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

Scheduled for a Public Hearing
Before the
SENATE COMMITTEE ON FINANCE
on July 15, 2003

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of the
JOINT COMMITTEE ON TAXATION

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INTRODUCTION

The Senate Committee on Finance has scheduled a public hearing for July 15, 2003, on the effects of the U.S. international tax rules on the competitiveness of U.S. businesses abroad. This document,[1] prepared by the staff of the Joint Committee on Taxation, provides general background on these rules and discusses selected issues relating to the tax treatment of the foreign activities of U.S. businesses.

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[1] This document may be cited as follows: *Joint Committee on Taxation, The U.S. International Tax Rules: Background and Selected Issues Relating to the Competitiveness of U.S Businesses Abroad* (JCX-68-03), July 14, 2003.

I. BACKGROUND: WORLDWIDE VS. TERRITORIAL TAX SYSTEMS

A. In General

Worldwide tax system

In a pure worldwide tax system, resident individuals and entities are taxable on their worldwide income, regardless of where the income is derived. Double taxation of foreign income is mitigated through the allowance of a foreign tax credit. However, the credit is generally limited to ensure that the residence country preserves its right to tax income derived within the residence country. Since corporations are generally respected as separate entities, foreign-source income earned by a resident through a foreign corporation generally is not subject to tax until repatriated. In the United States, several complex anti-deferral regimes apply as exceptions to this general rule and tax U.S. shareholders currently on certain mobile or passive income derived through certain foreign corporations.

Territorial tax system

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

Mixed systems

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

B. Rationale for a Worldwide Tax System

Economic efficiency

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

Equity

A worldwide tax system arguably promotes equity in a number of ways.

Horizontal equity

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

Vertical equity

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

Citizenship and residency as values

Taxing U.S. citizens and residents on their worldwide income arguably also reflects the notion that U.S. citizenship and residency bestow important benefits (e.g., legal and technical business infrastructure, military protection, passport and embassy services) that U.S. citizens and residents should be made to pay for, regardless of where they might earn their income. Consistent with this notion, the United States is the only industrialized country in the world that taxes its citizens on their worldwide income, even if they reside outside the country.

Preservation of the U.S. tax base

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

C. Rationale for a Territorial Tax System

Economic efficiency

A territorial system arguably promotes economic efficiency better than a worldwide tax system, because a territorial system treats all investment within a particular source country the same, regardless of the residence of the investor. This efficiency norm is referred to as capital import neutrality (or, in the business community, as "competitiveness"). Thus, if a residence country adopts a pure territorial system, residents of that country, when investing abroad in a particular source jurisdiction, will not be disadvantaged relative to other investors by virtue of their country of residence. For example, if a source country provides low effective tax rates on manufacturing income, a taxpayer resident in a country with a territorial tax system will fully enjoy the benefits of the lower source-country rate, while a taxpayer resident in a country with a worldwide tax system generally will not. In a world with diverse tax systems and rates, it is impossible to fully achieve both capital import neutrality and capital export neutrality at the same time. Thus, difficult balancing decisions are unavoidable, and there is no consensus as to which of the two goals should take precedence. The weight of academic opinion generally favors capital export neutrality, while the business community generally leans toward capital import neutrality. (It has also been argued that these concepts are inadequate, and too indeterminate to be of any use in formulating policy in the first place, but this is a minority view in the relevant literature.)

Simplicity in compliance and administration

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

Source vs. residence as basis for taxation

The concept of residence is the fundamental basis of taxation under a worldwide tax system, whereas a pure territorial system, by relying on source, renders the concept of residence generally irrelevant. Several commentators have argued that, as applied to corporations, the concept of residence is becoming meaningless as a practical matter, since large multinational corporations are becoming "nationless" in the sense that their shareholders, employees, business activities, and income are increasingly spread throughout the world, rather than concentrated predominantly in any one country. Since concepts that are meaningless in the real world probably should not dictate tax consequences, the de-emphasis of residence is arguably one advantage of a territorial system. Of course, in a territorial system that incorporates some attributes of a worldwide system, the concept of residence would become important again, although probably less so than under a predominantly worldwide system.

D. Methods of Implementing a Territorial Tax System

Exempt all foreign-source income

A pure territorial tax system would simply exempt all foreign-source income from residence-country tax.

Exempt only active foreign-source income

A modified territorial tax system might exempt only active foreign-source income, but tax passive (or other highly mobile) foreign-source income.

Exempt only high-taxed foreign-source income

Another approach could be to exempt only foreign-source income that is subject to a certain minimum effective foreign tax rate, and to tax foreign-source income that is subject to foreign tax below that rate.

Exempt only certain kinds of foreign-source income

Another approach would be to exempt limited categories of foreign-source income, such as income from e-commerce transactions.

Exempt only income derived from certain countries

Yet another approach might be to exempt only income earned in a country with which the United States has a tax treaty, or simply to extend more favorable treatment to such income if a broader exemption system were adopted (e.g., by not subjecting the exemption to a high-tax test in the case of income derived in a treaty country, if the high-tax variation described above were adopted). Alternatively, a broad exemption system could be adopted, but income derived in tax havens could be excepted from the system (a "blacklist" approach).

<u>Exemption with progression</u>

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

<u>"Participation exemption" systems</u>

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

As a mechanical matter, a participation exemption system might be implemented via a dividends-received deduction. For example, existing dividends-received deduction rules in the United States could be modified to extend to certain dividends received by U.S. corporations from their foreign subsidiaries.

<u>Transition issues</u>

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

E. Other Issues Raised by a Shift to a Territorial System

<u>U.S. employment and "runaway plants"</u>

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

Tax competition

Some argue that if the United States and other major home countries of multinational enterprises were to adopt territorial tax systems, tax competition would intensify. Without the constraint of some residence-based taxation of foreign-source income, a major barrier to tax competition would be removed, and a "race to the bottom" would arguably ensue. Some would argue that this state of affairs would be intolerable, and that some sort of concerted effort, through the OECD or otherwise, would be necessary to ensure an adequate level of tax revenues to finance necessary government operations throughout the world. Others would find nothing objectionable in the prospect of increased tax competition, and would reject any effort to prevent a country from determining its own tax rules and rates.

Tax treaties

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

F. Relationship of Territorial-vs.-Worldwide Debate to WTO Dispute over FSC/ETI

Exports under a territorial system

Many countries, including several EU countries, base their tax systems on territorial principles to a greater extent than the United States does. By exempting foreign-source income to varying degrees, such countries' tax systems arguably provide an incentive for their exports (as well as other foreign-related business activities of their residents). The extent of this arguable export benefit depends on both the definition of exports and the sourcing rules applicable to them.

Exports under a worldwide system

The United States, on the other hand, bases its tax system on the worldwide principle to a greater extent. Thus, the basic U.S. tax system does not include an inherent export incentive like the more territorial-based systems arguably do. In part for this reason, the United States has in the past provided special tax regimes designed to encourage U.S. exports -- specifically the domestic international sales corporation ("DISC") and foreign sales corporation ("FSC") regimes.

FSC/ETI disputes

The FSC regime was enacted in 1984 in response to concerns that the DISC regime violated the General Agreement on Tariffs and Trade ("GATT"). In 1999, the World Trade Organization ("WTO"), in response to EU complaints, held that the FSC regime constituted an illegal export subsidy under the relevant WTO agreements. In 2000, the United States repealed the FSC regime and enacted an exclusion for "extraterritorial income" ("ETI"). The EU immediately challenged the ETI regime in the WTO, and in January of 2002 a WTO Appellate Body held that the ETI regime also constituted a prohibited export subsidy under the relevant trade agreements.[2]

Implications of WTO rulings

The United States has consistently taken the view that these regimes (DISC, FSC, ETI) were designed merely to approximate in a worldwide system the benefits inherent in a more territorial-based system, and thus to allow U.S. companies to compete on an equal footing with companies resident in the more territorial-based countries. Indeed, on a technical level, the ETI system was structured as a partial territorial system for certain kinds of income. The WTO, however, found this difference unpersuasive in determining whether the ETI regime complied with U.S. obligations under international trade law. As a result of the WTO decision, countries with predominantly worldwide tax systems are arguably placed at a disadvantage relative to countries with more territorial-based tax systems. In other words, the more territorial-based systems are arguably allowed to provide an inherent export incentive without violating international trade law, while attempts to replicate this benefit under a more worldwide-based system have been found to violate this law. Moreover, countries that impose a value-added tax ("VAT") commonly provide for "zero-rating" of export sales, pursuant to which exporters receive a VAT rebate. This practice arguably also constitutes an export subsidy, but as an "indirect" tax, the VAT lies beyond the reach of existing WTO agreements, which address only "direct" taxes such as an income tax.

Relevance of WTO rulings to U.S. choice of overall tax framework

Some would argue that, given the current state of international trade law as reflected by the WTO's report on the ETI regime, it might make sense for the United States to consider shifting to a more territorial-based system (or, for that matter, to a VAT-based system), in order to allow U.S. companies to compete on an equal footing with other companies without running afoul of international trade law. However, others would argue that the benefits provided by the FSC and ETI regimes, and potentially provided under a more heavily territorial system, represent only one consideration among many in evaluating a fundamental shift in the country's entire tax framework. In dollar terms, the principal companies and activities that have benefited from the FSC and ETI regimes represent a relatively small portion of overall U.S. trade flows. Thus,

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[2] For a more detailed discussion of the FSC/ETI dispute, *see Joint Committee on Taxation, The U.S. International Tax Rules: Background, Data, and Selected Issues Relating to the Competitiveness of U.S.-Based Business Operations* (JCX-67-03), July 3, 2003.

some would argue that it would not be prudent to make a fundamental change to the entire tax system on the basis of this narrower set of concerns.

Some would argue that the competitiveness, complexity, and other concerns raised by U.S.-based multinational enterprises could be adequately addressed within the framework of the present system through a number of incremental changes. Indeed, some may even regard such incremental changes as constituting an appropriate and adequate response to the loss of the FSC and ETI regimes. In this regard, many different incremental changes have been proposed in recent years, mostly affecting two key areas of the U.S. international tax system: the foreign tax credit and the anti-deferral regime. Some of the major proposals in this regard are described in part IV, below.

II. OVERVIEW OF THE U.S. INTERNATIONAL TAX SYSTEM

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

In general

Under the U.S. worldwide tax system, domestic corporations generally are taxed on all income, whether derived in the United States or abroad. Income earned by a domestic parent corporation from foreign operations conducted by foreign corporate subsidiaries generally is subject to U.S. tax when the income is distributed as a dividend to the domestic corporation. Until such repatriation, the U.S. tax on such income generally is deferred. However, certain anti-deferral regimes may cause the domestic parent corporation to be taxed on a current basis in the United States with respect to certain categories of passive or highly mobile income earned by its foreign subsidiaries, regardless of whether the income has been distributed as a dividend to the domestic parent corporation. The main anti-deferral regimes in this context are the controlled foreign corporation rules of subpart F[3] and the passive foreign investment company rules.[4] A foreign tax credit generally is available to offset, in whole or in part, the U.S. tax owed on foreign-source income, whether earned directly by the domestic corporation, repatriated as an actual dividend, or included under one of the anti-deferral regimes.[5]

Foreign tax credit

The United States generally provides a credit for foreign income taxes paid or accrued.[6] In the case of foreign income taxes paid or accrued by a foreign subsidiary, a U.S. parent corporation is generally entitled to a "deemed paid" credit for such taxes when it receives an actual or deemed distribution of the underlying earnings from the foreign subsidiary.[7] The foreign tax credit generally is limited to the U.S. tax liability on a taxpayer's foreign-source income, in order to ensure that the credit serves its purpose of mitigating double taxation of foreign-source income without offsetting the U.S. tax on U.S.-source income.[8]

Due to this limitation, a taxpayer must allocate gross income and expenses between U.S. and foreign sources in order to determine the amount of allowable foreign tax credits. Under present law, interest expense that a U.S.-based multinational corporate group incurs in the United States is allocated to U.S. and foreign sources based on the gross assets located in the United States relative to those located abroad (measured either by basis or by fair market value), without

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[3] Secs. 951-964.

[4] Secs. 1291-1298.

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

[6] Sec. 901.

[7] Secs. 902, 960.

[8] Secs. 901, 904.

regard to any interest that the group incurs abroad.[9] Thus, a U.S.-based multinational with a significant portion of its assets overseas must allocate a significant portion of its U.S. interest expense to foreign-source income, which reduces the foreign tax credit limitation and thus the credits allowable (even though the interest expense incurred in the United States is not deductible in computing the actual tax liability under applicable foreign law).

The foreign tax credit limitation is applied separately to different types of foreign-source income, in order to reduce the extent to which excess foreign taxes paid in a high-tax foreign jurisdiction can be "cross-credited" against the residual U.S. tax on low-taxed foreign-source income. For example, if a taxpayer pays foreign tax at an effective rate of 45 percent on certain active income earned in a high-tax jurisdiction, and pays little or no foreign tax on certain passive income earned in a low-tax jurisdiction, then the earning of the untaxed (or low-taxed) passive income could expand the taxpayer's ability to claim a credit for the otherwise uncreditable excess foreign taxes paid to the high-tax jurisdiction, by increasing the foreign tax credit limitation without increasing the amount of foreign taxes paid. This sort of cross-crediting is constrained by rules that require the computation of the foreign tax credit limitation on a category-by-category basis.[10] Thus, in the example above, the rules would place the passive income and the active income into separate limitation categories (or "baskets"), and the low-taxed passive income would not be allowed to increase the foreign tax credit limitation applicable to the credits arising from the high-taxed active income. Present law provides nine separate baskets as a general matter, and effectively many more in situations in which various special rules apply.[11]

If a taxpayer generates an overall foreign loss ("OFL") for the year -- whether as the result of business losses or expense allocations under U.S. tax rules -- it will not be able to claim foreign tax credits for that year, since it will have no foreign-source income and thus will have a foreign tax credit limitation of zero. Moreover, if the taxpayer does generate foreign-source income in later years, some portion of such income will be "recaptured," or recharacterized as U.S.-source, thus reducing the foreign tax credit limitation in later years.[12] The rationale for OFL recapture is that the foreign-source losses offset U.S.-source income in the year generated, thereby reducing the U.S. tax collected with respect to U.S.-source income. The U.S. fisc would not be made whole when the taxpayer subsequently earns foreign-source income if the U.S. taxes on such income were completely offset by foreign tax credits.

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

[10] Sec. 904(d).

[11] *Id.*

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

Anti-deferral regimes

In general

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

Subpart F

Subpart F,[13] applicable to controlled foreign corporations and their shareholders, is the main anti-deferral regime of relevance to a U.S.-based multinational corporate group. A controlled foreign corporation generally is defined as any foreign corporation if U.S. persons own (directly, indirectly, or constructively) more than 50 percent of the corporation's stock (measured by vote or value), taking into account only those U.S. persons that own at least 10 percent of the stock (measured by vote only).[14] Under the subpart F rules, the United States generally taxes the U.S. 10-percent shareholders of a controlled foreign corporation on their pro rata shares of certain income of the controlled foreign corporation (referred to as "subpart F income"), without regard to whether the income is distributed to the shareholders.[15]

Subpart F income generally includes passive income and other income that is readily movable from one taxing jurisdiction to another. Subpart F income consists of foreign base company income,[16] insurance income,[17] and certain income relating to international boycotts and other violations of public policy.[18] Foreign base company income consists of foreign personal holding company income, which includes passive income (e.g., dividends, interest, rents, and royalties), as well as a number of categories of non-passive income, including foreign base company sales income, foreign base company services income, foreign base company shipping income and foreign base company oil-related income.[19]

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[13] Secs. 951-964.

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

[15] Sec. 951(a).

[16] Sec. 954.

[17] Sec. 953.

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

[19] Sec. 954.

In effect, the United States treats the U.S. 10-percent shareholders of a controlled foreign corporation as having received a current distribution out of the corporation's subpart F income. In addition, the U.S. 10-percent shareholders of a controlled foreign corporation are required to include currently in income for U.S. tax purposes their pro rata shares of the corporation's earnings invested in U.S. property.[20]

Passive foreign investment companies

The Tax Reform Act of 1986 established an anti-deferral regime for passive foreign investment companies. A passive foreign investment company generally is defined as any foreign corporation if 75 percent or more of its gross income for the taxable year consists of passive income, or 50 percent or more of its assets consists of assets that produce, or are held for the production of, passive income.[21] Alternative sets of income inclusion rules apply to U.S. persons that are shareholders in a passive foreign investment company, regardless of their percentage ownership in the company. One set of rules applies to passive foreign investment companies that are "qualified electing funds," under which electing U.S. shareholders currently include in gross income their respective shares of the company's earnings, with a separate election to defer payment of tax, subject to an interest charge, on income not currently received.[22] A second set of rules applies to passive foreign investment companies that are not qualified electing funds, under which U.S. shareholders pay tax on certain income or gain realized through the company, plus an interest charge that is attributable to the value of deferral.[23] A third set of rules applies to passive foreign investment company stock that is marketable, under which electing U.S. shareholders currently take into account as income (or loss) the difference between the fair market value of the stock as of the close of the taxable year and their adjusted basis in such stock (subject to certain limitations), often referred to as "marking to market."[24]

Coordination

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

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

[21] Sec. 1297.

[22] Sec. 1293-1295.

[23] Sec. 1291.

[24] Sec. 1296.

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

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

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

C. Transfer Pricing

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

Under section 482, the Secretary of the Treasury is authorized to redetermine the income of an entity subject to U.S. taxation when necessary to prevent an improper shifting of income between that entity and a commonly controlled entity. The statute generally does not prescribe any specific reallocation rules that must be followed, 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 generally attempt to identify the respective amounts of taxable income of the related parties that would have resulted if the parties had been uncontrolled parties dealing at arm's length. Special transfer pricing rules apply to transactions involving intangible property and services. These transactions present particular challenges to the administration of the arm's length standard, since intangibles and services may be unique, thus rendering a comparison with third-party market transactions difficult or impossible.

D. Treaties

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

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

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

For a number of years policymakers, business groups, and economists have argued that improving the international competitiveness of the economy of the United States should be a major policy goal. This focus on competitiveness is certainly related to some of the economic trends of the past two decades: large U.S. trade deficits; large inflows of foreign investment in the Unites States; and low national saving rates.[25] Cross-border mergers of recent years and cases of corporate inversions to re-incorporate outside the United States have heightened interest regarding the position of the United States in the global economy. Although the term "competitiveness" is used frequently, it does not have a consistent definition. The term "competitiveness" encompasses different concepts. This section briefly explores various meanings commonly given to the term "competitiveness" in writings on U.S. economic policy.

Trade competitiveness

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

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

Standard of living competitiveness

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

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

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

Multinational competitiveness

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

B. Taxation and Investment in the Global Economy

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

The concepts of capital export neutrality and capital import neutrality

Capital movements across national borders in response to tax policy, rather than investment in response to pure economic fundamentals, reduce worldwide economic welfare. The nature of these economic distortions depends on the method of taxing income from international investment. If investment income is taxed only at the source, substantial amounts of capital could be diverted to jurisdictions with the lowest tax rates instead of flowing to investment projects with the highest pre-tax rate of return. If a system of residence taxation is the worldwide norm,[26] enterprises resident in low-tax countries might be able to attract more investment capital or perhaps increase their market share through lower prices to the detriment of enterprises resident in high-tax jurisdictions, even though the latter are more efficient. In either case, capital is diverted from its more productive uses, and worldwide income and efficiency suffer. The most straightforward solution to this problem is equalization of effective tax rates, but this may not be a practical solution given differences in national preferences for the amount and method of taxation. There is no consensus on what method of taxing international investment income minimizes distortions in the allocation of capital when nations tax income at different effective rates, but the alternatives of capital export neutrality and capital import neutrality are the most cited guiding principles. These two standards are each desirable goals of international tax policy. The problem is that, with unequal tax rates, these two goals are not mutually attainable. Satisfying both principles at the same time is possible only if effective tax rates on capital income are the same in all countries.

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

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

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

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

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

a. Capital Export Neutrality

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

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

b. Capital Import Neutrality

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

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

Capital export neutrality and location of investment

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

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

Capital import neutrality and location of investment

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

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

The concept of national neutrality

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

In a world of source taxation, the national interest and the interests of outbound investors do not coincide. Outbound investment is only in the national interest if the return after foreign tax (but before domestic tax) equals or exceeds the before-tax return on domestic investment. To further its national interest, a government can reduce outbound investment by reducing the after-tax rate of return on outbound investment and driving its before-tax return above that on domestic investment. A government can penalize outbound investment by imposing a layer of taxation in addition to foreign taxation at source. This result can be achieved when a capital-exporting nation, in response to foreign source taxation, does not cede taxing jurisdiction over foreign source income (for example, through a foreign tax credit) and allows only a deduction for foreign taxes.[27]

The policy of allowing only deductions for foreign taxes is sometimes known as "national neutrality." A deduction penalizes outbound investment and aligns the interests of the taxpayer with the interests of its home country, but only at the expense of reduced worldwide economic welfare. Despite the potential to maximize national welfare, self-interested nations generally do not adopt tax systems designed to achieve national neutrality. There are at least three possible explanations for this. First, there is reason to expect that one nation's unilateral attempt to improve its own welfare through a policy of national neutrality would meet with retaliation by other nations with similar policies. Such tax competition would reduce worldwide income even further.[28] If, on the other hand, nations can coordinate their tax policies, a tax system can be designed to increase worldwide income above the inefficient level produced by national neutrality. With international coordination, there is potential for adopting a system in which worldwide income could be maximized (and, if necessary, redistributed) so all nations could be better off.

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

Third, even if the first two rebuttals to national neutrality do not hold, there is some evidence that outbound investment increases exports by more than it increases imports.[29] This increase in net exports may provide benefits to domestic labor and increase overall domestic income. If this is the case, policies discouraging outbound investment could increase the merchandise trade deficit and reduce national output.

The concept of capital ownership neutrality

Recently, some analysts have suggested that analysis of cross-border investment and tax policy should not be analyzed solely in terms of the location of investments, but rather by the

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

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

[29] See discussion below of foreign direct investment and domestic investment.

ownership of investments in addition to the location of those investments.[30] They argue that economic efficiency would be promoted if the tax system does not distort the ownership pattern of investments, that is, an efficient system would promote capital ownership neutrality. The underlying premise of this notion of neutrality is that the same units of physical capital (plant and equipment) will have different levels of productivity and profitability, depending upon who owns that capital and manages its operation. The differences in productivity from a given production facility may result from proprietary intangible assets of the owners.[31] If the productivity and profitability, of physical assets depends upon the intangible assets of those who own and manage the assets, efficiency is improved if those who possess the proper intangible assets that will permit the greatest productivity from the physical assets own the physical assets. If the tax system dissuaded the potentially most productive owners from owning any particular physical assets, wherever located, then economic efficiency would be diminished. Capital ownership neutrality would be sustained if all countries were to tax foreign income, but permit a full foreign tax credit. Likewise, if all countries were to exempt foreign income from their tax base, capital ownership neutrality would be sustained. In each circumstance, ownership would be determined by productivity differences and not tax differences.[32] In either circumstance, if any country's tax policy deviated from conformity, ownership neutrality could not be achieved.

[30] Mihir A. Desai and James R. Hines, Jr., "Evaluating International Tax Reform," *National Tax Journal*, forthcoming, September 2003.

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

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

Foreign direct investment and domestic investment

Some argue that if U.S. multinationals were exempted from the U.S. corporate tax on their foreign-source income, the after-tax return to establishing facilities overseas would be increased and U.S. multinational corporations would substitute investment in foreign facilities for investment in domestic facilities. For example, instead of manufacturing products in the United States and selling the products domestically and exporting products abroad, a firm might choose to locate production facilities abroad and import some products back to the United States and serve overseas markets from the foreign location.[33]

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

Empirical studies have attempted to examine whether foreign direct investment is a substitute for or complement of domestic investment. A decade ago the President's Council of Economic Advisors concluded, "On a net basis, it is highly doubtful that U.S. direct investment abroad reduces U.S. exports or displaces U.S. jobs."[34] Generally, empirical studies find either no effect or a positive effect of overseas production in a host-county market on home-country exports to that market. One survey of the empirical literature reports that, on average, studies find one dollar of overseas production by U.S. affiliates generates $0.16 of exports from the United States.[35] The evidence suggests that overseas production does displace certain types of domestic production as the parent firm shifts to more capital intensive and skill intensive domestic production.[36]

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

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

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

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

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

more managerial and technical employment....”[37] However, most of the evidence on this subject examines individual industries rather than aggregate economic effects. In aggregate, it is clear that U.S. manufacturing employment has fallen among U.S.-owned manufacturing enterprises, but the decline has been largely offset by employment at foreign-owned manufacturing facilities located in the United States.[38]

Summary

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

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

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

Deferral of tax on foreign income

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

[37] Lipsey, “Outward Direct Investment and the U.S. Economy,” p. 31. One recent study does find some substitution of foreign labor for U.S. labor but characterizes the degree of employment substitution as low between domestic and foreign affiliates, finding greater labor substitution between employees in different developing countries. See, S. Lael Brainard and David A. Riker, “Are U.S. Multinationals Exporting U.S. Jobs?” National Bureau of Economic Research Working Paper No. 5958, March 1997.

[38] Lipsey, “Home and Host Country Effects of FDI.”

trillion and paid $34.7 billion of foreign income taxes.[39] Foreign branches of U.S. multinationals reported $87.3 billion of gross branch income and paid $4.9 billion of foreign income taxes.[40]

If, for a particular taxpayer, the effective rate of foreign tax can be expected to be consistently above the U.S. rate, deferral of U.S. taxes would not provide any tax benefit. However, if the effective rate of foreign tax is at any time or in any jurisdiction below the U.S. rate, U.S. multinationals may enjoy two substantial benefits from deferral. First, deferral may delay the payment of U.S. taxes on foreign source income until earnings are repatriated. Second, because excess foreign tax credits cannot be carried forward indefinitely, deferral expands the opportunity for cross-crediting (if effective foreign tax rates vary across years or across jurisdictions) by not deeming high foreign taxes to be paid until a year when the U.S. taxpayer chooses also to repatriate low-taxed foreign source income.[41] The benefit from the deferral of tax until foreign earnings are repatriated may be viewed as similar to the benefit enjoyed from delaying realizations of capital gains. As with capital gains, one method of eliminating the tax benefit of deferral is the payment of taxes on income as it is earned, rather than when payment is received. This is achieved, in limited circumstances, by the various anti-deferral regimes in the Code.

Deferral does, however, impose costs on taxpayers. For example, subpart F, and its interactions with the credit rules and the other anti-deferral rules, are considered highly complex.[42] In addition, the interest allocation rules, by precluding full worldwide fungibility of interest among commonly controlled domestic and foreign subsidiaries, may impose costs on a U.S. corporation that operates through foreign subsidiaries, which costs might be avoided by operating through foreign branches of a U.S. corporation.

To the extent that deferral continues to provide an advantage to outbound investment, this advantage provides an incentive for outbound investment and therefore moves the U.S. system of

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

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

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

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

taxation of foreign income closer to capital import neutrality and away from capital export neutrality. Deferral provides an incentive for outbound investment, but restrictions on deferral negate this incentive.

<u>Foreign tax credit limitation</u>

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

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

In 1921, three years after the foreign tax credit was first made available to U.S. taxpayers, the credit was limited to the amount of tax that would be paid at domestic rates on foreign source income computed under U.S. tax rules. Taxpayers in an "excess limit": position (that is, taxpayers with foreign tax credit limitation in excess of creditable taxes) have no incentive to reduce their foreign taxes, and foreign governments have no inducement to lower their income taxes on income earned by those U.S. taxpayers. Without the credit limitation, there would be no reasonable bound on the potential transfer of funds from the U.S. Treasury to foreign governments. To the extent of U.S. tax liability (before foreign tax credits), the level of foreign taxation would be a matter of indifference to the U.S. investor since increased foreign taxes effectively would be paid by the U.S. Treasury.[43] The foreign tax credit limitation is thus among the most important of a variety of revenue protection features of the U.S. system of international taxation. To the extent that U.S. tax rates fall relative to foreign tax rates, the importance of the foreign tax credit limitation increases.

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

Cross-crediting of foreign taxes

In its 1984 tax reform proposals, the Treasury Department proposed a per-country foreign tax credit limitation to replace the overall limitation which provided "many taxpayers a tax motivated incentive to invest abroad rather than in the United States."[44] This tax reform proposal addressed the use of high foreign taxes imposed by one country (i.e., taxes in excess of the U.S. rate) to offset U.S. tax on income earned by the same U.S. taxpayer in a low-tax country. This is sometimes referred to as "averaging" or "cross-crediting."

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

In terms of the principles discussed above, limiting the ability to cross-credit moves the tax treatment of the marginal outbound investment by a U.S. investor away from capital import neutrality and toward capital export neutrality. On the other hand, under current U.S. law, taxpayers may cross-credit high foreign taxes paid to one country against U.S. tax on similar types of income earned in other low-tax foreign countries. Complete elimination of cross-crediting may be undesirable for administrative reasons, quite apart from issues of capital import and export neutrality. For example, substantial administrative issues could arise in the allocation and apportionment of foreign income of an integrated multinational business among separate foreign countries in which operations take place. Some of the separate foreign tax credit limitation rules of current law already create what may be regarded as undue complexity.

Creditability of subnational foreign taxes

Under present law, taxes paid by U.S. businesses to foreign governments that are by their nature taxes on income or profits, such as a corporate income tax, are fully creditable (within the foreign tax credit limitation) against Federal income taxes. This applies whether the tax is imposed by the national government or by a subnational government of that foreign country. However, income taxes paid by U.S. businesses to the States or to other subnational governments within the United States are only deductible against Federal income tax. Depending upon the rates of U.S. and foreign national and subnational taxes, this disparity in treatment of subnational

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

taxes can create an incentive to invest overseas. This is the case when the foreign tax credit limitation is not binding and the overall (i.e., national and subnational combined) level of foreign income tax is lower than the level of U.S. Federal and local income tax.

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

IV. RECENT COMPETITIVENESS AND SIMPLIFICATION PROPOSALS

A. Proposals Relating to the Foreign Tax Credit

Background

Since the United States taxes its citizens and residents on their worldwide income, and the countries in which such income is earned generally also assert their jurisdiction to tax the same income on the basis of source, cross-border income earned by U.S. persons may be subject to double taxation. In order to mitigate this possibility, the United States provides a credit against U.S. tax liability for foreign income taxes paid, subject to a number of limitations. Most recent incremental reform proposals in this area relate to these limitations.

Allocation of interest expense using "worldwide fungibility" approach[45]

The foreign tax credit generally is limited to the U.S. tax liability on a taxpayer's foreign-source income, in order to ensure that the credit serves its purpose of mitigating double taxation of cross-border income without offsetting the U.S. tax on U.S.-source income. In light of this limitation, a taxpayer must allocate gross income and expenses between U.S. and foreign sources in order to determine the amount of foreign tax credits allowable. Under present law, interest expense that a U.S.-based multinational enterprise incurs in the United States is allocated to U.S. and foreign sources based on the gross assets located in the United States and abroad, without regard to any interest that the enterprise incurs abroad. Thus, a U.S.-based multinational with a significant portion of its assets overseas must allocate a significant portion of its interest expense to foreign-source income, which reduces the foreign tax credit limitation and thus the credits allowable (even though the interest expense incurred in the United States is not deductible in computing the actual tax liability under the relevant foreign law). Many companies complain that this approach unduly limits their ability to claim foreign tax credits and leaves them excessively exposed to double taxation of their foreign-source income. They propose that interest expense instead be allocated using an elective "worldwide fungibility" approach, under which interest expense incurred in the United States would be allocated against foreign-source income only if the debt-to-asset ratio was higher for U.S. than for foreign investments. This measure would significantly expand the ability of many U.S.-based multinational enterprises to claim foreign tax credits.

Reduction of the number of foreign tax credit limitation categories (or "baskets")[46]

Present law applies the foreign tax credit limitation separately to different types of foreign-source income, in order to reduce the extent to which excess foreign taxes paid in a high-tax foreign jurisdiction can be "cross-credited" against the residual U.S. tax on low-taxed

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[45] A version of this proposal was in H.R. 285 (108th Congress), H.R. 5095 (107th Congress), and H.R. 2488 (106th Congress).

[46] A version of this proposal was in H.R. 285 (108th Congress) and H.R. 5095 (107th Congress).

foreign-source income. For example, if a taxpayer pays foreign tax at an effective rate of 45 percent on certain active income earned in a high-tax jurisdiction, and pays little or no foreign tax on certain passive income earned in a low-tax jurisdiction, then the earning of the untaxed (or low-taxed) passive income could expand the taxpayer's ability to claim a credit for the otherwise uncreditable excess foreign taxes paid to the high-tax jurisdiction, by increasing the foreign tax credit limitation without increasing the amount of foreign taxes paid. This sort of cross-crediting is constrained by rules that require the computation of the foreign tax credit limitation on a category-by-category basis. Thus, in the example above, the rules would place the passive income and the active income into separate limitation categories (or "baskets"), and the low-taxed passive income would not be allowed to increase the foreign tax credit limitation applicable to the credits arising from the high-taxed active income.

Present law provides nine separate baskets as a general matter, and effectively many more in situations in which various special rules apply. Separate foreign tax credit limitation categories are provided for the following items of income: (1) passive income; (2) high withholding tax interest; (3) financial services income; (4) shipping income; (5) certain dividends received from a noncontrolled section 902 foreign corporation (a "10/50 company");[47] (6) certain dividends from a domestic international sales corporation or former domestic international sales corporation; (7) taxable income attributable to certain foreign trade income; (8) certain distributions from a foreign sales corporation or former foreign sales corporation; and (9) any other income not described in items (1) through (8) (so-called "general basket" income).

Many companies complain that the large number of different baskets creates unnecessary complexity and distorts business decisionmaking. They argue that the number of baskets should be greatly reduced, to three or even two. This proposal would reduce complexity and compliance costs for some companies, but at a risk of allowing more cross-crediting in these cases than may be considered appropriate. Many companies would not be significantly affected by this proposal, because the bulk of their income already falls into only one or two baskets.

Overall foreign loss and proposed overall domestic loss rules[48]

If a taxpayer generates an overall foreign loss ("OFL") for the year -- whether as the result of business losses or expense allocations under U.S. tax rules -- it will not be able to claim foreign tax credits for that year, since it will have no foreign-source income and thus will have a foreign tax credit limitation of zero. Moreover, if the taxpayer does generate foreign-source

[47] 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. Subject to certain exceptions, dividends paid by a 10/50 company in taxable years beginning after December 31, 2002, are subject to either a look-through approach in which the dividend is attributed to a particular limitation category based on the underlying earnings which gave rise to the dividend (for post-2002 earnings and profits), or a single-basket limitation approach for dividends from all 10/50 companies (for pre-2003 earnings and profits).

[48] A version of this proposal was in H.R. 285 (108th Congress), H.R. 5095 (107th Congress), S. 1164 (106th Congress) and H.R. 2488 (106th Congress).

income in later years, some portion (generally no more than 50 percent) of such income will be "recaptured," or recharacterized as U.S.-source, thus reducing the foreign tax credit limitation in later years.[49] The rationale for OFL recapture is that the foreign-source losses offset U.S.-source income in the year generated, thereby reducing the U.S. tax collected with respect to U.S.-source income. The U.S. fisc would not be made whole when the taxpayer subsequently earns foreign-source income if the U.S. taxes on such income were completely offset by foreign tax credits.

Some argue that the OFL regime is unduly complicated and burdensome, and that the regime may result in some cases in overly strict limits on claiming the benefits of foreign tax credits. In some cases, as a result of the U.S. interest expense allocation rules, a company may build up an OFL so large as to impede its ability to claim foreign tax credits for the foreseeable future. Some have proposed mitigating these effects by slowing the OFL recapture rate. Others may argue that adoption of the worldwide fungibility interest allocation proposal would resolve the most significant issues involving the OFL regime, at least on a going-forward basis, rendering major changes to the OFL rules unnecessary.

Some also note that there is a lack of parity in the treatment of U.S. and foreign losses for foreign tax credit limitation purposes, and argue that a new resourcing rule in the taxpayer's favor should apply to U.S. source income in situations in which the taxpayer's foreign tax credit limitation has been reduced in a prior taxable year as a result of an overall domestic loss. Although the proposal would provide symmetry in the treatment of domestic and foreign losses, it would add significant complexity to Code.

Extension of carryover period and "FIFO" reordering[50]

Under present law, 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 (to the earliest year first) and carried forward five taxable years (in chronological order) and credited to the extent that the taxpayer otherwise has excess foreign tax credit limitation for those years. Excess credits that are carried back or forward are usable only to the extent that there is excess foreign tax credit limitation in such carryover or carryback year. Consequently, foreign tax credits arising in a taxable year are utilized before excess credits from another taxable year may be carried forward or backward. In addition, excess credits are carried forward or carried back on a separate limitation basis. Thus, if a taxpayer has excess foreign tax credits in one separate limitation category for a taxable year, those excess credits may be 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. If credits cannot be so utilized, they are permanently disallowed.

Many companies complain that these carryover rules, especially in conjunction with the OFL and interest allocation rules discussed above, create a potential for the expiration of

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

[50] A version of this proposal was in H.R. 285 (108th Congress), H.R. 5095 (107th Congress), and S. 1164 (106th Congress).

significant levels of foreign tax credits. It has been proposed that: (1) the carryforward period for foreign tax credits be extended from five to ten years; and/or (2) the utilization of foreign tax credits be reordered, so that credits carried forward from prior years would be used before current-year credits, on a first-in-first-out ("FIFO") basis. Some have argued that these proposals are inconsistent with a matching principle underlying the foreign tax credit rules (i.e., that foreign taxes should be creditable as near as possible to the time at which the earnings on which the foreign taxes are imposed are subject to U.S. tax). Others argue that the matching principle has already been largely abandoned in the foreign tax credit area, and that the prevention of credit expiration is a more important policy goal.

<u>Elimination of special foreign oil and gas income rules</u>[51]

Special foreign tax credit rules apply in the case of foreign oil and gas income. 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). 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.

In the case of taxes paid or accrued to any foreign country with respect to certain foreign oil-related income, discriminatory foreign taxes (i.e., taxes found to subject oil-related income to a heavier burden than other income) are not treated as creditable foreign taxes. For this purpose, foreign oil-related income is income derived from foreign sources from: (1) the processing of minerals extracted by the taxpayer or any other person from oil or gas wells into their primary products; (2) the transportation of such minerals or primary products; (3) the distribution or sale of such minerals or primary products; (4) the disposition of assets used by the taxpayer in such processing, transportation, or distributions or sales; or (5) the performance of any other related service.

These special rules are designed to ensure that high-rate foreign taxes relating to foreign oil and gas activities are not used to offset the U.S. tax on other types of income. In addition, there is a concern that some countries and taxpayers may seek to disguise a royalty for the extraction of a resource as a tax, in an effort to obtain for the taxpayer a foreign tax credit for a payment that is not, in substance, a tax. Companies affected by these special rules argue that they are unduly burdensome, and that the concerns underlying the rules are adequately addressed under the general foreign tax credit rules (e.g., the rules under section 901 distinguishing taxes from other kinds of payments to foreign governments).

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[51] A version of this proposal was in H.R. 285 (108th Congress), S. 1164 (106th Congress) and H.R. 2488 (106th Congress).

B. Proposals Relating to the Subpart F Anti-Deferral Rules

Background

Generally, income earned indirectly by a U.S. person through a foreign corporation is subject to U.S. tax only when the income is distributed to the U.S. person. This deferral of U.S. tax is limited by a number of anti-deferral regimes (e.g., "subpart F") that impose current U.S. tax on certain types of income earned by certain corporations, in order to prevent taxpayers from avoiding U.S. tax by shifting passive or highly mobile income into low-tax jurisdictions. Deferral of U.S. tax is considered appropriate, on the other hand, with respect to most types of active business income earned abroad. Drawing the line between "good" income and "tainted" income has proven contentious and has also engendered considerable complexity.

Exclusion of active income from the scope of subpart F

Repeal of foreign base company sales and services income rules[52]

Present law places the income from many sales and services activities conducted abroad on the "tainted" side of the line, because such activities are thought to be highly mobile and thus prone to tax-motivated manipulation. For example, if a multinational enterprise directs its sales of products manufactured in one country to customers located in a second country through the use of related-party transactions with a sales company incorporated in a low-tax third country, there is a concern that the enterprise may be attempting to shift some of its income away from the United States (or another higher-tax country) into the low-tax third country. Accordingly, present law generally subjects the income from these and similar arrangements to current U.S. tax. Many U.S.-based multinationals complain that these rules are overbroad and penalize the use of common, non-tax-motivated business structures (e.g., centralizing sales and services functions for a number of different foreign markets within a single foreign entity), thus placing U.S.-headquartered businesses at a competitive disadvantage in the normal conduct of their active business activities around the world. They argue that the scope of subpart F should be limited to passive income (e.g., dividends and interest) earned abroad, and that other rules (e.g., the arm's length transfer pricing rules of section 482) are sufficient to address any abuses involving the manipulation of active income streams.

Others would note that the design and enforcement of the transfer pricing rules can never be airtight, and thus a backstop to these rules in situations prone to manipulation may still be useful. In addition, the present-law rules arguably serve a purpose of promoting capital export neutrality even in cases in which the U.S. transfer pricing rules are not relevant (e.g., cases in which a multinational seeks to "deflect" income from a higher-tax foreign country to a low-tax foreign country, thus enhancing the overall attractiveness of foreign investment as compared with domestic investment). Thus, some would argue that the present-law rules should be retained, and that U.S.-based multinationals should propose more narrowly tailored measures to

[52] A version of this proposal was in H.R. 285 (108th Congress) and H.R. 5095 (107th Congress).

address their most compelling concerns, short of full repeal of the foreign base company sales and services income rules.

Repeal of foreign base company shipping income rules[53]

Another category of active income subject to the anti-deferral rules is foreign base company shipping income. Like foreign base company sales and services income, shipping income is thought to be prone to tax-motivated manipulation by reason of its high degree of mobility. Some argue that subjecting foreign shipping income to the anti-deferral regime places U.S.-based companies at a significant competitive disadvantage relative to competitors based in other countries, many of which have enacted special regimes under which shipping income is taxed lightly or not at all. Indeed, some argue that the present-law rules have caused a substantial decline in the overall number of ships under U.S.-based ownership, and that repeal of these rules would serve to reverse this trend.

Look-through treatment for payments of active earnings between CFCs[54]

For subpart F purposes, foreign personal holding company income generally includes dividends, interest, rents and royalties, among other types of income. Thus, in many cases, a U.S.-based multinational may trigger a current U.S. tax under subpart F as it moves its foreign earnings among its CFCs by means of such payments. However, this result often can be avoided as a practical matter by using a "hybrid branch arrangement" (e.g., making an interest payment through an entity that is treated as a corporation under foreign law but as a branch of a CFC under U.S. law).[55]

Some have argued that there is nothing objectionable about moving active, non-subpart-F earnings from one CFC to another, and therefore that dividends, interest, rents, and royalties received by one controlled foreign corporation from a related controlled foreign corporation should not be treated as foreign personal holding company income to the extent attributable to non-subpart-F earnings of the payor. According to this view, this proposal would remove certain frictions that exist under present law in allocating foreign earnings among different foreign uses. Others argue that the proposal would significantly enhance the benefit of deferral, further deterring the repatriation of foreign earnings and increasing the overall attractiveness of foreign investment relative to domestic investment.

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[53] A version of this proposal was in H.R. 3312 (107th Congress) and H.R. 265 (106th Congress).

[54] A version of this proposal was in H.R. 285 (108th Congress) and H.R. 5095 (107th Congress).

[55] *See, e.g.*, Notice 98-11, 1998-6 I.R.B. 18; Notice 98-35, 1998-27 I.R.B. 35.

C. Joint Committee Staff Simplification Recommendations

In general

In April 2001 the Joint Committee on Taxation released a study that included recommendations to simplify the Federal tax system (the "Study").[56] In developing these recommendations, the Joint Committee staff attempted not to alter the underlying policy articulated by the Congress in enacting the provisions at issue. Thus, the scope of the recommendations was generally limited to relatively uncontroversial proposals that eliminated unnecessary complexity without significantly altering the tax policy underlying the relevant provisions. The recommendations of the Study pertaining to the international tax rules are presented below.

Elimination of certain overlapping anti-deferral regimes

One proposal addresses the layering of anti-deferral regimes that are applicable or potentially applicable to U.S. persons who earn income through a foreign corporation. There are six such regimes: the accumulated earnings tax (1913), the personal holding company rules (1934); the foreign personal holding company rules (1937); the controlled foreign corporations rules (1962); the foreign investment company rules (1962); the passive foreign investment company rules (1986). To alleviate some of the complexity caused by the various overlapping regimes, the Joint Committee staff recommended:

- The foreign personal holding company and foreign investment company rules should be repealed, because they have little significance since the enactment of the subpart F and passive foreign investment company ("PFIC") rules.

- Assuming such repeal, foreign personal holding company income for subpart F purposes should be expanded to include certain income currently covered only by the foreign personal holding company rules.

- The personal holding company regime should no longer apply to foreign corporations, because the PFIC rules should adequately police the routing of passive income through foreign corporations.

Expansion of subpart F de minimis rule

Due to the complexity and compliance burden of a U.S. taxpayer associated with accounting for income both under the general rules for income earned through a foreign corporation and under the anti-deferral regimes, the Joint Committee staff recommended that the subpart F de minimis rule should be increased from the current threshold of the lesser of 5 percent of gross income or $1 million to the lesser of 5 percent of gross income or $5 million.

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[56] Joint Committee on Taxation, *Study of the Overall State of the Federal Tax System and Recommendations for Simplification, Pursuant to Section 8022(3)(B) of the Internal Revenue Code of 1986* (JCS-3-01), April 2001.

Acceleration of look-through rules for 10-50 companies

The Taxpayer Relief Act of 1997 modified the foreign tax credit limitation rules applicable to dividends received from a foreign corporation in which the taxpayer owns at least 10 percent of the stock by vote but which is not a controlled foreign corporation (a so called "10-50 company") in favor of a simpler look-through approach. However, the look-through approach does not apply to earnings accumulated in taxable years beginning on or before December 31, 2002, which has created unnecessary complexity, as companies must apply both a separate basket approach and a look-through approach with respect to their 10-50 companies. Consequently, the Joint Committee staff recommended that the look-through rules with respect to 10-50 companies apply without regard to the year in which earnings were accumulated.

Foreign tax credits claimed through a partnership

There may be uncertainty in the law regarding the claiming of indirect foreign tax credits through a partnership. The Joint Committee staff proposed clarifying that a domestic corporation may claim deemed-paid foreign tax credits with respect to a foreign corporation that is held indirectly through a foreign or U.S. partnership, provided that the domestic corporation owns (indirectly through the partnership) ten percent or more of the foreign corporation's voting stock.

Conform possessions-related provisions (sections 30A and 936)

If Congress chooses to extend the credits under sections 30A and 936 after their expiration in 2005, the Joint Committee staff recommended that consideration be given to applying a single set of rules for credit claimants in all U.S. possessions and to combining these rules under one Code section.

Application of uniform capitalization rules for foreign persons

Under current law, costs incurred in producing property or acquiring property for resale are capitalized under the uniform capitalization rules. Given the complexity of the uniform capitalization rules, the Joint Committee staff recommended that these costs be capitalized using U.S. generally accepted accounting principles for purposes of determining a foreign person's earnings and profits and subpart F income.

Elimination of secondary withholding tax

The Joint Committee staff called for the repeal of the secondary withholding tax on certain U.S.-source dividends paid by certain foreign corporations, because this tax has largely been supplanted by the branch profits tax.

Capital gains on certain nonresident individuals

Because the withholding tax on certain U.S.-source capital gains of nonresident alien individuals generally applies only in circumstances in which an individual would likely be treated as a U.S. resident or, if the individual would not be treated as a U.S. resident, the capital gains would not likely be U.S. source, the Joint Committee staff advocated the repeal of this rule.

Update U.S. model treaties

The Joint Committee staff recommended that the Treasury Department publish U.S. model treaties at least once every Congress. More frequent updates would provide useful information to taxpayers, the Congress, and to foreign governments as to the Administration's evolving policy on often complicated treaty matters.

Report to Congress on older U.S. tax treaties

Older U.S. tax treaties may no longer reflect current U.S. tax treaty policy. Accordingly, the Joint Committee staff recommended that the Treasury Department report to the Congress on the status of older U.S. tax treaties once every Congress.

V. TEMPORARY RATE REDUCTION FOR CERTAIN DIVIDEND REPATRIATIONS

A. Background

Income earned by a domestic parent corporation from the foreign operations of its foreign subsidiaries generally is subject to U.S. tax only when the income is distributed as a dividend to the domestic corporation. Until such repatriation, the U.S. tax on such income generally is deferred, subject to certain anti-deferral regimes. These regimes -- most significantly the subpart F regime -- may cause the domestic parent to be taxed on a current basis with respect to certain categories of passive or highly mobile income earned by its foreign subsidiaries. A foreign tax credit is available to offset, in whole or in part, the U.S. tax owed on the domestic corporation's foreign-source income, whether earned directly by the domestic corporation, repatriated as a dividend, or included under one of the anti-deferral regimes.

The amount of U.S. tax owed as a result of a dividend repatriation thus depends on the U.S. parent's ability to use foreign tax credits to offset some or all of the U.S. tax on the dividend. The foreign tax credit rules are highly complex, and the ability to use foreign tax credits depends on a number of different factors. As a general matter, however, earnings that are subject to higher rates of foreign tax often carry with them sufficient usable foreign tax credits to eliminate or substantially offset the U.S. tax on the repatriation, while earnings that are subject to lower rates of foreign tax are more likely to trigger substantial levels of residual U.S. tax at the time of repatriation.

It has long been recognized that this deferral system creates incentives in some cases for companies not to repatriate certain of their foreign earnings, and instead to accumulate and reinvest these earnings abroad, in order to maintain deferral of U.S. taxes. This distortion is of course more prevalent with respect to earnings generated in lower-tax jurisdictions, since, as explained above, it is often possible under present law to repatriate earnings generated in higher-tax jurisdictions with little or no residual U.S. tax.

One recent provision of prior law attempted to address this distortion by imposing a tax on certain "excess passive assets" accumulated abroad, in an effort to decrease the tax incentive to retain earnings offshore.[57] This provision generated considerable complexity, and it addressed only the incentive to redeploy earnings in passive, as opposed to active, foreign investments. It was repealed after only a few years of operation.

B. Recent Proposals

In general

Several recent proposals would reduce the disincentive for repatriating foreign earnings by effectively providing a partial amnesty for deferred U.S. taxes on earnings that a company repatriates within a certain temporary period. One such proposal was approved by the Senate in

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[57] Sec. 956A, as in effect from 1993 through 1996.

its amendment of H.R. 2, the “Jobs and Growth Tax Relief Reconciliation Act of 2003,” and similar proposals were included in a number of bills introduced earlier in the 108th Congress.[58] Supporters of these proposals argue that this temporary tax relief would trigger the repatriation of funds that otherwise would remain offshore, and that these funds would be put to productive use in the United States, thereby stimulating the domestic economy. Others argue that the proposals would confer a large retroactive tax benefit on foreign earnings that have already benefited from the deferral of U.S. taxes, and that increased repatriations would not necessarily result in significant increases in productive activity in the United States.

Description of the repatriation provision in the Senate amendment to H.R. 2

Under the Senate amendment to H.R. 2, certain actual and deemed dividends received by a U.S. corporation from a controlled foreign corporation would be subject to tax at a reduced rate of 5.25 percent. For corporations taxed at the top corporate income tax rate of 35 percent, this rate reduction would be equivalent to an 85-percent dividends-received deduction. This rate reduction would be available only for the first taxable year of an electing taxpayer ending 120 days or more after the date of enactment of the provision.

The reduced rate would apply only to repatriations in excess of the taxpayer’s average repatriation level over three of the five most recent taxable years ending on or before December 31, 2002, determined by disregarding the highest-repatriation year and the lowest-repatriation year among such five years.[59] The taxpayer would be allowed to designate which of its dividends are treated as meeting the base-period average level and which of its dividends are treated as comprising the excess.

In order to qualify for the reduced rate, dividends would have to be described in a “domestic reinvestment plan” approved by the taxpayer’s senior management and board of directors. This plan would have to provide for the reinvestment of the repatriated dividends in the United States, “including as a source for the funding of worker hiring and training; infrastructure; research and development; capital investments; or the financial stabilization of the corporation for the purposes of job retention or creation.”

The provision would disallow 85 percent of the foreign tax credits attributable to dividends subject to the reduced rate and would remove 85 percent of the underlying income from the taxpayer’s foreign tax credit limitation fraction under section 904.

In the case of an affiliated group, an election under the provision would be made by the common parent on a group-wide basis, and all members of the group would be treated as a single

[58] *See* S. 596 (the “Invest in the USA Act of 2003”), H.R. 767 (the “Homeland Investment Act of 2003”), and H.R. 1162 (the “Invest in America Act of 2003”). Sec. 531 of the Senate Amendment to H.R. 2 (the “Jobs and Growth Tax Relief Reconciliation Act of 2003”) included the language of S. 596, but the provision was not included in the conference agreement for H.R. 2.

[59] If the taxpayer has fewer than five taxable years ending on or before December 31, 2002, then the base period consists of all such taxable years, with none disregarded.

taxpayer. The election would apply to all controlled foreign corporations with respect to which an electing taxpayer is a United States shareholder.

The provision would be effective for the first taxable year of an electing taxpayer ending 120 days or more after the provision's date of enactment.

C. Analysis

As explained above, the present-law deferral system creates incentives for U.S.-based multinational enterprises to reinvest certain of their foreign earnings offshore, instead of repatriating them. This creates an economic inefficiency, in that it may prove more profitable on an after-tax basis for a business to use these retained earnings to fund a new offshore investment instead of making an alternative investment in the United States, even if the pre-tax rate of return on the investment in the United States exceeds the pre-tax rate of return on the foreign investment.

A number of fundamentally different approaches might be considered to eliminate or reduce this inefficiency, including: (1) a permanent territorial-type exemption for repatriated foreign earnings; (2) a permanent reduced rate of tax for repatriated foreign earnings; (3) a tax penalty for excess accumulations of earnings offshore;[60] (4) the elimination of deferral of U.S. taxes on the earnings of low-taxed foreign subsidiaries of U.S. parent corporations; and (5) the elimination of deferral of U.S. taxes on the earnings of all foreign subsidiaries of U.S. parent corporations. Any of these options would represent a fundamental change in U.S. tax policy and may warrant extensive deliberation.

The temporary tax-favored repatriation proposal, being temporary, would not resolve the underlying inefficiency that arises under the present-law deferral system. Instead, the proposal seeks only to encourage a one-time increase in dividend repatriations. The temporary proposal may "unlock" some monies held in investments offshore and redirect those funds to other uses, but after the temporary period, the underlying inefficiency discussed above would remain in place. Proponents of the proposal argue that the one-time "unlocking" would serve as a temporary economic stimulus measure, and thus that the proposal should be evaluated as such.

While the proposal may encourage the prompt repatriation of some earnings that would not otherwise be repatriated as quickly (or at all), proponents and opponents of the proposal differ as to the effects of these additional repatriations, as well as other implications of the proposal. Proponents of the proposal argue that the repatriated monies could be put to a number of beneficial domestic uses. First, proponents note that internally generated cash often is a corporation's cheapest source of investment capital. They argue that the availability of the additional repatriated funds would enable U.S.-based multinational enterprises to make productive investments in the United States that they otherwise would not make, thereby stimulating the domestic economy. According to this view, by lowering a company's cost of capital in the United States, the proposal would enable the company to make certain domestic investments that would be uneconomic under present law.

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[60] *See, e.g.*, sec. 956A, as in effect from 1993 through 1996.

Others argue that a company's investment decisions are normally made on an integrated, worldwide basis with a view to the expected performance of the various potential investments, and that the source of funds, whether foreign or domestic, external or internal, is unlikely to impact these investment decisions dramatically. For example, according to this view, a company's decision of whether or not to build a factory in the United States would be unlikely to turn on the relative levels of earnings retained in the company's U.S. and European treasury centers. Rather, if an investment is found to be attractive, the company should be able to find the financing for it (particularly at today's low interest rates). Thus, according to this view, the temporary reduced rate for dividend repatriations would serve mainly to increase the after-tax profits of benefiting companies, rather than generate any additional domestic investment.

Proponents observe that another potential use of repatriated funds would be to pay down the domestic debt of the enterprise, improving the company's balance sheet. They argue that this would produce two specific benefits. First, by reducing corporate leverage, the danger to the economy of bankruptcies in a future economic downtown would be diminished. Second, the reduction in any corporation's leverage would better enable the corporation to take on additional debt to finance projects in the future. However, opponents of the proposal note that debt reduction does not provide much, if any, current-year economic stimulus. Further, they observe that the financial markets generally assess the creditworthiness of multinational enterprises on the basis of their consolidated, global operations. They question how reducing the equity held in foreign affiliates in order to reduce the debt incurred by domestic affiliates can benefit the consolidated balance sheet of the multinational enterprise. They may further note that many multinational enterprises that might avail themselves of the proposal already carry solid credit ratings.[61]

Proponents argue that another potential use of repatriated monies would be to fund pension shortfalls that have arisen in part as a result of the recent economic downturn. Proponents argue that, to the extent that the pension law requires companies to compensate for these shortfalls, funds may be diverted to this purpose away from other productive investments. If a company's own accumulated foreign earnings could be applied more readily to this purpose, then this funding diversion need not occur, according to this view. Others would argue, as discussed above, that companies' investment decisions, especially those of the larger companies that may have pension shortfalls, are generally not driven by cash-flow constraints. Rather, if an investment is worthwhile, funding for it generally can be found, especially in view of the larger companies' sound bond ratings and current low interest rates. Opponents may further note that granting a partial tax holiday to help fund pension shortfalls would provide a subsidy from taxpayers at large to finance the promised retirement benefits of a relatively small number of

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[61] *See* Anne Swope, Bruce Kasman, and Robert Mellman, JP Morgan Securities Inc., Economic and Policy Research, Special Report, "Introducing the Homeland Investment Act," April 30, 2002. The JP Morgan analysis of the audited financial statements of 237 S&P 500 companies with reported cumulative amounts of foreign subsidiary earnings that could be repatriated found that more than 20 percent of potential repatriations were earnings of companies with AAA bond ratings, nearly 33 percent of potential repatriations were earnings of companies with AA or better bond ratings, and more than 77 percent of potential repatriations were earnings of companies with A- or better bond ratings.

U.S. based businesses. The company would get a double deduction of sorts, as it would be able to claim a deduction for pension contributions made from partially exempt income. This benefit would not be available to smaller, non-multinational companies facing pension shortfalls due to market conditions.

Another concern raised by opponents of the proposal is that, if enacted into law, pressure might then arise to "extend" the provision, thus rendering an ostensibly temporary stimulus provision the first step toward the adoption of a territorial-type tax system, without the degree of thorough examination and debate that would properly attend such a fundamental shift. Even if the provision is not extended immediately, taxpayers may view it as a precedent for this type of temporary tax relief as a response to future economic downturns. This could actually amplify present-law distortions, as taxpayers may refrain from repatriating earnings in the future, in the expectation that another partial amnesty may be implemented during the next economic downturn. Proponents of the proposal note that the proposal itself is indeed temporary and argue that it should be evaluated as such. They argue that the second-order effects predicted by opponents of the proposal are speculative and should be disregarded.

Proponents and opponents of the proposal also differ as to some of the specifics of implementing the proposal. For example, as described above, the proposal grants the benefit of the reduced rate only in connection with repatriations in excess of the average level of repatriations during a base period. Opponents of the proposal note that this feature has the effect of denying the benefit to companies that have been repatriating high levels of foreign earnings under present law, and rewarding companies that have repatriated little or no foreign earnings under present law. Proponents of the proposal argue that the tax incentive is intended only to encourage repatriations in excess of those observed under present law, and that the base period requirement tailors the proposal appropriately to that end. According to this view, to confer the benefit more broadly would be to give a windfall to those who face little or no impediment to repatriating earnings under present law. On the other hand, some companies that repatriate significant levels of earnings and pay residual taxes under present law may do so because they have less access to low-cost outside capital, compared to larger companies that have accumulated substantial earnings offshore, which may have readier access to low-cost external financing for domestic investment.

Another specific issue relates to the earmarking provision, which requires that a "domestic reinvestment plan" be adopted with respect to the repatriated earnings. This requirement would have little practical effect, in view of the fungibility of money. In other words, because the proposal does not require any increase in any particular type of U.S. investment on the part of a company, the earmarking requirement would have the effect of simply causing the company to declare that the repatriated funds are being used for a particular listed purpose, without necessarily altering the overall allocation of the company's funds between listed and unlisted purposes. Proponents of the proposal argue that, regardless of the effect of the earmarking provision, it is unlikely that a company would decide to pay U.S. tax at a rate of 5.25 percent in order to repatriate foreign earnings unless it intended to use the funds in the United States, given the practical ease with which such earnings can be moved from one foreign country to another without triggering current U.S. tax.

VI. EXCLUSION FOR FOREIGN EARNED INCOME

A. Background

U.S. citizens generally are subject to U.S. income tax on all their income, whether derived in the United States or elsewhere. A U.S. citizen who earns income in a foreign country also may be taxed on such income by that foreign country. However, the United States generally cedes the primary right to tax income derived by a U.S. citizen from sources outside the United States to the foreign country where such income is derived. Accordingly, a credit against the U.S. income tax imposed on foreign source income is generally available for foreign taxes paid on that income, to the extent of the U.S. tax otherwise owed on such income. If the foreign income tax rate is lower than the U.S. income tax rate, then the United States generally provides a credit up to the amount of the foreign tax and imposes a residual tax to the extent of the difference.

Under section 911 of the Code, U.S. citizens living abroad may be eligible to exclude from their income for U.S. tax purposes certain foreign earned income and foreign housing costs, in which case no residual U.S. tax is imposed to the extent of such exclusion, regardless of the foreign tax rate. In order to qualify for these exclusions, an individual must be either: (1) a U.S. citizen who is a bona fide resident of a foreign country for an uninterrupted period that includes an entire taxable year;[62] or (2) a U.S. citizen or resident present overseas for 330 days out of any 12-consecutive-month period. In addition, the taxpayer must have his or her tax home in a foreign country.

The exclusion for foreign earned income generally applies to income earned from sources outside the United States as compensation for personal services rendered by the taxpayer. The maximum exclusion for foreign earned income is $80,000 per taxable year for 2002 and thereafter. For taxable years beginning after 2007, the maximum exclusion amount is indexed for inflation.

The exclusion for housing costs applies to reasonable expenses, other than deductible interest and taxes, paid or incurred by or on behalf of the taxpayer for housing for the taxpayer and his or her spouse and dependents in a foreign country. The exclusion amount for housing costs for a taxable year is equal to the excess of such housing costs for the taxable year over an amount computed pursuant to a specified formula. In the case of housing costs that are not paid or reimbursed by the taxpayer's employer, the amount that would be excludible is treated instead as a deduction.

The combined earned income exclusion and housing cost exclusion may not exceed the taxpayer’s total foreign earned income. The taxpayer’s foreign tax credit is reduced by the amount of such credit that is attributable to excluded income.

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[62] Only U.S. citizens may qualify under the bona fide residence test. However, resident aliens of the United States who are citizens of foreign countries that have a treaty with the United States may qualify for Section 911 exclusions under the bona fide residence test by application of a nondiscrimination provision.

Special exclusions apply in the case of taxpayers who reside in one of the U.S. possessions.

B. Proposed Repeal

The Senate amendment to H.R. 2, the "Jobs and Growth Tax Relief and Reconciliation Act of 2003," included full repeal of the exclusion for foreign earned income and the exclusion and deduction for housing expenses. This provision was not adopted in the conference agreement for H.R. 2.

C. Analysis

Proponents of repealing section 911 argue that repeal would create parity in the tax treatment of U.S. citizens living abroad and U.S. citizens living in the United States. Without section 911, U.S. citizens living abroad would be taxed on their worldwide income, and a foreign tax credit would be allowed for foreign taxes paid on their foreign source income. Thus, U.S. citizens living in countries with tax rates equal to or higher than those in the United States would generally still not owe U.S. tax on their foreign earned income, because such taxes would be covered by the foreign tax credit. U.S. citizens living in countries with tax rates lower than those in the United States would generally be worse off without section 911, because the United States would impose a residual tax attributable to the difference between the U.S. tax rate and the lower foreign tax rate, but this residual tax would serve only to promote parity between U.S. citizens living in the United States and U.S. citizens living overseas.

Proponents of repealing section 911 argue that U.S. citizens with similar income levels should incur similar tax liabilities, regardless of where they live. They believe that present law provides an unwarranted benefit to U.S. citizens living in low-tax foreign countries, as well as to U.S. citizens exempt from income tax in a foreign country pursuant to a treaty or other agreement. The rules under section 911 prevent individuals from taking inconsistent positions with respect to residency in the United States and the foreign jurisdiction in order to avoid paying income tax in both countries, but in situations in which an individual is exempt from the income tax of a foreign country pursuant to a treaty or other agreement, such an exemption does not in itself prevent an individual for qualifying for the foreign earned income exclusion for U.S. tax purposes.[63] Proponents of repeal believe that U.S. citizens living and working abroad benefit from their U.S. citizenship and should be treated the same as U.S. citizens living and working in the United States.

Opponents of repeal argue that section 911 was enacted to promote foreign trade and to put Americans working abroad on an equal footing with their foreign counterparts. They argue that the Congressional aim in passing and maintaining section 911 has been to aid and encourage U.S. enterprises abroad. They believe that section 911 makes it easier for U.S. multinational firms to find U.S. employees who are willing to work and live abroad, despite the additional costs that doing so may sometimes entail (e.g., maintaining two homes). They also believe that

[63] *Scott v. United States*, 432 F.2d 1388 (Ct. Cl. 1970) and Rev. Rul. 72-497, 1972-2 C.B. 448.

U.S. citizens living and working abroad do not receive the same benefits of U.S. citizenship as a U.S. citizen living and working in the United States and thus should not bear the same tax burden.

Others have recommended partial repeal as a compromise. Under this approach, Congress would leave section 911 in place, but significantly lower the amount of the foreign earned income exclusion. Lowering the foreign earned income exclusion to $35,000, for example, would allow the average U.S. citizen working abroad for a religious or charitable organization to continue to benefit from the foreign earned income exclusion, but would treat Americans working abroad earning more than that amount the same as U.S. citizens living and working in the United States.

Section 911 provides that the combined earned income exclusion and housing cost exclusion may not exceed the taxpayer's total foreign earned income. Proponents of repeal argue that because the amount excludible from U.S. tax is tied to a U.S. citizen's total foreign earned income, not the foreign earned income exclusion amount, the mechanics of this provision provide a greater benefit to highly compensated individuals. This is illustrated by the following example: Consider a U.S. citizen who earns foreign wages of $100,000 and is provided a housing allowance of $50,000. The foreign earned income exclusion for 2003 is $80,000, so the U.S. citizen would be allowed to exclude $80,000 under the foreign earned income exclusion and only $20,000 of the housing allowance, because the exclusion is limited to total foreign wages ($80,000 + $20,000 = $100,000). In contrast, a U.S. citizen with the same $50,000 housing allowance, but instead earning $150,000 in foreign wages would be able to exclude the entire $50,000 housing allowance (and $80,000 of foreign wages).

Another criticism of retaining section 911 is that it operates as a subsidy to multinational companies that send employees overseas under "tax equalization" packages. Tax equalization packages are guarantees by an employer to the employee that the employee will not suffer a greater tax burden in accepting an assignment to work overseas. If an employee incurs a greater tax liability working overseas than the employee would have incurred if he or she had remained working in the United States, the employer guarantees to reimburse the employee for the difference. Many employers also provide housing allowances to their overseas employees to assist with cost of living expenses. In the United States, such housing benefits would normally be considered additional compensation to the employee and thus fully taxable. However, section 911 generally allows overseas workers to exclude housing expenses, and thus the U.S. employer is relieved of reimbursing the employee for U.S. tax attributable to such an allowance, which otherwise would have been owed to the employee pursuant to the employer's tax equalization package.

Opponents of section 911 repeal argue that most U.S. multinational companies send employees on assignment to European countries, where individuals are subject to tax rates higher than the U.S. income tax rates. Thus, U.S. companies incur a great deal of expense reimbursing overseas employees for additional foreign taxes paid, and the subsidy provided to a U.S. company by section 911 merely facilitates a company's ability to absorb these expenses. Opponents of repeal argue that, absent such a provision, U.S. companies would experience greater difficulty trying to compete in foreign markets, and U.S. citizens living overseas would be faced with additional compliance burdens because they would be required to calculate their foreign tax credit and comply with the rules and requirements related to such calculation. These additional compliance requirements, coupled with increased cost of living expenses and often the burden of maintaining two households, could discourage Americans from working abroad. Opponents of repeal maintain that section 911 removes obstacles to sending employees abroad, which helps a U.S. company grow by expanding into new markets, ultimately creating jobs in the United States. Opponents further argue that employing Americans instead of foreign individuals in positions overseas can translate into additional business for U.S. suppliers and service providers, because American employees are knowledgeable about and accustomed to working with such companies. Some also may argue that employing U.S. citizens abroad enhances social ties between the United States and other countries, which may produce broader social benefits.