest had the interest been capitalized into the basis of the qualified property on the taxpayer's books and records. The interest capitalized by the related party is then recovered at the same time and in the same manner as it would have been recovered had it been capitalized into the basis of the property produced by the taxpayer.[27]

A producing taxpayer may elect to use a substitute cost method instead of subjecting the related party to the deferred asset method. Under the substitute cost method, the producing

[25] For taxable years of the producing taxpayer beginning on or after January 1, 1988, a person is considered related to the producing taxpayer if such person and the taxpayer are members of the same parent-subsidiary controlled group of corporations as defined in section 1563(a)(1) regardless of whether such persons would be treated as component members of such group under section 1563(b). For this purpose, the constructive ownership rules of section 1563(e) apply. See Notice 88-99. Thus, a foreign corporation may be treated as a member of a controlled group, even though it is not a member of the consolidated group, and thus may be subject to the interest capitalization and avoided cost rules.

[26] The interest incurred by related parties is subject to these rules only if the producing taxpayer's accumulated production expenditures exceed the total amount of its traced and avoided cost debt, and only if interest on the eligible debt of related parties has not already been allocated by the related party with respect to its own production expenditures of qualified property for the taxable year.

[27] In the event that the related party leaves the controlled group, the producing taxpayer increases its basis in the qualified property by the amount remaining in the deferred asset account of the related party that corresponds to the particular qualified property. The former related party is not permitted to continue to amortize, deduct, or take into account the capitalized interest.

taxpayer capitalizes, during each year of the production period, certain "substitute" costs in lieu of the taxpayer's related parties being required to capitalize interest on their related party avoided cost debt.

For taxable years of producing taxpayers beginning on or after January 1, 1988, if interest incurred by related parties becomes subject to the interest capitalization rules, the following ordering rules apply in determining which related party's interest is first capitalized, and in determining the production expenditures of which producing taxpayer are first subject to the deferred asset method: (1) with respect to producing taxpayers organized outside of the United States, interest incurred by every related party organized outside the United States must be capitalized before the interest of any other related party is capitalized; (2) with respect to producing taxpayers organized within the United States, interest incurred by every related party organized within the United States must be capitalized before the interest of any other related party is capitalized.

Description of Proposal

The proposal would apply the uniform capitalization rules to foreign persons only for purposes of determining U.S. effectively connected income. Thus, foreign persons (including U.S.-controlled foreign corporations) that conduct no U.S. trade or business would not be subject to the uniform capitalization rules. Section 481 would not apply to any change in method of accounting by reason of the proposal.

Effective Date

The proposal would apply to taxable years beginning after December 31, 1999.

3. Treatment of military property of foreign sales corporations (sec. 303 of the bill)

Present Law

A portion of the foreign trade income of an eligible foreign sales corporation ("FSC") is exempt from federal income tax. Foreign trade income is defined as the gross income of a FSC that is attributable to foreign trading gross receipts. In general, the term "foreign trading gross receipts" means the gross receipts of a FSC from the sale or lease of export property, services related and subsidiary to the sale or lease of export property, engineering or architectural services for construction projects located outside the United States, and certain managerial services for an unrelated FSC or DISC.

Section 923(a)(5) contains a special limitation relating to the export of military property. Under regulations prescribed by the Treasury Secretary, the portion of a FSC's foreign trading gross receipts from the disposition of, or services relating to, military property that may be treated as exempt foreign trade income is limited to 50 percent of the amount that would otherwise be so treated. For this purpose, the term "military property" means any property that is an arm, ammunition, or implement of war designated in the munitions list published pursuant to federal law.[28] Under this provision, the export of military property through a FSC is accorded one-half the tax benefit that is accorded to exports of non-military property.

Description of Proposal

The proposal would repeal the special FSC limitation relating to the export of military property, thus providing exports of military property through a FSC with the same treatment currently provided exports of non-military property.

Effective Date

The proposal would be effective for taxable years of FSCs beginning after December 31, 1999.

4. United States property not to include certain assets acquired by dealers in ordinary course of trade or business (sec. 304 of the bill)

Present Law

Under the rules of subpart F, the U.S. 10-percent shareholders of a controlled foreign corporation ("CFC") generally are subject to U.S. tax currently on their pro rata shares of certain income of the CFC (referred to as "subpart F income"), whether or not such earnings are distributed currently to the shareholders. 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 certain U.S. property (sec. 951(a)(1)(B)).

A shareholder's current income inclusion with respect to a CFC's investment in U.S. property for a taxable year is based on the CFC's average investment in U.S. property for such year. For this purpose, the U.S. property held (directly or indirectly) by the 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. The amount determined for current inclusion is the shareholder's pro rata share of an

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[28] Section 923(a)(5) defines "military property" by reference to section 995(b)(3)(B), which contains a technical error. Section 995(b)(3)(B) references the Military Security Act of 1954. The proper reference should have been to the Mutual Security Act of 1954 which subsequently was superceded by the International Security Assistance and Arms Export Control Act of 1976. Current Treasury regulations provide the correct reference for purposes of defining "military property."

amount equal to the lesser of (1) the CFC's average investment in U.S. property as of the end of each quarter of such taxable 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 (but not including a deficit), 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).

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 certain intangible assets including a patent or copyright, an invention, model or design, a secret formula or process or similar property right which is acquired or developed by the CFC for use in the United States. (sec. 956(c)(1)).

Specified exceptions from the definition of U.S. property are provided for (1) obligations of the United States and U.S. bank deposits, (2) certain export property, (3) certain trade or business obligations, (4) aircraft, railroad rolling stock, vessels, motor vehicles or containers used in transportation in foreign commerce and used predominantly outside of the United States, (5) certain insurance company reserves and unearned premiums related to insurance of foreign risks, (6) stock or debt of certain unrelated U.S. corporations (7) moveable property (other than a vessel or aircraft) used for the purpose of exploring, developing, or certain other activities in connection with the ocean waters of the U.S. Continental Shelf, (8) an amount of assets equal to the CFC's accumulated earnings and profits attributable to income effectively connected with a U.S. trade or business, (9) property (to the extent provided in regulations) held by a foreign sales corporation and related to its export activities, (10) certain deposits or receipts of collateral or margin by a securities or commodities dealer, if such deposit is made or received on commercial terms in the ordinary course of the dealer's business as a securities or commodities dealer, and (11) certain repurchase and reverse repurchase agreement transactions entered into by or with a dealer in securities or commodities in the ordinary course of its business as a securities or commodities dealer (sec. 956(c)(2)).

Description of Proposal

The proposal would add a new exception from the definition of "United States property" for section 956 purposes for securities acquired and held by a CFC in the ordinary course of its trade or business as a dealer in securities. The exception would apply only if the CFC dealer (1) accounts for the securities as securities held primarily for sale to customers in the ordinary course of business and (2) disposes of such securities (or such securities mature while being held by the dealer) within a period consistent with the holding of securities for sale to customers in the ordinary course of business.

Effective Date

The proposal would be effective for taxable years of foreign corporations beginning after December 31, 1999, and for taxable years of United States shareholders with or within which such taxable year of the foreign corporation ends.

5. Treatment of certain dividends of regulated investment companies (sec. 305 of the bill)

Present Law

Regulated investment companies

A regulated investment company ("RIC") is a domestic corporation that, at all times during the taxable year, is registered under the Investment Company Act of 1940 as a management company or as a unit investment trust, or has elected to be treated as a business development company under that Act (sec. 851(a)).

In addition, to qualify as a RIC, a corporation must elect such status and must satisfy certain tests (sec. 851(b)). These tests include a requirement that the corporation derive at least 90 percent of its gross income from dividends, interest, payments with respect to certain securities loans, and gains on the sale or other disposition of stock or securities or foreign currencies, or other income derived with respect to its business of investment in such stock, securities, or currencies.

Generally, a RIC pays no income tax because it is permitted to deduct dividends paid to its shareholders in computing its taxable income. The amount of any distribution generally is not considered as a dividend for purposes of computing the dividends paid deduction unless the distribution is pro rata, with no preference to any share of stock as compared with other shares of the same class (sec. 562(c)). For distributions by RICs to shareholders who made initial investments of at least $10,000,000, however, the distribution is not treated as non-pro rata or preferential solely by reason of an increase in the distribution due to reductions in administrative expenses of the company.

A RIC generally may pass through to its shareholders the character of its long-term capital gains. It does this by designating a dividend it pays as a capital gain dividend to the extent that the RIC has net capital gain (i.e., net long-term capital gain over net short-term capital loss). These capital gain dividends are treated as long-term capital gain by the shareholders. A RIC generally also can pass through to its shareholders the character of tax-exempt interest from State and municipal bonds, but only if, at the close of each quarter of its taxable year, at least 50 percent of the value of the total assets of the RIC consists of these obligations. In this case, the RIC generally may designate a dividend it pays as an exempt-interest dividend to the extent that the RIC has tax-exempt interest income. These exempt-interest dividends are treated as interest excludable from gross income by the shareholders.

U.S. source investment income of foreign persons

In general

The United States generally imposes a flat 30-percent tax, collected by withholding, on the gross amount of U.S.-source investment income payments, such as interest, dividends, rents, royalties or similar types of income, to nonresident alien individuals and foreign corporations ("foreign persons") (secs. 871(a), 881, 1441, and 1442). Under treaties, the United States may reduce or eliminate such taxes. Even taking into account U.S. treaties, however, the tax on a dividend generally is not entirely eliminated. Instead, U.S.-source portfolio investment dividends received by foreign persons generally are subject to U.S. withholding tax at a rate of at least 15 percent.

Interest

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 183 days or less from the date of original issue (without regard to the period held by the taxpayer) is also exempt from tax (sec. 871(g)). 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, (i) on an obligation that satisfies certain registration requirements or specified exceptions thereto (i.e., the obligation is "foreign targeted"), and (ii) that is not received by a 10-percent shareholder (secs. 871(h)(3) and 881(c)(3)). With respect to a registered obligation, a statement that the beneficial owner is not a U.S. person is required (secs. 871(h)(2), (5) and 881(c)(2)). 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 (secs. 871(h)(4) and 881(c)(4)). The payment of interest must not be to any person within a foreign country (and must not be a payment addressed to, or for the account of, persons within a foreign country) with respect to which the Treasury Secretary has determined that exchange of information is inadequate to prevent evasion of U.S. income tax by U.S. persons (secs. 871(h)(6), and 881(c)(6)).

Capital gains

Foreign persons generally are not subject to U.S. tax on gain realized on the disposition of stock or securities issued by a U.S. person (other than a "U.S. real property holding corporation," as described below), unless the gain is effectively connected with the conduct of a trade or business in the United States. This exemption does not apply, however, to the extent that the foreign person is a nonresident alien individual present in the United States for a period or periods aggregating 183 days or more during the taxable year (sec. 871(a)(2)). A RIC may elect not to withhold on a distribution to a foreign person representing a capital gain dividend. (Treas. Reg. sec. 1.1441-3(c)(2)(D)).

Under the Foreign Investment in Real Property Tax Act of 1980 ("FIRPTA"), as amended, gain or loss of a foreign person from the disposition of a U.S. real property interest is subject to net basis tax as if the taxpayer were engaged in a trade or business within the United States and the gain or loss were effectively connected with such trade or business (sec. 897). In addition to an interest in real property located in the United States or the Virgin Islands, U.S. real property interests include (among other things) any interest in a domestic corporation unless the taxpayer establishes that the corporation was not, during a 5-year period ending on the date of the disposition of the interest, a U.S. real property holding corporation (which is defined generally to mean a corporation the fair market value of whose U.S. real property interests equals or exceeds 50 percent of the sum of the fair market values of its real property interests and any other of its assets used or held for use in a trade or business).

Under the FIRPTA provisions, a distribution by a real estate investment trust ("REIT") to a foreign person is, to the extent attributable to gain from sales or exchanges by the REIT of U.S. real property interests, treated as gain recognized by the foreign person from the sale or exchange of a U.S. real property interest (sec. 897(h)). Under Treasury regulations, a REIT generally is required to withhold tax upon such a distribution to a foreign person, at a rate of 35 percent times the maximum amount of that distribution that could be designated by the REIT as a capital gain dividend (Treas. Reg. sec. 1.1445-8(a)(2), (b)(1), and (c)(2)).

In view of the nature of a REIT, an interest in a REIT may in some cases be considered to be a U.S. real property interest. An interest in a domestically-controlled REIT, however, is not considered a U.S. real property interest (sec. 897(h)(2)). Nonetheless, the foreign ownership percentage of taxable appreciation in the value of a U.S. real property interest distributed by a domestically-controlled REIT is subject to tax in the hands of the REIT (sec. 897(h)(3)).

Estate taxation

Decedents who were citizens or residents of the United States are generally subject to Federal estate tax on all property, wherever situated. Nonresidents who are not U.S. citizens, however, are subject to estate tax only on their property which is within the United States. Property within the United States generally includes debt obligations of U.S. persons, including the Federal government and State and local governments (sec. 2104(c)), but does not include either bank deposits or portfolio obligations, the interest on which would be exempt from U.S. income tax under section 871 (sec. 2105(b)). Stock owned and held by a nonresident who is not a U.S. citizen is treated as property within the United States only if the stock was issued by a domestic corporation (sec. 2104(a); Treas. Reg. sec. 20.2104-1(a)(5)).

Treaties may reduce U.S. taxation on transfers by estates of nonresident decedents who are not U.S. citizens. Under recent treaties, for example, U.S. tax may generally be eliminated except insofar as the property transferred includes U.S. real property or business property of a U.S. permanent establishment.

Description of Proposal

In general

Under the proposal, a RIC that earns certain interest income which would not be subject to U.S. tax if earned by a foreign person directly may, to the extent of such income, designate a dividend it pays as derived from such interest income. A foreign person who is a shareholder in the RIC generally would treat such a dividend as exempt from gross-basis U.S. tax, just as if the foreign person had earned the interest directly. Similarly, a RIC that earns an excess of net short-term capital gains over net long-term capital losses, which excess would not be subject to U.S. tax if earned by a foreign person, generally may, to the extent of such excess, designate a dividend it pays as derived from such excess. A foreign person who is a shareholder in the RIC generally would treat such a dividend as exempt from gross-basis U.S. tax, just as if the foreign person had realized the excess directly. The estate of a foreign decedent would be exempt from U.S. estate tax on a transfer of stock in the RIC in the proportion that the assets held by the RIC are debt obligations, deposits, or other property that would generally be treated as situated outside the United States if held directly by the estate.

Interest-related dividends

Under the proposal, a RIC could, under certain circumstances, designate all or a portion of a dividend as an "interest-related dividend," by written notice mailed to its shareholders not later than 60 days after the close of its taxable year. An interest-related dividend received by a foreign person generally would generally be exempt from U.S. gross-basis tax under sections 871(a), 881, 1441 and 1442.

This exemption would not apply, however, to a dividend on shares of RIC stock in a case where the withholding agent does not receive a statement, similar to that required under the portfolio interest rules, that the beneficial owner of the shares is not a U.S. person. The exemption would not apply to a dividend paid to any person within a foreign country (or dividends addressed to, or for the account of, persons within such foreign country) with respect to which the Treasury Secretary has determined, under the portfolio interest rules, that exchange of information is inadequate to prevent evasion of U.S. income tax by U.S. persons.

In addition, the exemption generally would not apply to dividends paid to a controlled foreign corporation to the extent such dividends are attributable to income received by the RIC on a debt obligation of a person with respect to which the recipient of the dividend (i.e., the controlled foreign corporation) is a related person. Nor would the exemption generally apply to dividends to the extent such dividends are attributable to income (other than short-term original discount or bank deposit interest) received by the RIC on indebtedness issued by the RIC-dividend recipient or by any corporation or partnership with respect to which the recipient of the RIC dividend is a 10-percent shareholder. In these two cases, however, the RIC remains exempt from its withholding obligation unless the RIC knows that the dividend recipient is such a controlled foreign corporation or 10-percent shareholder. To the extent that an interest-related dividend received by a controlled foreign corporation is attributable to interest income of the RIC that would be portfolio interest if received by a foreign corporation, the dividend would be treated as portfolio interest for purposes of the de minimis rules, the high-tax exception, and the same country exceptions of subpart F (see sec. 881(c)(5)(A)).

The aggregate amount designated as interest-related dividends for the RIC's taxable year (including dividends so designated that are paid after the close of the taxable year but treated as paid during that year as described in section 855) generally is limited to the qualified net interest income of the RIC for the taxable year. The qualified net interest income of the RIC equals the excess of (1) the amount of qualified interest income of the RIC over (2) the amount of expenses of the RIC properly allocable to such interest income.

Qualified interest income of the RIC is the sum of its U.S.-source income with respect to (1) bank deposit interest, (2) short term original issue discount that is currently exempt from the gross-basis tax under section 871, (3) any interest (including amounts recognized as ordinary income in respect of original issue discount, market discount, or acquisition discount under the provisions of sections 1271-1288, and such other amounts as regulations may provide) on an obligation which is in registered form, unless it is earned on an obligation issued by a corporation or partnership in which the RIC is a 10-percent shareholder or is contingent interest not treated as portfolio interest under section 871(h)(4), and (4) any interest-related dividend from another RIC.

Where the amount designated as an interest-related dividend is greater than the qualified net interest income described above, then the portion of the distribution so designated which constitutes an interest-related dividend will be only that proportion of the amount so designated as the amount of the qualified net interest income bears to the amount so designated.

Short-term capital gain dividends

Under the proposal, a RIC could also, under certain circumstances, designate all or a portion of a dividend as a "short-term capital gain dividend," by written notice mailed to its shareholders not later than 60 days after the close of its taxable year. For purposes of the U.S. gross-basis tax, a short-term capital gain dividend received by a foreign person generally would be exempt from U.S. gross-basis tax under sections 871(a), 881, 1441 and 1442. This exemption would not apply to the extent that the foreign person is a nonresident alien individual present in the United States for a period or periods aggregating 183 days or more during the taxable year. In this case, however, the RIC remains exempt from its withholding obligation unless the RIC knows that the dividend recipient has been present in the United States for such period.

The aggregate amount qualified to be designated as short-term capital gain dividends for the RIC's taxable year (including dividends so designated that are paid after the close of the taxable year but treated as paid during that year as described in sec. 855) is the excess of the RIC's net short-term capital gains over net long-term capital losses. The short-term capital gain would include short-term capital gain dividends from another RIC. As is provided under present law for purposes of computing the amount of a capital gain dividend, the amount is determined (except in the case where an election under sec. 4982(e)(4) applies) without regard to any net capital loss or net short-term capital loss attributable to transactions after October 31 of the year. Instead, that loss would be treated as arising on the first day of the next taxable year. To the extent provided in regulations, this rule would apply also for purposes of computing the taxable income of the RIC.

In computing the amount of short-term capital gain dividends for the year, no reduction is made for the amount of expenses of the RIC allocable to such net gains. In addition, where the amount designated as short-term capital gain dividends is greater than the amount of qualified short-term capital gain, then the portion of the distribution so designated which constitutes a short-term capital gain dividend will be only that proportion of the amount so designated as the amount of the excess bears to the amount so designated.

As is true under current law for distributions from REITs, the proposal would provide that any distribution by a RIC to a foreign person shall, to the extent attributable to gains from sales or exchanges by the RIC of an asset that is considered a U.S. real property interest, be treated as gain recognized by the foreign person from the sale or exchange of a U.S. real property interest. The proposal also would extend the special rules for domestically-controlled REITs to domestically-controlled RICs.

Estate tax treatment

Under the proposal, a portion of the stock in a RIC held by the estate of a nonresident decedent who is not a U.S. citizen would be treated as property without the United States. The portion so treated would be based on the proportion of the assets held by the RIC at the end of the quarter immediately preceding the decedent's death (or such other time as the Secretary may designate in regulations) that are "qualifying assets." Qualifying assets for this purpose are bank deposits of the type that are exempt from gross-basis income tax, portfolio debt obligations, certain original issue discount obligations, debt obligations of a domestic corporation that are treated as giving rise to foreign source income, and other property not within the United States.

Effective Date

The proposal generally would apply to dividends with respect to taxable years of RICs beginning after the date of enactment. With respect to the treatment of a RIC for estate tax purposes, the proposal would apply to estates of decedents dying after the date of enactment.

With respect to the treatment of RICs under section 897 (dealing with U.S. real property interests), the proposal would be effective on the date of enactment.

6. Regulatory authority to exclude certain preliminary agreements from definition of intangible property (sec. 306 of the bill)

Present Law

Section 367 applies to require gain recognition upon certain transfers by U.S. persons to foreign corporations. Under section 367(d), a U.S. person that contributes intangible property to a foreign corporation is treated as having sold the property to the corporation and is treated as receiving deemed royalty payments from the corporation. The deemed royalty payments are treated as foreign-source income to the same extent that an actual royalty payment would be considered to be foreign-source income. Regulatory authority is granted to provide similar treatment in the case of a transfer of intangible property to a partnership. For these purposes, intangible property is defined (by reference to sec. 936(h)(3)(B)) to include such items as patents, copyrights, trademarks, franchises, licenses, and contracts (sec. 367(d)).

Section 482 authorizes the Treasury Secretary to distribute, apportion or allocate gross income, deductions, credits or allowances between or among commonly controlled parties to prevent tax evasion or to clearly reflect income. Section 482 provides that in the case of any transfer or license of intangible property (as defined in sec. 936(h)(3)(B)), the income with respect to such transfer or license is required to be commensurate with the income attributable to the intangible.

Description of Proposal

The proposal would direct the Secretary of the Treasury to provide by regulation that the term "intangible property," as defined in section 936(h)(3)(B), does not include preliminary agreements which are not legally enforceable. Thus, such agreements would be excluded from the definition of intangible property for purposes of sections 367 and 482.

Effective Date

The proposal would apply to agreements entered into after date of enactment.

7. Airline mileage awards to certain foreign persons (sec. 307 of the bill)

Present Law

Excise taxes are imposed on domestic and international air passenger transportation and on domestic air cargo transportation to fund Airport and Airway Trust Fund programs. Table 1, below, summarizes the current aviation excise taxes. With the exception of 4.3 cents per gallon of the aviation fuels taxes, all of these taxes are scheduled to expire after September 30, 2007.

Table 1.–Airport and Airway Trust Fund Excise Tax Rates

Tax	Tax rate
Domestic air passenger transportation	8 percent of fare *plus* $2 per domestic flight segment (through September 30, 1999).[1]
International air passenger transportation	$12.20 per arrival and $12.20 per departure.[2]
Rights to free and reduced-rate air passenger transportation	7.5 percent of amount paid to air carrier.
Air cargo transportation	
Domestic transportation	6.25 percent of the amount charged.[3]
International transportation	No tax.

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[1] The *ad valorem* portion of the rate is scheduled to decline to 7.5 percent, effective for transportation beginning after September 30, 1999.

The flight segment portion of the rate is scheduled to increase to $2.25 per flight segment for October 1, 1999-December 31, 1999, to $2.50 for January 1, 2000-December 31, 2000, to $2.75 for January 1, 2001-December 31, 2001, and to $3 for January 1, 2002-December 31, 2002. Beginning on January 1, 2003, the $3 flight segment rate will be indexed annually for inflation.

Flight segments to or from qualified rural airports are subject to a 7.5-percent *ad valorem* rate (i.e., the rate is not phased in), and no flight segment rate is imposed.

[2] As enacted in 1997, the rate was $12 per arrival or departure. This amount is indexed annually for inflation, beginning on January 1, 1999.

[3] Tax does not apply to amounts attributable to "accessorial ground services."

Table 1.–Airport and Airway Trust Fund Excise Tax Rates (Continued)

Tax	Tax rate
Aviation fuels	
Commercial aviation fuels[4]	4.3 cents per gallon
Noncommercial aviation:[5]	
Aviation gasoline	19.3 cents per gallon
Aviation jet fuel	21.8 cents per gallon

[4] Commercial aviation fuels are subject to an additional 0.1-cent-per-gallon rate through March 31, 2005, to fund the Leaking Underground Storage Tank Trust Fund.

[5] Noncommercial aviation fuels are subject to an additional 0.1-cent-per-gallon rate through March 31, 2005, to fund the Leaking Underground Storage Tank Trust Fund.

As described in Table 1, amounts paid to air carriers (in cash or in kind) for the right to award or otherwise distribute free or reduced-rate air transportation are treated as amounts paid for taxable air transportation, subject to the 7.5 percent *ad valorem* tax rate. Like the general air passenger transportation tax, the tax on the purchase of these rights to air transportation (e.g., frequent flyer mileage awards) applies to payments, whether made within the United States or elsewhere, if the rights to transportation for which payments are made can be used in whole or in part for transportation that, if purchased directly, would be subject to either the domestic or international air passenger taxes. Also, subject to an exception for miles actually used for certain non-air transportation uses, the tax applies without regard to whether transportation ultimately is provided pursuant to the transferred rights. Examples of amounts taxable under this provision include (1) payments for frequent flyer miles (including other rights to air transportation) purchased by credit card companies, telephone companies, rental car companies, television networks, restaurants and hotels, air carriers (or related parties), mutual funds, and other businesses, and (2) amounts received by airlines (whether paid in cash or in kind) pursuant to joint venture credit card or other air transportation marketing arrangements as compensation for the right to air travel.

Description of Proposal

The proposal would direct the Treasury Department to adopt regulations exempting awards to persons having a mailing address outside the United States from the tax on amounts paid for the right to award free or reduced-rate air transportation under frequent flyer and similar programs.

Effective Date

The proposal would apply to amounts paid after December 31, 1997.

8. Repeal of reduction of subpart F income of export trade corporations (sec. 308 of the bill)

Present Law

Under the rules of subpart F, the U.S. 10-percent shareholders of a controlled foreign corporation ("CFC") generally are subject to U.S. tax currently on their pro rata shares of 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)). To the extent that such undistributed income was previously taxed under subpart F, such amounts will not be subject to U.S. tax again upon distribution (sec. 959).

Subpart F income includes, among other things, foreign base company income (sec. 954). The export trade corporation ("ETC") provisions, however, reduce the subpart F income of an ETC by certain export trade income that constitutes foreign base company income (sec. 970). In effect, an ETC is permitted deferral of U.S. tax on such export-related earnings until those earnings are repatriated.

An ETC is a CFC (as defined in sec. 957) in which (1) 90 percent or more of the gross income for the immediately preceding 3-year period was derived from sources without the United States and (2) 75 percent or more (50 percent in the case of certain agricultural products) of its gross income for such period was export trade income (sec. 971).

In 1971, the ETC provisions were replaced by rules applicable to domestic international sales corporations ("DISCs") (secs. 991-997). Only those ETCs in existence at that time (i.e., ETCs that qualified for taxable years beginning before October 31, 1971) were permitted to continue operating as ETCs (sec. 971(a)(3)). In 1984, the DISC provisions were largely replaced by the rules applicable to foreign sales corporations ("FSCs") (secs. 921-927). Certain foreign trade income of a FSC is exempt from U.S. income tax. In connection with the enactment of the FSC provisions, ETCs were given the opportunity to elect to convert to FSC status (or to dissolve as ETCs) and repatriate their then accumulated export trade earnings (i.e., earnings derived before January 1, 1985) without U.S. tax. ETCs that did not make this election were permitted to continue operating as ETCs.

The Tax Reform Act of 1986 established an anti-deferral regime for passive foreign investment companies ("PFICs") (secs. 1291-1298). The Small Business Job Protection Act of 1996 clarified that foreign trade income of a FSC and export trade income of an ETC do not constitute passive income for purposes of the PFIC provisions (sec. 1297(b)(2)(D)).

Description of Proposal

The proposal would repeal the ETC provisions. The proposal also would treat post-enactment distributions by former ETCs as previously taxed income (thereby exempting such distributions from U.S. taxation) to the extent of any actual distributions of export trade income that were made after December 31, 1986 by an ETC (or a former ETC that was an ETC on December 31, 1986).[29]

Effective Date

The proposal would be effective for taxable years beginning after December 31, 1999.

9. Study of interest allocation (sec. 309 of the bill)

Present Law

In general

In order to compute the foreign tax credit limitation, a taxpayer must determine the amount of taxable income from foreign sources. Thus the taxpayer must allocate and apportion deductions between items of U.S. source gross income, on the one hand, and items of foreign source gross income, on the other. Generally it is left to the Treasury to provide detailed rules for the allocation and apportionment of expenses.

In the case of interest expense, regulations generally are based on the approach that money is fungible and that interest expense is properly attributable to all business activities and property of a taxpayer, regardless of any specific purpose for incurring an obligation on which interest is paid. (Exceptions to the fungibility concept are recognized or required, however, in particular cases, some of which are described below.) The Code provides that for interest allocation purposes all members of an affiliated group of corporations generally are to be treated as a single corporation (the so-called "one-taxpayer rule"), and that allocation must be made on the basis of assets rather than gross income.

Affiliated group

The term "affiliated group" in this context generally is defined by reference to the rules for determining whether corporations are eligible to file consolidated returns. However, some groups of corporations are eligible to file consolidated returns yet are not treated as affiliated for

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[29] The post-enactment distributions that are treated as previously taxed income under this provision would be treated as an amount described in section 951(a)(2)(B) that reduces the pro rata share of subpart F income described in section 951(a)(2)(A).

interest allocation purposes, and other groups of corporations are treated as affiliated for interest allocation purposes even though they are not eligible to file consolidated returns. Thus, under the one-taxpayer rule, the factors affecting the allocation of interest expense of one corporation may affect the sourcing of taxable income of another, related corporation even if the two corporations do not elect to file, or are ineligible to file, consolidated returns. (See, e.g., Treas. Reg. sec. 1.861-11T(g).)

Definition of affiliated group--consolidated return rules

For consolidation purposes, the term "affiliated group" means one or more chains of includible corporations connected through stock ownership with a common parent corporation which is an includible corporation, but only if the common parent owns directly at least 80 percent of the total voting power of all classes of stock and at least 80 percent of the total value of all outstanding stock of at least one other includible corporation. In addition, for each such other includible corporation (except the common parent), stock possessing at least 80 percent of the total voting power of all classes of its stock and at least 80 percent of the total value of all of its outstanding stock must be directly owned by one or more other includible corporations.

Generally the term "includible corporation" means any domestic corporation except certain corporations exempt from tax under section 501 (for example, corporations organized and operated exclusively for charitable or educational purposes), certain life insurance companies, corporations electing application of the possession tax credit, regulated investment companies, real estate investment trusts, and domestic international sales corporations. A foreign corporation is not an includible corporation.

Definition of affiliated group--special interest allocation rules

Subject to exceptions, the consolidated return and interest allocation definitions of affiliation generally are consistent with each other. For example, both definitions exclude all foreign corporations from the affiliated group. Thus, while debt generally is considered fungible among the assets of a group of domestic affiliated corporations, the same rule does not apply as between the domestic and foreign members of a group with the same degree of common control as the domestic affiliated group. Moreover, Congress in 1986 expressly considered and rejected a rule that would have accomplished a result more consistent with worldwide fungibility by taking foreign members' borrowings into account when allocating the interest expense of the domestic members (H. Rept. 99-841, II-605 (1986)). In practice, the limit in the degree of fungibility recognized by present law can reduce the foreign tax credit limitations that otherwise would apply if the principle of fungibility were extended to foreign and domestic members of a commonly controlled group.

The statutory definition of affiliation for purposes of group-wide allocation of interest expenses expressly provides for two exceptions from the definition of affiliation for consolidation purposes, one of which contracts the affiliated group and the other of which expands it.

Banks. savings institutions and other financial affiliates

Under the first-mentioned exception, the affiliated group for interest allocation purposes generally excludes what are known in the regulations as "financial corporations" (Treas. Reg. sec. 1.861-11T(d)(4)). These include any corporation, otherwise a member of the affiliated group for consolidation purposes, that is a financial institution (described in section 581 or 591), the business of which is predominantly with persons other than related persons or their customers, and which is required by State or Federal law to be operated separately from any other entity which is not a financial institution (sec. 864(e)(5)(C)). The category of financial corporations also includes, to the extent provided in regulations, bank holding companies and subsidiaries of banks, bank holding companies, and savings institutions predominantly engaged in the active conduct of a banking, financing, or similar business (sec. 864(e)(5)(D)).

A financial corporation is not treated as a member of the regular affiliated group for purposes of applying the one-taxpayer rule to other nonfinancial members of that group. Instead, all such financial corporations which would be so affiliated are treated as a separate single corporation for interest allocation purposes.

Section 936 corporations

Under the second exception referred to above, the affiliated group for interest allocation purposes includes any corporation which has elected the application of the possession tax credit for the taxable year, if the corporation would be excluded solely for this reason from the affiliated group as defined for consolidation purposes (sec. 864(e)(5)(A)).

Description of Proposal

The proposal would direct the Secretary of the Treasury to conduct a study of the interest expense allocation rules, including an analysis of the effects of such rules such as effects the rules have on different industries. The proposal would require the results of the study to be reported to the House Committee on Ways and Means and the Senate Committee on Finance, along with any legislative recommendations, no later than six months after date of enactment.

10. Interest payments deductible where disqualified guarantee has economic effect (sec. 310 of the bill)

Present Law

Interest expenses of a U.S. corporate taxpayer are generally deductible, whether or not the interest is paid to a related party and whether or not the interest income is subject to U.S. taxation in the hands of the recipient. In certain cases where interest is paid by a corporation to a related person, and no U.S. tax is imposed on the recipient's interest income, the so-called "earnings stripping rules" in the Code provide for denial of interest deductions by the corporate payor to the extent that the corporation's net interest expenses exceed 50 percent of its adjusted taxable income (sec. 163(j)). The disallowance is limited by, among other things, the amount of tax-exempt interest paid to related persons.

Under the earnings stripping rules, interest paid on a loan from an unrelated party generally is treated as interest paid to a related person with respect to which no U.S. tax is imposed if: (1) no gross-basis U.S. income tax is imposed on the interest (whether or not the interest recipient is subject to net-basis U.S. income tax with respect to that interest), and (2) there is a disqualified guarantee of the loan. A "disqualified guarantee" generally is defined for these purposes as any guaranty of a loan by a related person which is either exempt from U.S. Federal income tax or is a foreign person. Disqualified guarantees do not include cases in which the taxpayer controls the guarantor, and in cases, identified by regulation, where the interest on the indebtedness would have been subject to net basis tax if the interest had been paid to the guarantor. Except as provided in regulations, a guarantee is defined to include any arrangement under which a person directly or indirectly assures, on a conditional or unconditional basis, the payment of another's obligation.

Description of Proposal

The proposal would provide an additional exception from the term "disqualified guarantee," for purposes of the earnings stripping rules, for guarantees by a foreign person in cases in which the taxpayer establishes to the satisfaction of the Treasury Secretary that the loan giving rise to the indebtedness would have been made by the unrelated person without regard to the guarantee and that the guarantee resulted in a reduction in interest payable on the loan.

Effective Date

The proposal would be effective with respect to guarantees issued on or after the date of enactment.

11. Modifications of reporting requirements for certain foreign owned corporations (sec. 311 of the bill)

Present Law

U.S. corporations with a 25-percent or greater foreign shareholder are subject to special reporting rules (sec. 6038A).[30] For example, a U.S. corporation that engages in specified transactions with its 25-percent foreign shareholder (or a foreign related party) is required to report the transactions annually on Form 5472 (sec. 6038A(b)). Information reporting relating to such transactions is required regardless of the respective amounts of the individual transactions, the aggregate amount of all transactions, or the size of the taxpayer.

In addition, U.S. corporations with a 25-percent foreign shareholder are required to maintain permanent books of account or records that are sufficient to establish the correct treatment of transactions with related parties (sec. 6038A(a)). If the IRS requests that certain records be translated into English, the U.S. corporation is required to produce the translated documents within 30 days of the request (Treas. Reg. sec. 1.6038A-3(f)(2)).

The IRS may request that a 25-percent foreign shareholder (or a foreign related party) authorize the U.S. corporation to be its agent for purposes of responding to an IRS request to examine records (or to produce testimony) or an IRS summons (sec. 6038A(e)(1)).

A U.S. corporation is not subject to the requirements under section 6038A to maintain records or authorize an agent in any tax year in which either (1) the U.S. corporation has less than $10 million in U.S. gross receipts, or (2) the aggregate value of all gross reportable payments is not more than $5 million and is less than 10 percent of its U.S. gross income (Treas. Reg. sec. 1.6038A-1(h) and (i)). These exceptions do not apply to the information reporting requirements with respect to transactions with foreign related parties.

Description of Proposal

The proposal would exempt the U.S. corporation from the reporting requirements with respect to transactions with foreign related parties under section 6038A if the aggregate value of the transactions between the U.S. corporation and its 25-percent foreign shareholder (or a foreign related party) during a tax year does not exceed $5 million. Thus, in such cases, the U.S. corporation would not be required to file Form 5472.

The proposal also would extend the period of time in which the U.S. corporation is required to produce translated documents, after requested by the IRS, from 30 days to 60 days.

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[30] Failure on behalf of the U.S. corporation to comply with such rules may subject the U.S. corporation to penalties.

Effective Date

The proposal relating to the exception from the section 6038A reporting requirements would apply to taxable years beginning after December 31, 1999. The proposal relating to translations of specific documents would apply to requests made by the IRS after December 31, 1999.