

**PRESENT LAW AND ISSUES IN U.S. TAXATION
OF CROSS-BORDER INCOME**

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INTRODUCTION

The Senate Committee on Finance has scheduled a public hearing on September 8, 2011, entitled “Tax Reform Options: International Issues.” This document,¹ prepared by the staff of the Joint Committee on Taxation (“Joint Committee staff”), provides general background on economic data relating to international trade and U.S. international tax rules applicable to cross-border income both those rules applicable to foreign persons earning income in the United States and those rules applicable to U.S. persons earning income abroad. The document also provides a discussion of issues related to the present-law U.S. tax system and describes aspects of a territorial and full inclusion tax system.

¹ This document may be cited as follows: Joint Committee on Taxation, *Present Law and Issues in U.S. Taxation of Cross-Border Income* (JCX-42-11), September 6, 2011. This document can be found on our website at www.jct.gov.

I. U.S. CROSS-BORDER TRANSACTIONS AND INVESTMENTS

This section discusses the economic relationship between trade deficits and cross-border investment. In doing so, it also presents background data relating to the scope of the international trade sector in the United States economy, and briefly reviews trends in both the current account (the trade surplus or deficit) and the financial account (U.S. investment abroad and foreign investment in the United States).²

In short, among other things, the data show increased trade in goods and services (exports and imports). Increased levels of exports increase income that U.S. persons must allocate between U.S.-source and foreign-source income for income tax purposes. Likewise, increased levels of imports increase income that foreign persons must allocate between U.S.-source and foreign-source income. The tax rules generally applicable to such income are described in part II.A.3. below.

The data also document increasing levels of direct investments and portfolio investments abroad by U.S. persons (called “outbound” investment) and increasing levels of direct investments and portfolio investments in the United States by foreign persons (called “inbound” investments). The income earned by such investments is subject to U.S. taxation as described in Part II.B., below, in the case of inbound investment and in part II.C., below, in the case of outbound investment.

A. Trade Deficits and Cross-Border Capital Flows

1. National income accounting

In popular discussion of trade issues, much attention is given to the trade deficit or surplus, that is, the difference between the economy’s exports and imports. In the late 1980s, just as at present, there was also attention given to inflows of capital from abroad. Capital inflows can take the form of foreign purchases of domestic physical (or “real”) assets, or of domestic financial assets, such as equity interests or debt instruments.

² Prior to 1999, the U.S. Department of Commerce, Bureau of Economic Analysis reported and described international transactions by reference to the “current account” and the “capital account.” Beginning in June 1999 the Bureau of Economic Analysis adopted a three-group classification to make U.S. data reporting more closely aligned with international guidelines. The three groups are labeled: current account; capital account; and financial account. Under this regrouping, the “financial account” encompasses all transactions that used to fall into the old “capital account,” that is, the financial account measures U.S. investment abroad and foreign investment in the United States. Under the new system, the “current account” is redefined by removing a small part of the old measure of unilateral transfers and including it in the newly defined “capital account.” The capital account consists of capital transfers and the acquisition and disposal of non-produced, non-financial assets. For example, the capital account includes such transactions as forgiveness of foreign debt, migrants’ transfers of goods and financial assets when entering or leaving the country, transfers of title to fixed assets, and the acquisition and disposal of non-produced assets such as natural resource rights, patents, copyrights, and leases. In practice, the Bureau of Economic Analysis believes that “capital account” transactions will be small in comparison to the current account and financial account.

These two phenomena, trade balances and capital inflows, are related to each other. More generally, trade deficits, capital inflows, investment, savings, and income are all connected in the economy. The connection among these economic variables can be examined through the “national income and product accounts,” which measure the flow of goods and services and income in the economy.³

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

In other words, if the economy is a net importer, it must attract capital inflows to pay for those imports. If the economy is a net exporter, it must have capital outflows to dispose of the payments it receives for its exports. For example, when the United States imports more than it exports, the United States pays for the imports with dollars. If foreigners are not buying U.S. goods or services with the dollars, then they will use the dollars to purchase U.S. assets. (Another way of viewing these relationships is that dollars flowing out of the U.S. economy in order to purchase goods or to service foreign debt must ultimately return to the economy as payment for exports or as capital inflows.)

The connection between capital flows and the goods and services in the economy can also be understood by concentrating on the sources of funds for investment. Investment in the United States must come either from domestic saving (that is saving by U.S. persons) or from foreign investors. If domestic saving is less than investment in the United States, that difference must be attributable to net capital inflows from foreign persons. In government reporting, such net capital inflows from foreign persons are termed “net foreign borrowing” even though the capital inflows may take the form of either equity investments or loans.

³ The national income and product accounts measure the flow of goods and services (product) and income in the economy. The most commonly reported measure of national economic income is gross domestic product (“GDP”). Related to GDP is gross national product (“GNP”). GDP can be understood as the total annual value of goods and service produced by the U.S. economy, regardless of the nationality of the owners of the factors of production (land, labor, and capital) that are required to produce the goods and services. GNP, by contrast is the total annual value of goods and services produced anywhere in the world where the relevant factors of production are owned by U.S. persons. Thus, wages earned by a U.S. resident from temporary work abroad, or dividends received by a U.S. person from an investment in a foreign corporation, constitutes part of GNP but not GDP.

Relation of Trade Deficits to Cross-Border Capital Flow

In formal terms, the connection between trade deficits and cross-border capital flows is as follows. In the following it is useful to use GNP, which includes cross border returns to investment, rather than the more commonly reported GDP concept.

One way to measure GNP is by expenditures on final product. By this measure,

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

Equation (1) is an accounting identity which states that gross national product for a period equals the sum of private consumption expenditures (C), private investment expenditures on plant, equipment, inventory, and residential construction (I), government purchases of goods and services (G), net exports (exports less imports of goods and services and net interest payments to foreigners, or X-M), plus net investment income (the excess of investment income of U.S. persons received from abroad over investment income paid to foreign persons from investments located in the United States), denoted "NI" in equation (1).

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

$$(2) \text{ GNP} = C + S + T.$$

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

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

$$(3) I = S + (T - G) + (M - X) - \text{NI}$$

Equation (3) states that private investment equals private saving (S), plus public saving (T-G) and net imports (M - X), less net investment income. An intuitive interpretation of equation (3) is that it requires dollars to make investments in the United States and equation (3) identifies the sources of investment dollars. Equation (3) identifies private saving by U.S. persons, S, as one source of dollars and government saving, T - G, as another source of dollars. The next two terms in equation (3) identify dollars that result from cross-border transactions as yet additional sources of potential investment dollars. If imports, M, exceed exports, X, then, on net, dollars are in the hands of foreign persons and available for investment in the United States. If the earnings of foreign persons from their investments in the United States exceeds the earning of U.S. persons on their investments abroad, then NI is negative and, on net, dollars are in the hands of foreign person and available for investment in the United States. If the opposite is the case, NI is positive, there are not additional dollars available for investment. (If net investment income is reinvested in the economy then that reinvestment of course is reflected as savings, S.)

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

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

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

For this purpose, imports and exports include both goods and services, and net investment income is equal to the excess of investment income received from abroad over investment income sent abroad.⁴ The excess of imports over exports is called the “trade deficit” in goods and services. Net investment income can be viewed as payments received on previously-acquired foreign assets (foreign investments) less payments made to service previous net foreign borrowing.

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

2. Economic implications of trade deficits

A trade deficit is not necessarily undesirable; what is important is the present and future consumption possibilities of the economy. Those consumption possibilities depend in part on whether the trade deficit is financing consumption or investment.

For example, if a country uncovers profitable investment opportunities, then it will be in that country’s interest to obtain funds from abroad to invest in these profitable projects.⁵ If the economy currently does not have enough domestic savings to invest in these projects, it could reduce its consumption (generating more domestic saving) or look to foreign sources of funds (thus allowing investment without reducing current consumption).

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

⁴ This equation in the text can be derived from equation (3) in the text box on page 4 above if the government budget is assumed to be balanced, that is, if $G = T$. It follows that if the government runs a deficit, that is, if $G > T$, for a given level of investment, saving, and net investment income, net foreign borrowing must be greater.

⁵ This scenario describes the experience of the United States in the mid to late 1800s, when foreign capital inflows financed much of the investment in railroads and other assets.

The borrowing from foreign investors in the above example was used to finance investment. This borrowing did not reduce the living standards of current or future U.S. residents, because the interest and dividends that were paid to foreigners came from the return from the new investment. The increased capital investment led to increases in labor productivity, resulting in higher wages both at that time and in the future.

If, by contrast, foreign borrowing finances consumption instead of investment, there are no new assets created to generate a return that can support the borrowing. When the debt eventually is repaid, the repayments will come at the expense of future consumption.

For instance, consider a situation in which the domestic supply of funds for investment decreases because domestic saving rates fall. Foreign borrowing in this case is not associated with increased investment, but instead is devoted to investment that was previously financed with domestic savings. Because the foreign borrowing is not associated with increased investment, future output does not increase, and interest and dividends on the investment will be paid to foreign persons at the expense of future domestic consumption. In this case, there may be an increase in the standard of living for current U.S. residents at the expense of a decrease in the standard of living of future residents.

The difference between the case where foreign investors fund incremental investment in the United States on top of domestic saving and the case where foreign investment simply replaces current domestic saving (which instead are currently consumed) can be summarized as follows. In the first case, the economy grows faster over time than it would without the incremental foreign investment and both U.S. and foreign persons share in that growth. In the second case, the economy continues to grow (but not as quickly as the first case) but all the future returns to the foreign investment belong to foreign persons. U.S. persons enjoy the immediate boost to their standard of living that comes from consuming money that they formerly saved, but future residents will not enjoy the returns from the money their predecessors consumed rather than saved.

During the period that foreign borrowing finances U.S. consumption, the United States runs a trade deficit. Although the United States could service its growing foreign debt by increased borrowing, and thereby generating larger trade deficits, in the long run trade deficits cannot keep growing. In fact, the United States must eventually run a trade surplus. If the United States imported more goods than it exported every year, there also would be an inflow of foreign capital every year. As the capital inflow grew from year to year, so would costs of servicing the claims held by foreign investors (e.g., interest on U.S. debt instruments). Eventually, foreigners would be unwilling to continue investing in the United States, and the value of the dollar would fall. The fall in the dollar would eliminate the trade deficit, and the United States would eventually run a trade surplus, so that the current account deficit (the sum of the trade deficit in goods and services and the net interest on foreign obligations) would be small enough for foreigners to be willing to lend again to the United States.⁶

⁶ An alternative adjustment would require U.S. interest rates to rise to make it more attractive for foreigners to invest in the United States. The rise in interest rates could also encourage increased domestic savings,

Even when foreign investment finances domestic consumption, trade deficits and capital inflows themselves should not necessarily be viewed as undesirable, because the foreign capital inflows help to keep investment in the domestic economy, and hence labor productivity, from falling. (As noted in the preceding paragraph, however, this pattern cannot continue indefinitely.) For instance, the large inflow of foreign capital to the United States in the 1980s is widely viewed to have been a result of low U.S. saving rates. If the mobility of foreign capital had been restricted (through capital or import controls, for example), then the low saving rate could have led to higher domestic interest rates and lower rates of investment. That decreased investment would have led to decreases in future living standards because the lower growth rate of the capital stock would have resulted in lower growth rates of U.S. labor productivity. In this instance, the fact that foreign capital was not restricted and did finance U.S. investment helped mitigate some of the negative effects on economic growth of low domestic saving.

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

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

helping to reduce the need for foreign investment funds. Some combination of dollar devaluation and rising interest rates is also possible.

**Table 1.—International Transactions of the United States, Selected Years,
1975-2010
(Dollars in Billions Nominal)**

	1975	1985	1995	2000	2005	2010
Current Account Balance	18.1	-118.2	-113.6	-416.4	-747.6	-470.2
Exports of Goods and Services	157.9	387.6	1,004.6	1,421.5	1,816.4	2,496.6
Merchandise	107.1	215.9	575.2	784.2	909.0	1,288.6
Services	25.5	73.2	219.2	286.4	372.2	545.5
Receipts from U.S. assets abroad	25.4	98.5	210.2	350.9	-535.3	662.5
Imports of Goods and Services	-132.7	-483.8	-1,080.1	-1,779.2	2,458.3	-2,829.4
Merchandise	-98.2	-338.1	-749.4	-1,230.4	-1,692.8	-1,935.7
Services	-22.0	-72.9	-141.4	-219.0	-302.5	-394.2
Payments on foreign-owned U.S. assets	-12.6	-72.8	-189.4	-329.9	-462.9	-499.5
Unilateral Transfers	-7.1	-22.0	-38.1	-58.6	-105.8	-137.5
Financial Account Balance	-22.5	101.3	113.3	443.2	785.4	220.1
Foreign Investment in the United States	16.9	144.2	435.1	1,038.2	1,247.3	1,244.8
Direct Investment	2.6	19.7	57.8	321.3	112.6	194.5
Private non-direct investment	7.2	125.6	267.4	674.2	875.4	752.3
Official	7.0	-1.1	109.9	42.8	259.3	298.0
U.S. Investment Abroad	-39.7	-44.8	-352.3	-560.5	-546.6	-1,024.7
Direct Investment	-14.2	-18.9	-98.8	-159.2	-36.2	-345.6
Private non-direct investment	-21.1	-19.1	-242.8	-400.1	-530.0	-684.8
Increase in government assets	-4.3	-6.7	-10.7	-1.2	19.6	5.6
Financial Derivatives, net	n.a.	n.a.	n.a.	n.a.	n.a.	15.1
Capital Account Transactions, net	n.a.	n.a.	-0.2	0.0	14.1	0.2
Statistical Discrepancy	4.7	18.7	31.0	-61.3	33.8	235.1

¹ Preliminary Figures for 2010.

Source: Department of Commerce, Bureau of Economic Analysis, "U.S. International Transactions, 1960-2010."

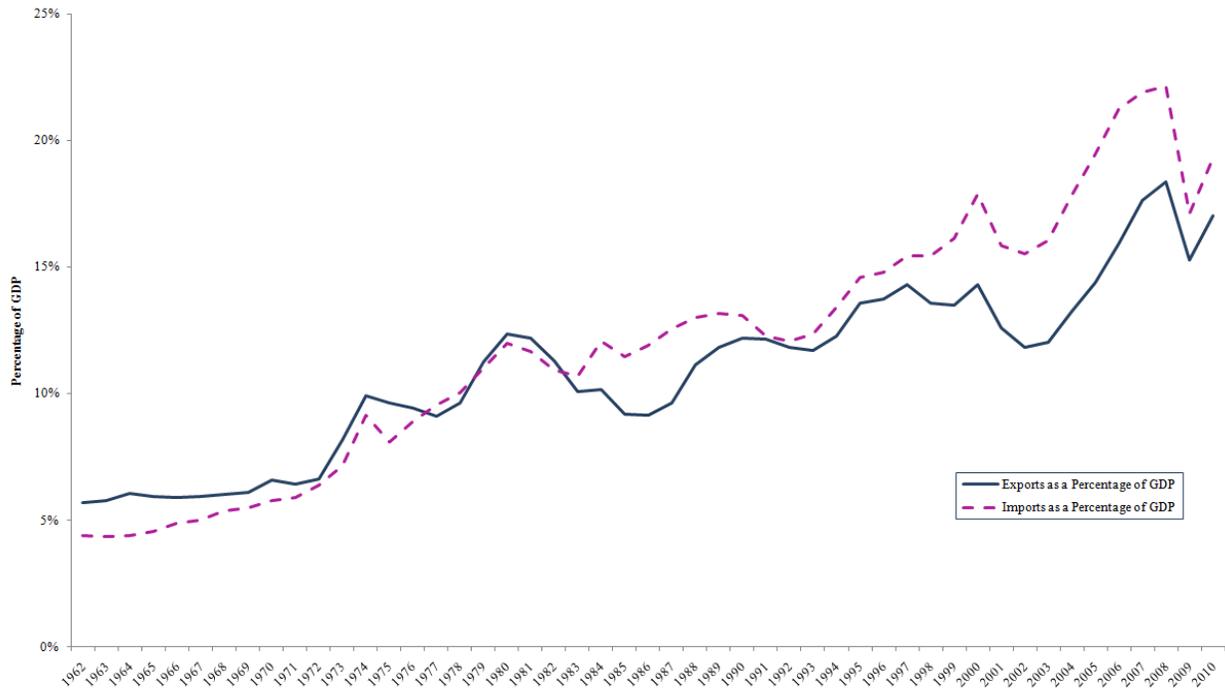
n.a. - not applicable.

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

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

Foreign trade has become increasingly important to the United States economy. Figure 1 presents the value of exports from the United States and imports into the United States as a percentage of GDP for the period 1962-2010. As depicted in Figure 1, exports and imports each have risen from less than six percent of GDP in 1962 to more than 17 percent in 2010. Imports have consistently exceeded 15 percent of U.S. GDP since 1997. Figure 1 also shows that the United States generally was a net exporter of goods and services prior to 1982. Since that time, the United States has been a net importer of goods and services.

Figure 1.-Exports and Imports as a Percentage of United States GDP, 1962-2010

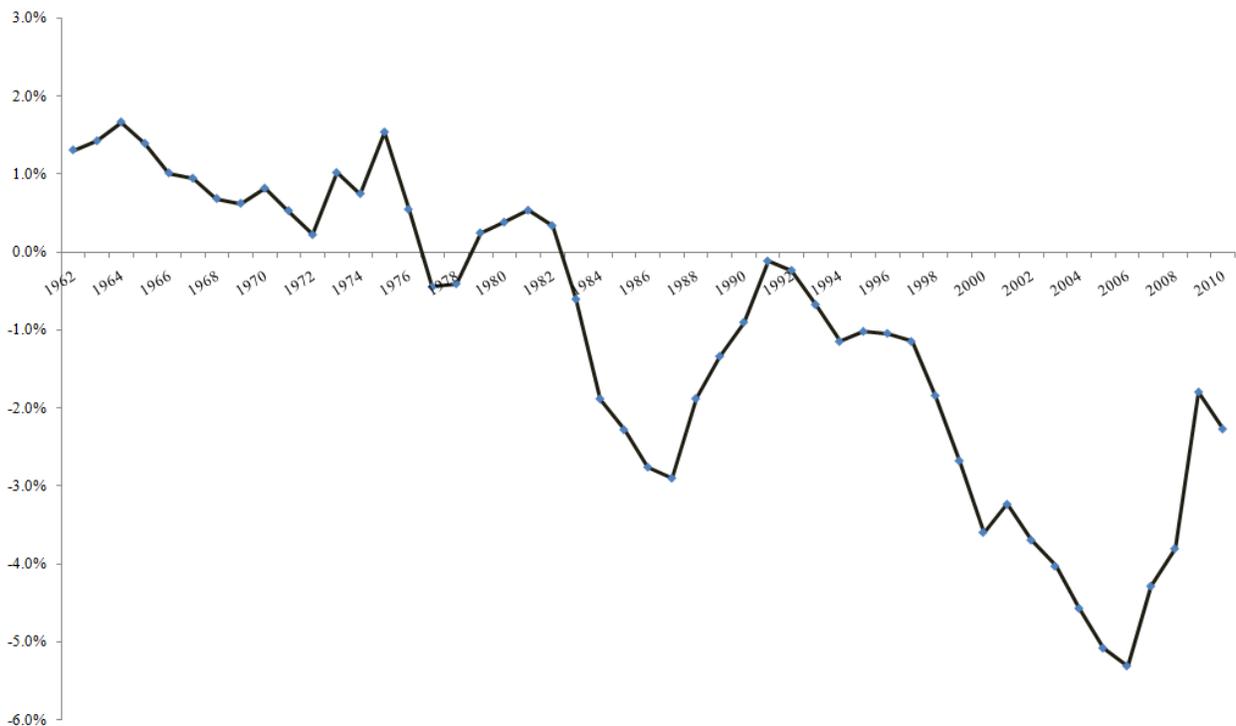


Source: Department of Commerce, Bureau of Economic Analysis

Note: Figures for 2010 are preliminary.

The net trade position of a country is commonly summarized by its current account. The U.S. current account as a whole, which compares exports of goods and services and income earned by U.S. persons on foreign investments to imports of goods and services and income earned by foreign persons on their investments in the United States (plus unilateral remittances), generally was positive from 1962 through 1981, but generally has been in deficit since 1982. Figure 2 reports the current account balance of the United States for the period 1962 through 2010 as a percentage of GDP to eliminate the effect of inflation on reported nominal figures.⁷

Figure 2.-United States Current Account Balance as a Percentage of GDP, 1962-2010



Source: Department of Commerce, Bureau of Economic Analysis

Note: Figures for 2010 are preliminary.

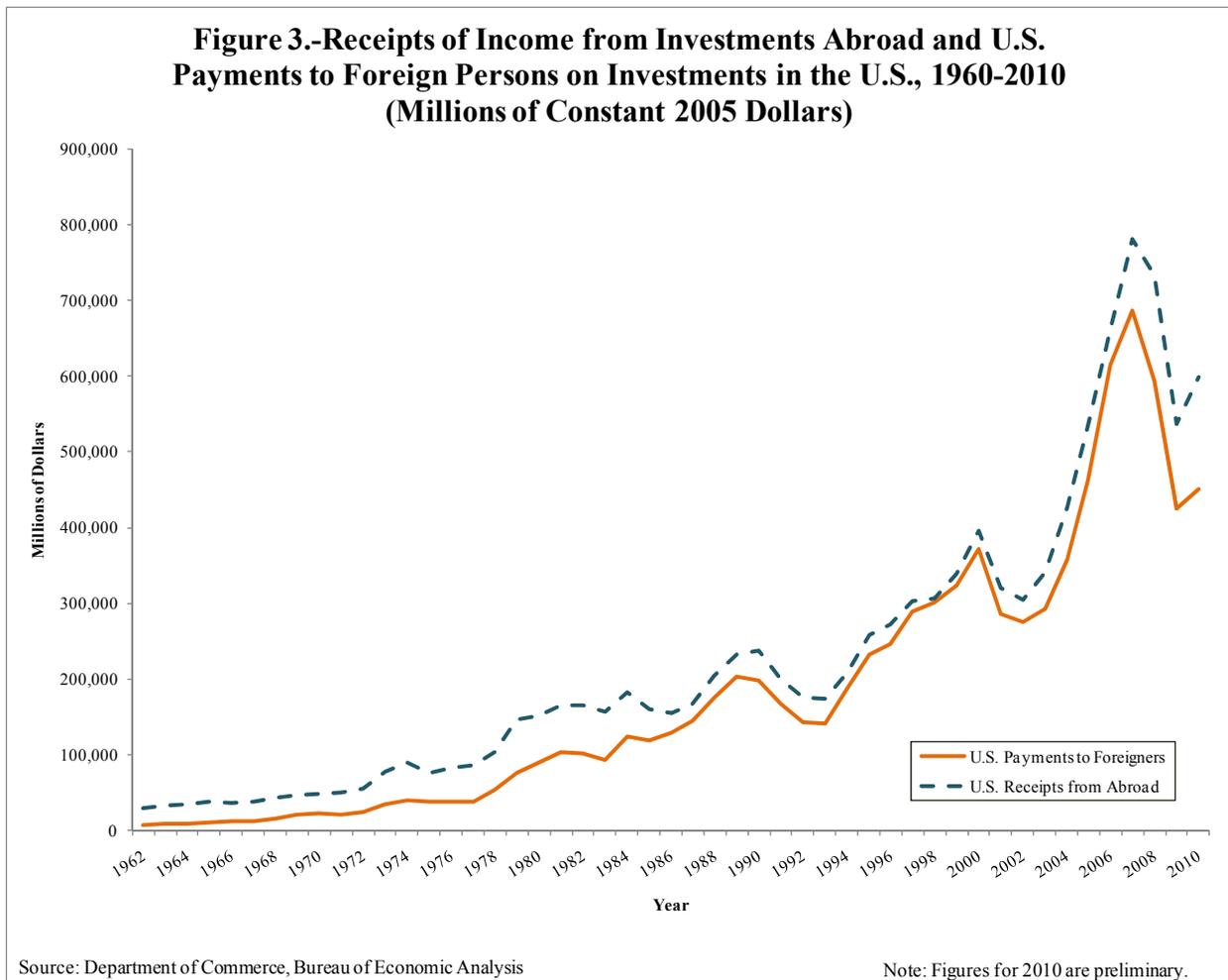
⁷ The current account balance generally reflects purely market activity. However, in 1992 the United States received substantial payments from certain foreign governments related to the prosecution of the Persian Gulf War. These payments are included in the computation of the current account balance and account for the substantial reduction in the current account deficit for that year.

2. Components of the current account

Merchandise trade, trade in services, and income from investments

The aggregate data reported in Figure 1 and Figure 2 mask differences in the trade position of various sectors of the economy. As explained above, the current account compares exports of goods and services and payments of income earned by U.S. persons on foreign investments to imports of goods and services and payments of income earned by foreign persons on their investments in the United States.

Several different trends are embedded within the data. Measuring the trade deficit in real, inflation adjusted year 2005 dollars, as has been widely reported, the merchandise (goods only) trade deficit has been over \$450 billion per year since 2000. On the other hand, the United States has been a net exporter of services since the 1970s. This surplus in trade in services has exceeded \$100 billion per year (real, inflation-adjusted 2005 dollars) for the past three years. Also, throughout the entire period covered in Figure 2, U.S. receipts of income on investments abroad have exceeded payments of income to foreign persons on their U.S. investments (see Figure 3, below).



C. Trends in the U.S. Financial Account

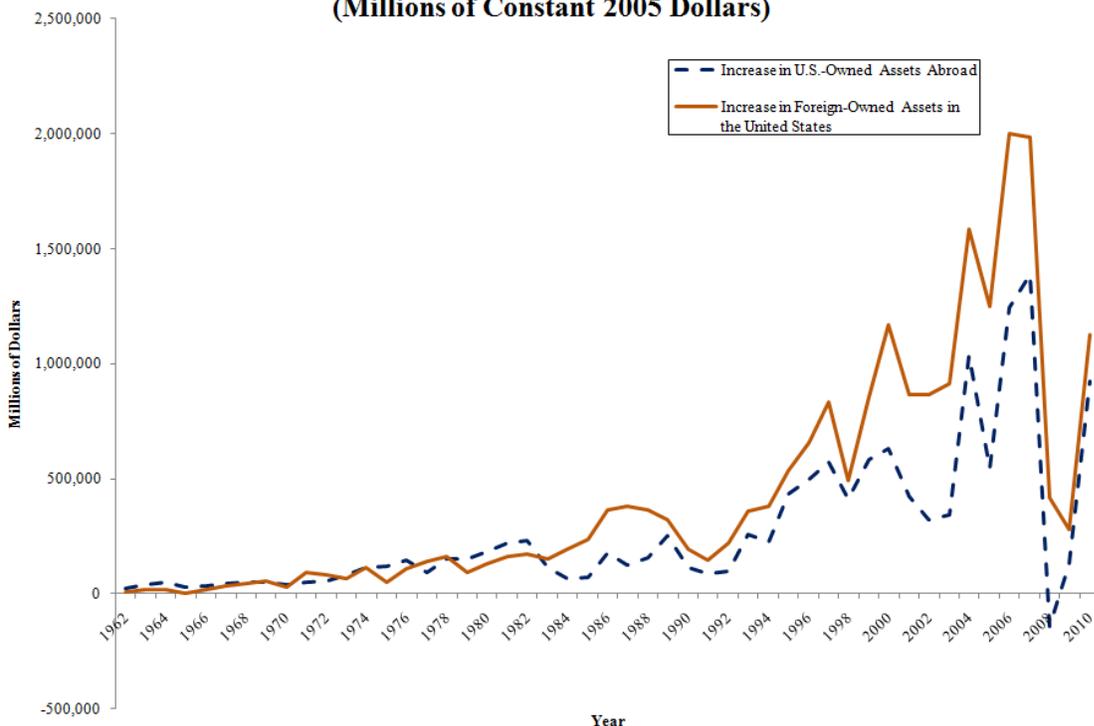
1. Overview of the U.S. financial account

As explained above, when the United States imports more than it exports, the dollars the United States uses to buy the imports must ultimately return to the United States as payment for U.S. exports or to purchase U.S. assets. As Figure 2 and Table 1 document, the U.S. current account has been in deficit since the early 1980s. As a direct result, the United States changed from being a modest exporter of capital in relation to GDP to being a large importer of capital. In addition, the domestic saving rate has declined. As a consequence of both of these trends, net foreign investment has become a larger proportion of the economy and a more significant proportion of total domestic investment than in the past. In 2009, gross investment in the United States was \$2.09 trillion and net foreign investment was \$380.3 billion, or 18.2 percent of gross domestic investment. In 1993, net foreign investment was equal to 6.8 percent of gross domestic investment.⁸

Net foreign investment in the United States is measured by the U.S. financial account. The financial account measures the increase in U.S. assets abroad compared to the increase in foreign assets in the United States. Figure 4 plots the annual increase of U.S. assets abroad and of foreign assets in the United States in constant dollars for the period 1962-2010 in constant, inflation-adjusted 2005 dollars. Foreign assets in the United States increased by \$1.20 trillion in 2005, \$1.86 trillion in 2006, and \$1.86 trillion in 2007 in nominal dollars. The 2008 recession resulted in a slowdown in foreign acquisition of U.S. assets, but in 2010 foreign assets increased by over \$1 trillion. At the same time, foreign assets owned by U.S. persons increased by \$427 billion in 2005, \$1.06 trillion in 2006, and \$1.21 trillion in 2007 (nominal dollars). However, during the 2008 recession, U.S. holdings of foreign assets decreased for the first time since 1960. Since 2009, U.S. holding of foreign assets has begun to increase once more.

⁸ Economic Report of the President, Table B-32. In 2008, net foreign investment totaled 25.7 percent of gross domestic investment.

Figure 4.-Annual Increase in U.S. Assets Abroad and in Foreign Assets in the U.S., 1962-2010
(Millions of Constant 2005 Dollars)



Source: Department of Commerce, Bureau of Economic Analysis

Note: Figures for 2010 are preliminary.

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

Overview

Measured in nominal dollars, the amount of foreign-owned assets in the United States grew at an annual rate of more than 13 percent per year between 1980 and 2009. The total amount of foreign-owned assets in the United States exceeded \$20 trillion by the end of 2009.⁹ The recorded value of U.S.-owned assets abroad grew less rapidly during the same period. The Department of Commerce reports that in 1976 the amount of U.S.-owned assets abroad exceeded foreign-owned assets in the United States by \$165 billion. By the mid-1980s, however, the situation had reversed, so that the amount of foreign-owned assets in the United States exceeded U.S.-owned assets abroad. By 2009, the amount of foreign-owned assets in the United States exceeded U.S.-owned assets abroad by \$2.5 trillion.¹⁰ The value of investments abroad by private U.S. persons has grown from \$693 billion in 1980 to \$14.38 trillion in 2009.¹¹ The rate

⁹ U.S. Department of Commerce, Bureau of Economic Analysis, "International Investment Position of the United States at Year-End, 1976-2009."

¹⁰ *Ibid.*

¹¹ This figure values the direct investment at current cost. Both the 1980 and 2009 values are reported in nominal dollars. 2009 figures are preliminary.

of growth of private U.S. investment abroad has not been as rapid as the rate of growth in the value of investments by foreign persons in the United States. Foreign non-official holdings of U.S. assets have grown from \$388.2 billion in 1980 to \$13.4 trillion in 2009.¹²

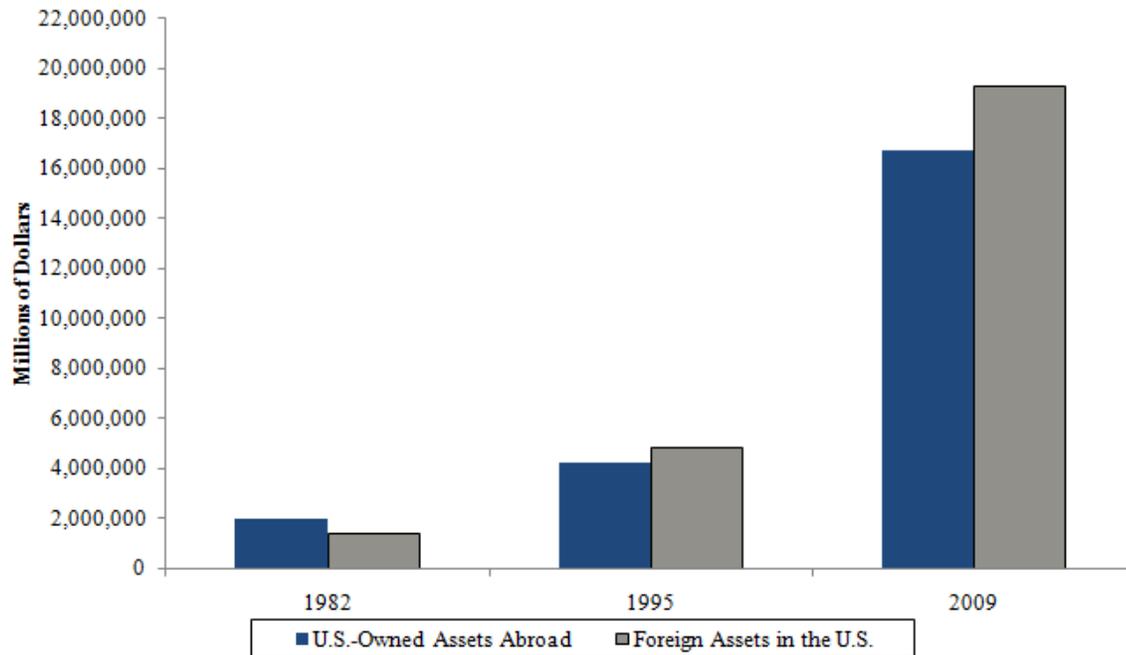
These investments are measured at their so-called “current cost.”¹³ Some argue that the market value of U.S.-owned assets abroad is similar to, or greater than, the market value of foreign-owned assets in the United States, if market values were measured accurately.¹⁴ Figure 5 and Figure 6 display the value of U.S.-owned assets abroad and foreign-owned assets in the United States for selected years measured in constant dollars both under current cost and on the basis of estimates of current market values. Regardless of whether this argument is correct with respect to the current net investment position, it is clear that foreign-owned U.S. assets are growing more rapidly than U.S.-owned assets abroad, as depicted in Figure 6.

¹² 2009 figures are preliminary.

¹³ The Bureau of Economic Analysis estimates the values of U.S. foreign direct investment abroad and foreign direct investment in the United States using three different bases: historical cost, current cost, and market value. Using the historical cost base, assets are measured according to values carried on taxpayers’ books. Thus, investments reflect the price level of the year in which the asset was acquired. Under the current cost measure, a parent’s share of its affiliates’ tangible assets (property, plant, and equipment and inventories) is revalued from historical cost to replacement cost. Under the market value measure, an owner’s equity in foreign assets is revalued to current market value using indexes of stock prices.

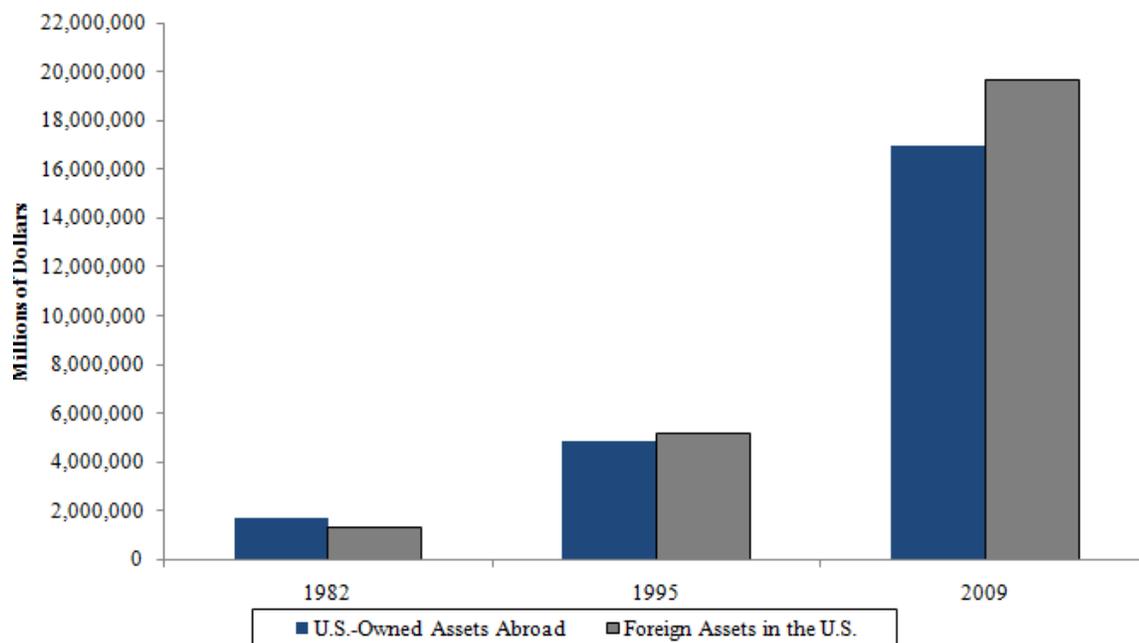
¹⁴ The distinction between book valuation and market valuation is only relevant for the category of investment labeled “direct investment,” not for “portfolio investment.” The distinction between direct and portfolio investment is explained in the text below.

Figure 5.-International Investment Position of the United States, 1982, 1995, and 2009 in Constant 2005 Dollars (Direct Investment Component Measured at Current Cost)



Source: Department of Commerce, Bureau of Economic Analysis Note: Figures for 2009 are preliminary.

Figure 6.-International Investment Position of the United States, 1982, 1995, and 2009 in Constant 2005 Dollars (Direct Investment Component Measured at Market Value)



Source: Department of Commerce, Bureau of Economic Analysis Note: Figures for 2009 are preliminary.

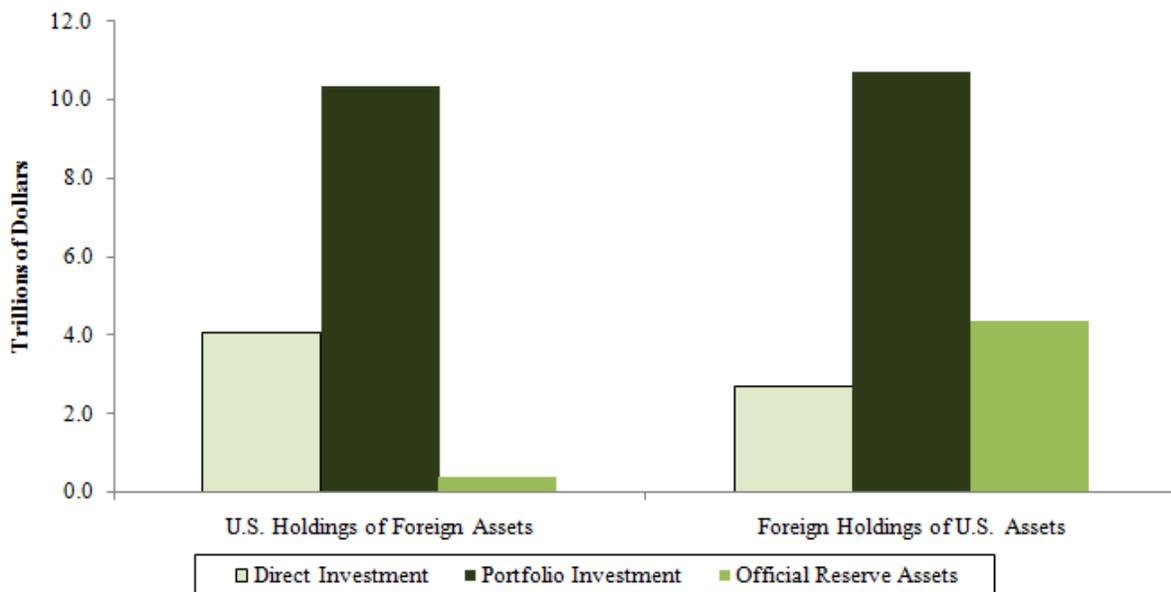
Direct investment, non-direct (portfolio) investment, and official investment

Foreign-owned assets in the United States (and U.S.-owned assets abroad) can be categorized as direct investment, non-direct investment, and official assets. Direct investment constitutes assets over which the owner has direct control. The Department of Commerce defines an investment as direct when a single person owns or controls, directly or indirectly, at least 10 percent of the voting securities of a corporate enterprise or the equivalent interests in an unincorporated business.

The largest category of outbound and inbound investment is non-direct investment held by private (non-governmental) foreign investors, commonly referred to as portfolio investment. In general, foreign portfolio investment annually has exceeded foreign direct investment, making portfolio investment responsible for the majority of growth in foreign ownership of U.S. assets. Foreign portfolio investment consists mostly of holdings of corporate equities, corporate and government bonds, and bank deposits. The portfolio investor generally does not have control over the assets that underlie the financial claims. Foreign investment in bonds, corporate equities, and bank deposits, like other types of financial investment, provide a source of funds for investment in the United States but also represent a claim on future U.S. resources.

The final category of foreign-owned U.S. assets or U.S.-owned foreign assets is official assets: in the former case, for example, U.S. assets held by governments, central banking systems, and certain international organizations. The foreign currency reserves of other governments and banking systems, for example, are treated as official assets. Figure 7, below reports the value of these different categories as estimated for the close of 2009.

Figure 7.-International Investment Position by Type of Investment
Trillions of Dollars, 2009



Source: Department of Commerce, Bureau of Economic Analysis

Note: Figures for 2009 are preliminary.

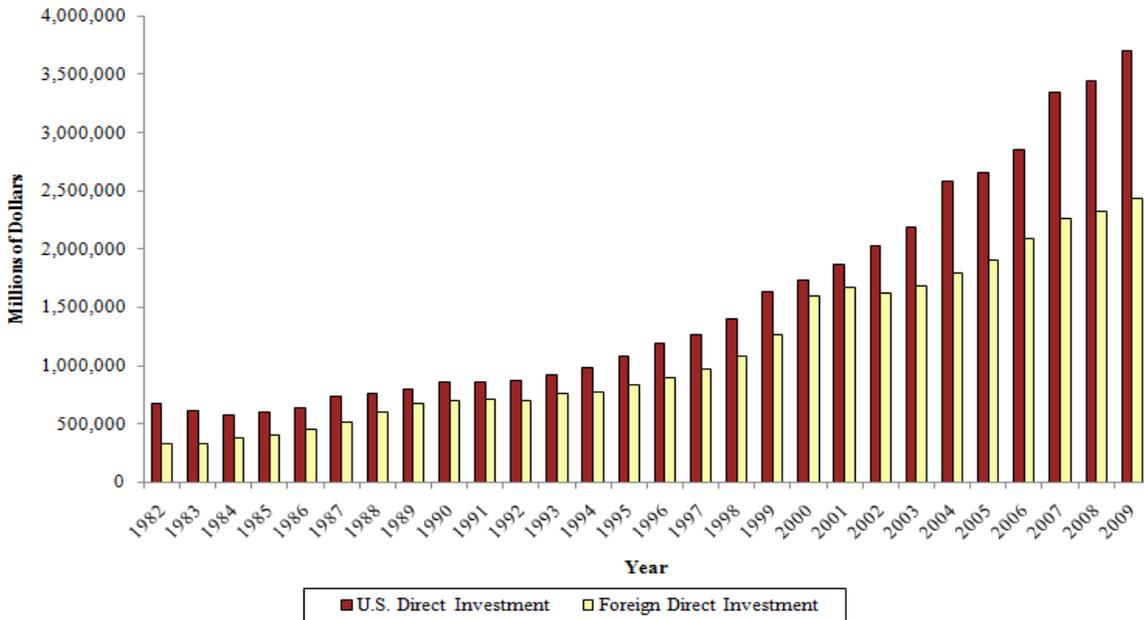
Foreign persons held direct investments of \$2.7 trillion in the United States in 2009, having grown from \$127 billion in 1980.¹⁵ In 2009, portfolio assets of foreign persons in the United States were about four times the recorded value of direct investment, \$10.7 trillion compared to \$2.7 trillion, respectively. Bank deposits account for nearly one-third of this total (\$3.6 trillion), and reflect, in part, the increasingly global nature of banking activities. Levels of foreign-held official assets have grown substantially since 2002. In 2002, foreign official assets were estimated to be \$1.26 trillion. In 2009, foreign official assets were estimated to be \$4.4 trillion.

As has been the case for foreign investors in U.S. assets, in general, increases in U.S. investors' portfolio holdings of foreign assets have exceeded the increases in U.S. foreign direct investment. At year-end 2009, U.S. foreign direct investment constituted approximately one-quarter of U.S. ownership of foreign assets, with foreign direct investment valued at \$4.05 trillion and portfolio investment valued at \$10.33 trillion (with direct investment measured at current cost).

Measured at current cost, the value of U.S. direct investment abroad has remained above the value of foreign direct investment in the United States. (See Figure 8.) Measured at market value, the value of foreign direct investment in the United States and the value of U.S. direct investment abroad were estimated to have been comparable for 1998-2002, but recent preliminary estimates place the value of U.S. owned foreign direct investment in excess of foreign owned direct investments in the United States. (See Figure 9.) The value of U.S. direct investment abroad has increased substantially over the past three decades; in terms of both current cost and market value, the rise between 1982 and 2009 has been almost fivefold (in real dollars).

¹⁵ This values the direct investment at current cost. The Bureau of Economic Analysis estimate for 2009, when valued at market value, is \$3.1 trillion.

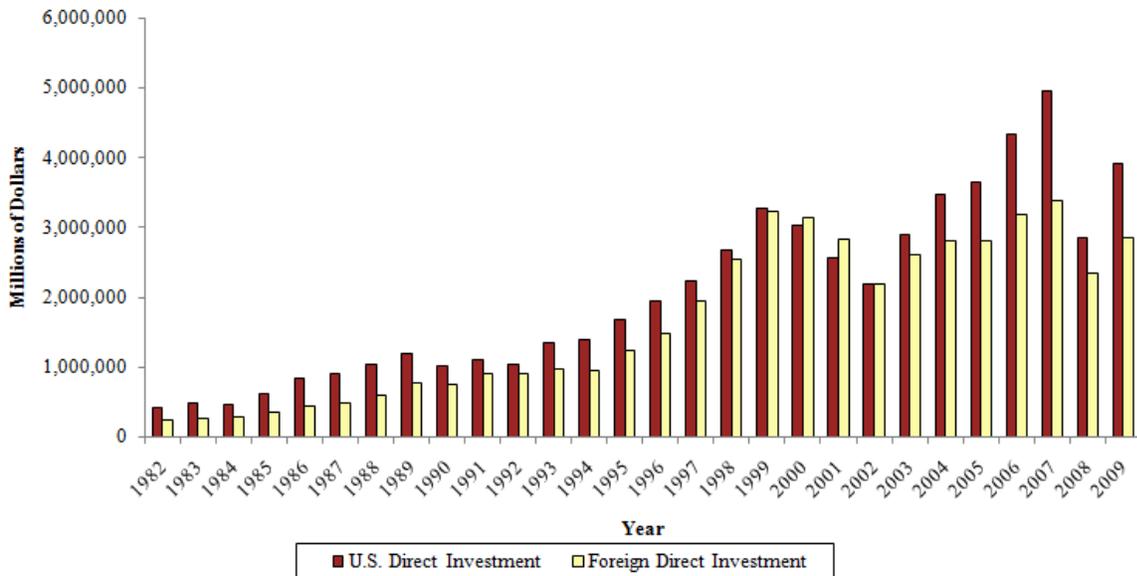
Figure 8.-Year-End Value of Foreign Direct Investment in the U.S. and U.S. Direct Investment Abroad, 1982-2009
(Millions of Constant 2005 Dollars Measured at Current Cost)



Source: Department of Commerce, Bureau of Economic Analysis

Note: Figures for 2009 are preliminary.

Figure 9.-Year-End Value of Foreign Direct Investment in the U.S. and U.S. Direct Investment Abroad, 1982-2009
(Millions of Constant 2005 Measured at Market Value)



Source: Department of Commerce, Bureau of Economic Analysis

Note: Figures for 2009 are preliminary.

D. Summary and Implications for Tax Reform

As discussed above, since the U.S. began to maintain a trade deficit in the 1980s, it has become a net importer of capital as a result. Taking all forms of investment into account, net foreign investment has become an increasingly significant proportion of the economy. However, despite this trend, the level U.S. direct investment abroad continues to exceed the level of foreign direct investment in the U.S. The increase in U.S. foreign direct investment cannot, therefore, be explained in terms of the balance of trade.

In addition, as is evident in Figure 3, U.S. income receipts from assets abroad have exceeded U.S. payments of income to foreigners, even though foreign holdings of U.S. assets exceeds U.S. holdings of foreign assets on net. This trend is attributable to the rise in U.S. direct investment abroad. In 2009, of approximately \$588 billion income earned on U.S. holdings of all foreign assets, \$346 billion or 59 percent of the total were receipts from direct investments. In the same year, U.S. foreign direct assets comprised only 28 percent of total overseas private investment (Figure 7).

Although portfolio investment constitutes the largest share of cross-border investment, direct investment is more central to discussions of income tax reform. U.S. direct investment abroad may create the opportunity for tax arbitrage. As discussed in greater detail below, in the case of foreign direct investment, in contrast to portfolio investments (which are not directly controlled by the asset holder), a taxpayer might shift private business activity from the United States to other jurisdictions, potentially for the purpose of reducing one's tax burden. However, such behavior is neither a necessary cause nor effect of increased foreign activity of U.S. business entities.

II. PRESENT LAW

A. General Overview

1. International tax principles

International law recognizes the right of each sovereign nation to regulate conduct based on a nexus of the conduct to the territory of the nation or to a person (whether natural or juridical) whose status links the person to the nation, subject to limitations based on evaluating the reasonableness of the regulatory action.¹⁶ In turn, these two broad bases of jurisdiction, i.e., territoriality and nationality of the person whose conduct is regulated, have been refined and, in varying combinations, form the bases of most systems of income taxation. A number of commonly accepted principles have developed to minimize the extent to which conflicts arise as a result of extraterritorial or overlapping exercise of taxing authority. In addition to general acceptance of some variation of territorial or national nexus as a basis for taxing jurisdiction, most systems also comport with international norms by respecting reasonableness as a limit on extraterritorial enforcement, providing an enforcement mechanism such as withholding tax at source of a payment, and establishing guidelines for determining how to resolve duplicative assertions of authority.¹⁷

Exercise of taxing authority based on a person's status as a national, resident, or domiciliary of a jurisdiction reaches worldwide activities of such persons and is the broadest assertion of taxing authority. A more limited exercise of taxation occurs when taxation is imposed only to the extent that activities occur or property is located in the territory of the taxing jurisdiction. If a person conducts business or owns property in a jurisdiction, or if a transaction occurs in whole or in part in a jurisdiction, the resulting limited basis of taxation is a territorial application. Whether the broader or narrower basis of taxation is used by a jurisdiction, identification of the tax base depends upon establishing rules for determining the source of income and its proper allocation among related parties, as well as the status of all persons, i.e., their residency for tax purposes.

The same income may be subject to taxation in two jurisdictions if those jurisdictions adopt different standards for determining residency of persons, source of income, or other basis for taxation. To the extent that the rules of two or more countries overlap, rules to mitigate potential double taxation generally apply, either by operation of bilateral treaties to avoid double taxation or in the form of legislative relief, such as credits for taxes paid to another jurisdiction.

2. International principles as applied in the U.S. system

The United States has adopted a Code¹⁸ that combines the worldwide taxation of all U.S. persons (U.S. citizens or resident aliens and domestic corporations)¹⁹ on all income, whether

¹⁶ Restatement (Third) of Foreign Relations Law of the United States, secs. 402 and 403, (1987).

¹⁷ American Law Institute, *Federal Income Tax Project: International Aspects of United States Income Taxation, Proposals on U.S. Taxation of Foreign Persons and of the Foreign Income of U.S. Persons*, 4-8 (1987).

derived in the United States or abroad, with territorial-based taxation of U.S.-source income of nonresident aliens and foreign entities, and limited deferral for foreign income earned by subsidiaries of U.S. companies. This combination is sometimes described as the U.S. hybrid system. Under this system, the application of the Code to outbound investment (the foreign activities of U.S. persons) differs somewhat from its rules applicable to inbound investment (foreign persons with investment in U.S. assets or activities).

With respect to outbound activities, income earned directly by a U.S. person, including as a result of a domestic corporation's conduct of a foreign business itself (by means of direct sales, licensing or branch operations in the foreign jurisdiction) rather than through a separate foreign legal entity, or through a pass-through entity such as a partnership, is taxed on a current basis. However, active foreign business income earned by a domestic parent corporation indirectly through a foreign corporate subsidiary generally is not subject to U.S. tax until the income is distributed as a dividend to the domestic corporation. This taxpayer-favorable result is circumscribed by the anti-deferral rules of subpart F of the Code, described below in part II.C.3, which provide that a domestic parent corporation is subject to U.S. tax on a current basis with respect to certain categories of passive or highly mobile income earned by its foreign subsidiaries.

By contrast, nonresident aliens and foreign corporations are generally subject to U.S. tax only on their U.S.-source income. Thus, the source and type of income received by a foreign person generally determines whether there is any U.S. income tax liability, and the mechanism by which it is taxed (as described below in part II.B, either by gross-basis withholding or on a net basis through tax return filing).

Category-by-category rules determine whether income has a U.S. source or a foreign source. For example, compensation for personal services generally is sourced based on where the services are performed, dividends and interest are, with limited exceptions, sourced based on the residence of the taxpayer making the payments, and royalties for the use of property generally are sourced based on where the property is used. These and other source rules are described in more detail at part II.A.3, below.

To mitigate double taxation of foreign-source income, the United States allows a credit for foreign income taxes paid. As a consequence, even though resident individuals and domestic corporations are subject to U.S. tax on all their income, both U.S. and foreign source, source of income remains a critical factor to the extent that it determines the amount of credit available for foreign taxes paid. In addition to the statutory relief afforded by the credit, the network of bilateral treaties provides a system for removing double taxation and ensuring reciprocal treatment of taxpayers from treaty countries.

¹⁸ Unless otherwise indicated, all section references are to the Internal Revenue Code of 1986, as amended (the "Code").

¹⁹ Sec. 7701(a)(30) defines U.S. person to include all U.S. citizens and residents as well as domestic entities such as partnerships, corporations, estates and certain trusts. Whether a noncitizen is a resident is determined under rules in section 7701(b).

Present law provides detailed rules for the allocation of deductible expenses between U.S.-source income and foreign-source income. These rules do not, however, affect the timing of the expense deduction. A domestic corporation generally is allowed a current deduction for its expenses (such as interest and administrative expenses) that support income that is derived through foreign subsidiaries and on which U.S. tax is deferred. Instead, the expense allocation rules apply to a domestic corporation principally for determining the corporation's foreign tax credit limitation, discussed below in part II.C.2. This limitation is computed by reference to the corporation's U.S. tax liability on its taxable foreign-source income in each of two principal limitation categories, commonly referred to as the "general basket" and the "passive basket." Consequently, the expense allocation rules primarily affect taxpayers that may not be able to fully use their foreign tax credits because of the foreign tax credit limitation.

U.S. tax law includes rules intended to prevent reduction of the U.S. tax base, whether through excessive borrowing in the United States (discussed in parts II.B.4 and III.A), migration of the tax residence of domestic corporations from the United States to foreign jurisdictions through corporate inversion transactions (described in part II.C.4.) or aggressive intercompany pricing practices with respect to intangible property (described immediately below).

3. Principles common to inbound and outbound taxation

Although the U.S. tax rules often differ depending upon whether the activity in question is inbound or outbound, there are certain concepts that are equally applicable to both inbound and outbound investment. Two such areas are the transfer pricing rules and the rules for determination of source.

Transfer pricing

A basic U.S. tax principle applicable in dividing profits from transactions between related taxpayers is that the amount of profit allocated to each related taxpayer must be measured by reference to the amount of profit that a similarly situated taxpayer would realize in similar transactions with unrelated parties. The transfer pricing rules of section 482 and the accompanying Treasury regulations are intended to preserve the U.S. tax base by ensuring that taxpayers do not shift income properly attributable to the United States to a related foreign company through pricing that does not reflect an arm's-length result.²⁰ Similarly, the domestic laws of most U.S. trading partners include rules to limit income shifting through transfer pricing. The arm's-length standard is difficult to administer in situations in which no unrelated party market prices exist for transactions between related parties. When a foreign person with U.S. activities has transactions with related U.S. taxpayers, the amount of income attributable to U.S. activities is determined in part by the same transfer pricing rules of section 482 that apply when U.S. persons with foreign activities transact with related foreign taxpayers.

²⁰ For a detailed description of the U.S. transfer pricing rules, see Joint Committee on Taxation, *Present Law and Background Related to Possible Income Shifting and Transfer Pricing* (JCX-37-10), July 20, 2010, pp. 18-50.

Section 482 authorizes the Secretary of the Treasury to allocate income, deductions, credits, or allowances among related business entities²¹ when necessary to clearly reflect income or otherwise prevent tax avoidance, and comprehensive Treasury regulations under that section adopt the arm's-length standard as the method for determining whether allocations are appropriate.²² 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 unrelated parties dealing at arm's length. For income from intangible property, section 482 provides "In the case of any transfer (or license) of intangible property (within the meaning of section 936(h)(3)(B)), the income with respect to such transfer or license shall be commensurate with the income attributable to the intangible." By requiring inclusion in income of amounts commensurate with the income attributable to the intangible, Congress was responding to concerns regarding the effectiveness of the arm's-length standard with respect to intangible property—including, in particular, high-profit-potential intangibles.²³

Source of income rules

Rules for determining the source of certain types of income are specified in the Code, as described briefly below. The various factors relied upon to determine the source of income for U.S. tax purposes include the status or nationality of the payor, the status or nationality of the recipient, the location of the recipient's activities that generate the income, and the situs of the assets that generate the income. To the extent that the source of income is not specified in the statute, the Secretary may promulgate regulations that explain the appropriate treatment. Many items of income are not explicitly addressed by either the Code or Treasury regulations. On several occasions, courts have determined the source of such items by applying the rule for the type of income to which the disputed income is most closely analogous, based on all facts and circumstances.²⁴

Interest

Interest is derived from U.S. sources if it is paid by the United States or any agency or instrumentality thereof, a State or any political subdivision thereof, or the District of Columbia. Interest is also from U.S. sources if it is paid by a resident or a domestic corporation on a bond, note, or other interest-bearing obligation.²⁵ Special rules apply to treat as foreign source certain amounts paid on deposits with foreign commercial banking branches of U.S. corporations or

²¹ The term "related" as used herein refers to relationships described in section 482, which refers to "two or more organizations, trades or businesses (whether or not incorporated, whether or not organized in the United States, and whether or not affiliated) owned or controlled directly or indirectly by the same interests."

²² Section 1059A buttresses section 482 by limiting the extent to which costs used to determine custom valuation can also be used to determine basis in property imported from a related party. A taxpayer that imports property from a related party may not assign a value to the property for cost purposes that exceeds its customs value.

²³ H.R. Rep. No. 99-426, p. 423.

²⁴ See, e.g., *Hunt v. Commissioner*, 90 T.C. 1289 (1988).

²⁵ Sec. 861(a)(1); Treas. Reg. sec. 1.861-2(a)(1).

partnerships and certain other amounts paid by foreign branches of domestic financial institutions.²⁶ Interest paid by the U.S. branch of a foreign corporation is also treated as U.S.-source income.²⁷

Dividends

Dividend income is generally sourced by reference to the payor's place of incorporation.²⁸ Thus, dividends paid by a domestic corporation are generally treated as entirely U.S.-source income. Similarly, dividends paid by a foreign corporation are generally treated as entirely foreign-source income. Under a special rule, dividends from certain foreign corporations that conduct U.S. businesses are treated in part as U.S.-source income.²⁹

Rents and royalties

Rental income is sourced by reference to the location or place of use of the leased property.³⁰ The nationality or the country of residence of the lessor or lessee does not affect the source of rental income. Rental income from property located or used in the United States (or from any interest in such property) is U.S.-source income, regardless of whether the property is real or personal, intangible or tangible.

Royalties are sourced in the place of use of (or the place of privilege to use) the property for which the royalties are paid.³¹ This source rule applies to royalties for the use of either tangible or intangible property, including patents, copyrights, secret processes, formulas, goodwill, trademarks, trade names, and franchises.

Income from sales of personal property

Subject to significant exceptions, income from the sale of personal property is sourced on the basis of the residence of the seller.³² For this purpose, special definitions of the terms "U.S. resident" and "nonresident" are provided. A nonresident is defined as any person who is not a U.S. resident,³³ while the term "U.S. resident" comprises any juridical entity which is a U.S.

²⁶ Sec. 861(a)(1) and 862(a)(1). For purposes of certain reporting and withholding obligations (discussed *infra*, in part II.B.2), the source rule in section 861(a)(1)(B) does not apply to interest paid by the foreign branch of a domestic financial institution, resulting in treating the payment as a withholdable payment. Sec. 1473(1)(C).

²⁷ Sec. 884(f)(1).

²⁸ Secs. 861(a)(2), 862(a)(2).

²⁹ Sec. 861(a)(2)(B).

³⁰ Sec. 861(a)(4).

³¹ *Ibid.*

³² Sec. 865(a).

³³ Sec. 865(g)(1)(B).

person, all U.S. citizens, as well as any individual who is a U.S. resident without a tax home in a foreign country or a nonresident alien with a tax home in the United States.³⁴ As a result, nonresident includes any foreign corporation.³⁵

Under several exceptions to the general rule, income from sales of property by nonresidents may be treated as U.S.-source income. For example, gain of a nonresident on the sale of inventory property may be treated as U.S.-source income if title to the property passes in the United States or if the sale is attributable to an office or other fixed place of business maintained by the nonresident in the United States.³⁶ If the inventory property is manufactured in the United States by the person that sells the property, a portion of the income from the sale of such property in all events is treated as U.S.-source income.³⁷ Gain of a nonresident on the sale of depreciable property is treated as U.S.-source income to the extent of prior U.S. depreciation deductions.³⁸ Payments received on sales of intangible property are sourced in the same manner as royalties to the extent the payments are contingent on the productivity, use, or disposition of the intangible property.³⁹

Personal services income

Compensation for labor or personal services is generally sourced to the place-of-performance. Thus, compensation for labor or personal services performed in the United States generally is treated as U.S.-source income, subject to an exception for amounts that meet certain de minimis criteria.⁴⁰ Compensation for services performed both within and without the United States is allocated between U.S. and foreign source.⁴¹

³⁴ Sec. 865(g)(1)(A).

³⁵ Sec. 865(g).

³⁶ Secs. 865(b) and (e), 861(a)(6).

³⁷ Sec. 863(b).

³⁸ Sec. 865(c).

³⁹ Sec. 865(d).

⁴⁰ Sec. 861(a)(3). Gross income of a nonresident alien individual, who is present in the United States as a member of the regular crew of a foreign vessel, from the performance of personal services in connection with the international operation of a ship is generally treated as foreign-source income.

⁴¹ Treas. Reg. sec. 1.861-4(b).

Insurance income

Underwriting income from issuing insurance or annuity contracts generally is treated as U.S.-source income if the contract involves property in, liability arising out of an activity in, or the lives or health of residents of, the United States.⁴²

Transportation income

Generally, income from furnishing transportation that begins and ends in the United States is U.S.-source income.⁴³ Fifty percent of other income attributable to transportation which begins or ends in the United States is treated as U.S.-source income.

Income from space or ocean activities or international communications

In the case of a foreign person, generally no income from a space or ocean activity is treated as U.S.-source income.⁴⁴ The same holds true for international communications income unless the foreign person maintains an office or other fixed place of business in the United States, in which case the income attributable to such fixed place of business is treated as U.S.-source income.⁴⁵

Amounts received with respect to guarantees of indebtedness

Amounts received from a noncorporate resident or from a domestic corporation for the provision of a guarantee of indebtedness of such person are income from U.S. sources, whether received directly or indirectly.⁴⁶ This includes payments that are made indirectly for the provision of a guarantee. For example, the provision would treat as income from U.S. sources a guarantee fee paid by a foreign bank to a foreign corporation for the foreign corporation's guarantee of indebtedness owed to the bank by the foreign corporation's domestic subsidiary, where the cost of the guarantee fee is passed on to the domestic subsidiary through, for example, additional interest charged on the indebtedness. In this situation, the domestic subsidiary has paid the guarantee fee as an economic matter through higher interest costs, and the additional

⁴² Sec. 861(a)(7).

⁴³ Sec. 863(c).

⁴⁴ Sec. 863(d).

⁴⁵ Sec. 863(e).

⁴⁶ Sec. 861(a)(9). This provision effects a legislative override of the opinion in *Container Corp. v. Commissioner*, 134 T.C. No. 5 (February 17, 2010), *aff'd* 2011 WL1664358, 107 A.F.T.R.2d 2011-1831 (5th Cir. May 2, 2011). The Tax Court held that fees paid by a domestic corporation to its foreign parent with respect to guarantees issued by the parent for the debts of the domestic corporation were more closely analogous to compensation for services than to interest, and determined that the source of the fees should be determined by reference to the residence of the foreign parent-guarantor. As a result, the income was treated as income from foreign sources.

interest payments made by the subsidiary are treated as indirect payments of the guarantee fee and, therefore, as U.S. source.

Such U.S.-source income also includes amounts received from a foreign person, whether directly or indirectly, for the provision of a guarantee of indebtedness of that foreign person if the payments received are connected with income of such person which is effectively connected with conduct of a U.S. trade or business. Amounts received from a foreign person, whether directly or indirectly, for the provision of a guarantee of that person's debt, are treated as foreign-source income if they are not from sources within the United States under section 861(a)(9).

B. U.S. Tax Rules Applicable to U.S. Activities of Non-U.S. Persons (Inbound)

1. In general

The U.S. tax rules for U.S. activities of foreign taxpayers apply differently to two broad types of income: U.S.-source that is “fixed or determinable annual or periodical gains, profits, and income” (“FDAP income”) or income that is “effectively connected with the conduct of a trade or business within the United States” (“ECI”). FDAP income generally is subject to a 30-percent gross-basis withholding tax, while ECI is generally subject to the same U.S. tax rules that apply to business income derived by U.S. persons. That is, deductions are permitted in determining taxable ECI, which is then taxed at the same rates applicable to U.S. persons. Much FDAP income and similar income is, however, exempt from withholding tax or is subject to a reduced rate of tax under the Code or a bilateral income tax treaty. The rules for U.S.-source FDAP and for ECI are discussed in more depth below.

Branch taxes, described below, are intended to provide rough equality in the taxation of branch and subsidiary operations in the United States. Also described below are special rules for the taxation of foreign persons’ sales and other dispositions of U.S. real estate and for the treatment of interest on related-party indebtedness.

2. Gross-basis taxation of U.S.-source income

Non-business income received by foreign persons from U.S. sources is generally subject to tax on a gross basis at a rate of 30 percent, which is collected by withholding at the source of the payment. As explained below, the categories of income subject to the 30-percent tax and the categories for which withholding is required are generally coextensive, with the result that determining the withholding tax liability determines the substantive liability.

Types of income subject to gross-basis taxation

The income of non-resident aliens or foreign corporations that is subject to tax at a rate of 30-percent includes FDAP income that is not effectively connected with the conduct of a U.S. trade or business.⁴⁷ The items enumerated in defining FDAP income are illustrative; the common characteristic of types of FDAP income is that taxes with respect to the income may be readily computed and collected at the source, in contrast to the administrative difficulty involved in determining the seller’s basis and resulting gain from sales of property.⁴⁸ The words “annual or periodical” are “merely generally descriptive” of the payments that could be within the

⁴⁷ Secs. 871(a), 881. If the FDAP income is also ECI, it is taxed on a net basis, at graduated rates, as explained in part II.B.3., below.

⁴⁸ *Commissioner v. Wodehouse*, 337 U.S. 369, 388-89 (1949). After reviewing legislative history of the Revenue Act of 1936, the Supreme Court noted that Congress expressly intended to limit taxes on nonresident aliens to taxes that could be readily collectible, i.e., subject to withholding, in response to “a theoretical system impractical of administration in a great number of cases. H.R. Rep. No. 2475, 74th Cong., 2d Sess. 9-10 (1936).” In doing so, the Court rejected P.G. Wodehouse’s arguments that an advance royalty payment was not within the purview of the statutory definition of FDAP income.

purview of the statute and do not preclude application of the withholding tax to one-time, lump sum payments to nonresident aliens.⁴⁹

FDAP income encompasses a broad range of types of gross income, but has limited application to gains on sales of property, including market discount on bonds and option premiums.⁵⁰ Capital gains received by nonresident aliens present in the United States for fewer than 183 days are generally treated as foreign source and are thus not subject to U.S. tax, unless the gains are effectively connected with a U.S. trade or business; capital gains received by nonresident aliens present in the United States for 183 days or more⁵¹ that are treated as U.S.-source are subject to gross-basis taxation.⁵² In contrast, U.S.-source gains from the sale or exchange of intangibles are subject to tax, and subject to withholding if they are contingent upon productivity of the property sold and are not effectively connected with a U.S. trade or business.⁵³

Withholding on FDAP payments to foreign payees is required unless the withholding agent,⁵⁴ i.e., the person making the payment to the foreign person receiving the income, can establish that the beneficial owner of the amount is eligible for an exemption from withholding or a reduced rate of withholding under an income tax treaty.⁵⁵ The principal statutory exemptions from the 30-percent withholding tax apply to interest on bank deposits, and portfolio interest.⁵⁶

⁴⁹ *Commissioner v. Wodehouse*, 337 U.S. 369, 393 (1949).

⁵⁰ Although technically insurance premiums paid to a foreign insurer or reinsurer are FDAP income, they are exempt from withholding under Treas. Reg. sec. 1.1441-2(a)(7) if the insurance contract is subject to the excise tax under section 4371. Treas. Reg. sec. 1.1441-2(b)(1)(i), -2(b)(2).

⁵¹ For purposes of this rule, whether a person is considered a resident in the United States is determined by application of the rules under section 7701(b).

⁵² Sec. 871(a)(2). In addition, certain capital gains from sales of U.S. real property interests are subject to tax as effectively connected income (or in some instances as dividend income) under the Foreign Investment in Real Property Tax Act of 1980, discussed *infra* at part II.B.4.

⁵³ Secs. 871(a)(1)(D), 881(a)(4).

⁵⁴ Withholding agent is defined broadly to include any U.S. or foreign person that has the control, receipt, custody, disposal, or payment of an item of income of a foreign person subject to withholding. Treas. Reg. sec. 1.1441-7(a).

⁵⁵ Secs. 871, 881, 1441, 1442; Treas. Reg. sec. 1.1441-1(b).

⁵⁶ A reduced rate of withholding of 14 percent applies to certain scholarships and fellowships paid to individuals temporarily present in the United States. Sec. 1441(b). In addition to statutory exemptions, the 30-percent withholding tax with respect to interest, dividends or royalties may be reduced or eliminated by a tax treaty between the United States and the country in which the recipient of income otherwise subject to withholding is resident.

Interest on bank deposits

Interest on bank deposits may qualify for exemption on two grounds, depending on where the underlying principal is held on deposit. Interest paid with respect to deposits with domestic banks and savings and loan associations, and certain amounts held by insurance companies, are U.S. source but are not subject to the U.S. withholding tax when paid to a foreign person, unless the interest is effectively connected with a U.S. trade or business of the recipient.⁵⁷ Interest on deposits with foreign branches of domestic banks and domestic savings and loan associations is not treated as U.S.-source income and is thus exempt from U.S. withholding tax (regardless of whether the recipient is a U.S. or foreign person).⁵⁸ Similarly, interest and original issue discount on certain short-term obligations is also exempt from U.S. withholding tax when paid to a foreign person.⁵⁹ Additionally, there is generally no information reporting required with respect to payments of such amounts.⁶⁰

Portfolio interest

Portfolio interest received by a nonresident individual or foreign corporation from sources within the United States is exempt from 30 percent withholding.⁶¹ For obligations issued before March 19, 2012, the term “portfolio interest” means any interest (including original issue discount) that is paid on an obligation that is in registered form and for which the beneficial owner has provided to the U.S. withholding agent a statement certifying that the beneficial owner is not a U.S. person, as well as interest paid on an obligation that is not in registered form provided the obligation is shown to be targeted to foreign investors under the conditions sufficient to establish deductibility of the payment of such interest.⁶² Portfolio interest, however, does not include interest received by a 10-percent shareholder,⁶³ certain contingent interest,⁶⁴

⁵⁷ Secs. 871(i)(2)(A), 881(d); Treas. Reg. sec. 1.1441-1(b)(4)(ii).

⁵⁸ Sec. 861(a)(1)(B); Treas. Reg. sec. 1.1441-1(b)(4)(iii).

⁵⁹ Secs. 871(g)(1)(B), 881(a)(3); Treas. Reg. sec. 1.1441-1(b)(4)(iv).

⁶⁰ Treas. Reg. sec. 1.1461-1(c)(2)(ii)(A), (B). Regulations require a bank to report interest if the recipient is a resident of Canada and the deposit is maintained at an office in the United States. Treas. Reg. secs. 1.6049-4(b)(5) and 1.6049-8. The IRS and the Treasury Department recently proposed regulations that would expand the required annual reporting to include U.S. bank deposit interest paid to any nonresident alien. Prop. Treas. Reg. sec. 1.6049-4, 76 Fed. Reg. 1105 (Jan. 7, 2011). The proposed regulation is similar to an earlier, short-lived proposal. See 66 Fed. Reg. 3925 (Jan. 17, 2001), withdrawn at 67 Fed. Reg. 50,386 (Aug. 2, 2002).

⁶¹ Secs. 871(h), 881(c). In 1984, to facilitate access to the global market for U.S. dollar-denominated debt obligations, Congress repealed the withholding tax on portfolio interest paid on debt obligations issued by U.S. persons. See Joint Committee on Taxation, *General Explanation of the Revenue Provisions of the Deficit Reduction Act of 1984* (JCS-41-84), December 31, 1984, pp. 391-92.

⁶² Sec. 163(f)(2)(B). The exception to the registration requirements for foreign targeted securities were repealed in 2010, effective for obligations issued two years after enactment, thus narrowing the portfolio interest exemption for obligations issued after March 18, 2012. See, Hiring Incentives to Restore Employment Law of 2010, Pub. L. No. 111-147, sec. 502(b).

⁶³ Sec. 871(h)(3).

interest received by a controlled foreign corporation from a related person,⁶⁵ or interest received by a bank on an extension of credit made pursuant to a loan agreement entered into in the ordinary course of its trade or business.⁶⁶

Reduced and zero rates of withholding under tax treaties

The 30-percent withholding tax on FDAP income is reduced or eliminated under bilateral income tax treaties that cover a large portion of that income. Because each treaty reflects considerations unique to the relationship between the two treaty countries, treaty withholding tax rates on each category of income are not uniform across treaties. The United States, however, has set forth its negotiating position on withholding rates and other provisions in the United States Model Income Tax Convention of November 15, 2006 (the “U.S. Model Treaty”). The following table illustrates treaty reductions of withholding tax and the U.S. Model Treaty rates.

⁶⁴ Sec. 871(h)(4).

⁶⁵ Sec. 881(c)(3)(C).

⁶⁶ Sec. 881(c)(3)(A).

Withholding Tax Rates Under Selected U.S. Bilateral Income Tax Treaties

	Royalties	Interest ¹	Dividends ²
Bangladesh	10	10 (0 or 5 in limited cases)	10 / 15
Canada	10 (certain circumstances 0)	0	5 / 15
Germany	0	0	0 / 5 / 15
Japan	0	10 (certain circumstances 0)	0 / 5 / 10
Malta	10	10	5 / 15
United Kingdom	0	0	0 / 5 / 15
U.S. Model Treaty	0	0	5 / 15

¹ Special rates up to 15 percent may apply with respect to contingent interest.

² The dividend withholding tax rates vary based on the percentage of stock of the dividend-paying company owned by the recipient of the dividend. Certain treaties also contain a holding period requirement (generally 12 months) to obtain a reduced withholding rate even if the ownership requirement is satisfied. Treaties provide lower withholding tax rates (five percent, for example) at ownership levels of ten percent and greater. When available, zero percent withholding rates require ownership of at least 80 percent (in the case of Japan, 50 percent).

Imposition of gross-basis tax and reporting by U.S. withholding agents

The 30-percent tax on FDAP income is generally collected by means of withholding.⁶⁷ In many instances, the income subject to withholding is the only income of the foreign recipient that is subject to any U.S. tax. No U.S. Federal income tax return from the foreign recipient is required with respect to the income from which tax was withheld, if the recipient has no ECI income and the withholding is sufficient to satisfy the recipient's liability. Accordingly,

⁶⁷ Secs. 1441, 1442.

although the 30-percent gross-basis tax is a withholding tax, it is also generally the final tax liability of the foreign recipient.

A withholding agent that makes payments of U.S.-source amounts to a foreign person is required to report and pay over any amounts of U.S. tax withheld. The reports are due to be filed with the IRS by March 15 of the calendar year following the year in which the payment is made. Two types of reports are required: (1) a summary of the total U.S.-source income paid and withholding tax withheld on foreign persons for the year and (2) a report to both the IRS and the foreign person of that person's U.S.-source income that is subject to reporting.⁶⁸ The nonresident withholding rules apply broadly to any financial institution or other payor, including foreign financial institutions.⁶⁹

To the extent that the withholding agent deducts and withholds an amount, the withheld tax is credited to the recipient of the income.⁷⁰ If the agent withholds more than is required, and results in an overpayment of tax, the excess may be refunded to the recipient of the income upon filing of a timely claim for refund.

The U.S. withholding tax rules are administered through a system of self-certification. A nonresident investor seeking to obtain withholding tax relief for U.S.-source investment income must certify to the withholding agent, under penalty of perjury, the person's foreign status and eligibility for an exemption or reduced rate. This self-certification is made on the relevant IRS form, similar to those used by U.S. persons to establish an exemption from the rules governing information reporting on IRS Form 1099 and backup withholding.⁷¹

The United States imposes tax on the beneficial owner of income, not its formal recipient. To avoid cascading imposition of the withholding tax as payments move through intermediaries to the beneficial owner, the regulations outline the specific rules relating to situations whereby an intermediary may take on the responsibility to withhold and the withholding agent may rely upon the intermediary to do so.⁷²

The qualified intermediary program

If the intermediary is a qualified intermediary ("QI"), a withholding foreign partnership, or a withholding foreign trust,⁷³ the series of disclosures described above may be simplified. A

⁶⁸ Treas. Reg. sec. 1.1461-1(b), (c).

⁶⁹ See Treas. Reg. secs. 1.1441-7(a) (definition of withholding agent includes foreign persons).

⁷⁰ Sec. 1462.

⁷¹ See Treas. Reg. sec. 1.1441-1(b)(5).

⁷² Treas. Reg. sec. 1.1441-1(b)(1)

⁷³ A withholding foreign partnership or trust is a foreign partnership or trust that has entered into an agreement with the IRS to collect appropriate IRS Forms W-8 from its partners or beneficiaries and act as a U.S. withholding agent with respect to those persons. Rev. Proc. 2003-64, 2003-32 I.R.B. 306 (July 10, 2003).

QI is defined as a foreign financial institution or a foreign clearing organization, other than a U.S. branch or U.S. office of such institution or organization, which has entered into a withholding and reporting agreement (a “QI agreement”) with the IRS. The definition also includes: a foreign branch or office of a U.S. financial institution or U.S. clearing organization; a foreign corporation for purposes of presenting income tax treaty claims on behalf of its shareholders; and any other person acceptable to the IRS.⁷⁴ A foreign financial institution that becomes a QI is not required to forward beneficial ownership information with respect to its customers to a U.S. financial institution or other withholding agent of U.S.-source investment-type income to establish their eligibility for an exemption from, or reduced rate of, U.S. withholding tax.⁷⁵ Instead, the QI is permitted to establish for itself the eligibility of its customers for an exemption or reduced rate, based on information as to residence obtained under the “know-your-customer” rules to which the QI is subject in its home jurisdiction as approved by the IRS or as specified in the QI agreement. The QI certifies eligibility on behalf of its customers and provides withholding rate pool information to the U.S. withholding agent as to the portion of each payment that qualifies for an exemption or reduced rate of withholding.

In exchange for entering into a QI agreement, the QI is able to shield the identities of its customers from other intermediaries (for example, other financial institutions in the chain of payment that may be business competitors of the QI) in certain circumstances and is subject to reduced information reporting duties to the IRS compared to those that apply in the absence of the QI agreement. This ability to shield customer information is limited, however, with respect to accounts of U.S. persons for which it acts as QI, because the QI is required to furnish Forms 1099 to its U.S. customers if it has assumed primary reporting and backup withholding responsibility for these accounts, or to provide Forms W-9 or information sufficient to complete a Form W-9, to the withholding agent in cases in which the QI has not assumed such primary responsibility.

The terms of a QI agreement include presumptions to apply to different scenarios to determine whether to withhold. U.S.-source investment income that is paid outside the United States to an offshore account is presumed to be paid to an undocumented foreign account holder, thus requiring the QI to withhold at a 30-percent rate and report the payment as a payment to an unknown account holder on IRS Form 1042-S.⁷⁶ Foreign-source income and broker proceeds paid outside the United States to an offshore account are presumed to be paid to a U.S. exempt recipient and thus are exempt from withholding.

⁷⁴ Treas. Reg. sec. 1.1441-1(e)(5)(ii).

⁷⁵ U.S. withholding agents are allowed to rely on a QI’s Form W-8IMY without any underlying beneficial owner documentation. By contrast, nonqualified intermediaries are required both to provide a Form W-8IMY to a U.S. withholding agent and to forward with that document Form W-8s or W-9s for each beneficial owner.

⁷⁶ U.S.-source deposit interest and interest or original issue discount on short-term obligations that are paid outside the United States to an offshore account are statutorily exempt from nonresident withholding when paid to non-U.S. persons, but may be subject to other withholding requirements under regulations or the terms of the QI agreement.

Foreign Account Tax Compliance Act (“FATCA”)

In contrast to the QI regime, which focuses on tax compliance of foreign persons with U.S.-source income, a new Chapter 4, commonly referred to as the Foreign Account Tax Compliance Act,⁷⁷ is a new reporting and withholding regime in subpart A of the Code that addresses compliance of U.S. persons.⁷⁸ The new regime requires reporting of specific information by third parties for certain U.S. accounts held in foreign financial institutions (“FFIs”).⁷⁹ Information reporting is encouraged by requiring that a withholding tax of 30 percent of the gross amount of certain payments to FFIs be withheld unless the FFI enters into and complies with an information reporting agreement with the Secretary of the Treasury.⁸⁰

3. Net-basis taxation

Income from a U.S. business

The United States taxes on a net basis the income of foreign persons that is “effectively connected” with the conduct of a trade or business in the United States.⁸¹ Any gross income derived by the foreign person that is not effectively connected with the person’s U.S. business is not taken into account in determining the rates of U.S. tax applicable to the person’s income from the business.⁸²

U.S. trade or business

A foreign person is subject to U.S. tax on a net basis if the person is engaged in a U.S. trade or business. Partners in a partnership and beneficiaries of an estate or trust are treated as engaged in the conduct of a trade or business within the United States if the partnership, estate, or trust is so engaged.⁸³

The question whether a foreign person is engaged in a U.S. trade or business is factual and has generated much case law. Basic issues include whether the activity constitutes business

⁷⁷ Foreign Account Tax Compliance Act of 2009 is the name of the House and Senate bills in which the provisions first appeared. See H.R. 3933 and S. 1934 (October 27, 2009).

⁷⁸ Hiring Incentives to Restore Employment (“HIRE”) Act of 2010, Pub. L. No. 111-147.

⁷⁹ Under section 1471(c), an FFI must report with respect to a U.S. account (1) the name, address, and taxpayer identification number of each U.S. person holding an account or a foreign entity with one or more substantial U.S. owners holding an account, (2) the account number, (3) the account balance or value, and (4) except as provided by the Secretary, the gross receipts and gross withdrawals or payments from the account.

⁸⁰ The information reporting requirement under Chapter 4 generally applies to payments made after December 31, 2012.

⁸¹ Secs. 871(b), 882.

⁸² Secs. 871(b)(2), 882(a)(2).

⁸³ Sec. 875.

rather than investing, whether sufficient activities in connection with the business are conducted in the United States, and whether the relationship between the foreign person and persons performing functions in the United States in respect of the business is sufficient to attribute those functions to the foreign person.

The trade or business rules differ from one activity to another. The term “trade or business within the United States” expressly includes the performance of personal services within the United States.⁸⁴ If, however, a nonresident alien individual performs personal services for a foreign employer, and the individual’s total compensation for the services and period in the United States are minimal (\$3,000 or less in total compensation and 90 days or fewer of physical presence in a year), the individual is not considered to be engaged in a U.S. trade or business.⁸⁵ Detailed rules govern whether trading in stocks or securities or commodities constitutes the conduct of a U.S. trade or business.⁸⁶ A foreign person who trades in stock or securities or commodities in the United States through an independent agent generally is not treated as engaged in a U.S. trade or business if the foreign person does not have an office or other fixed place of business in the United States through which trades are carried out. A foreign person who trades stock or securities or commodities for the person’s own account also generally is not considered to be engaged in a U.S. business so long as the foreign person is not a dealer in stock or securities or commodities.

For eligible foreign persons, U.S. bilateral income tax treaties restrict the application of net-basis U.S. taxation. Under each treaty, the United States is permitted to tax business profits only to the extent those profits are attributable to a U.S. permanent establishment of the foreign person. The threshold level of activities that constitute a permanent establishment is generally higher than the threshold level of activities that constitute a U.S. trade or business. For example, a permanent establishment typically requires the maintenance of a fixed place of business over a significant period of time.

Effectively connected income (“ECI”)

A foreign person that is engaged in the conduct of a trade or business within the United States is subject to U.S. net-basis taxation on the income that is “effectively connected” with the business. Specific statutory rules govern whether income is ECI.⁸⁷

In the case of U.S.-source capital gain and U.S.-source income of a type that would be subject to gross basis U.S. taxation, the factors taken into account in determining whether the income is ECI include whether the income is derived from assets used in or held for use in the conduct of the U.S. trade or business and whether the activities of the trade or business were a

⁸⁴ Sec. 864(b).

⁸⁵ Sec. 864(b)(1).

⁸⁶ Sec. 864(b)(2).

⁸⁷ Sec. 864(c).

material factor in the realization of the amount (the “asset use” and “business activities” tests).⁸⁸ Under the asset use and business activities tests, due regard is given to whether the income, gain, or asset was accounted for through the U.S. trade or business. All other U.S.-source income is treated as ECI.⁸⁹

A foreign person who is engaged in a U.S. trade or business may have limited categories of foreign-source income that are considered to be ECI.⁹⁰ Foreign-source income not included in one of these categories (described next) generally is exempt from U.S. tax.

A foreign person’s foreign-source income generally is considered to be ECI only if the person has an office or other fixed place of business within the United States to which the income is attributable and the income is in one of the following categories: (1) rents or royalties for the use of patents, copyrights, secret processes or formulas, good will, trade-marks, trade brands, franchises, or other like intangible properties derived in the active conduct of the trade or business; (2) interest or dividends derived in the active conduct of a banking, financing, or similar business within the United States or received by a corporation the principal business of which is trading in stocks or securities for its own account; or (3) income derived from the sale or exchange (outside the United States), through the U.S. office or fixed place of business, of inventory or property held by the foreign person primarily for sale to customers in the ordinary course of the trade or business, unless the sale or exchange is for use, consumption, or disposition outside the United States and an office or other fixed place of business of the foreign person in a foreign country participated materially in the sale or exchange.⁹¹ Foreign-source dividends, interest, and royalties are not treated as ECI if the items are paid by a foreign corporation more than 50 percent (by vote) of which is owned directly, indirectly, or constructively by the recipient of the income.⁹²

In determining whether a foreign person has a U.S. office or other fixed place of business, the office or other fixed place of business of an agent generally is disregarded. The place of business of an agent other than an independent agent acting in the ordinary course of business is not disregarded, however, if the agent either has the authority (regularly exercised) to negotiate and conclude contracts in the name of the foreign person or has a stock of merchandise from which he regularly fills orders on behalf of the foreign person.⁹³ If a foreign person has a U.S. office or fixed place of business, income, gain, deduction, or loss is not considered attributable to the office unless the office was a material factor in the production of the income,

⁸⁸ Sec. 864(c)(2).

⁸⁹ Sec. 864(c)(3).

⁹⁰ This income is subject to net-basis U.S. taxation after allowance of a credit for any foreign income tax imposed on the income. Sec. 906.

⁹¹ Sec. 864(c)(4)(B).

⁹² Sec. 864(c)(4)(D)(i).

⁹³ Sec. 864(c)(5)(A).

gain, deduction, or loss and the office regularly carries on activities of the type from which the income, gain, deduction, or loss was derived.⁹⁴

Special rules apply in determining the ECI of an insurance company. The foreign-source income of a foreign corporation that is subject to tax under the insurance company provisions of the Code is treated as ECI if the income is attributable to its United States business.⁹⁵

Income, gain, deduction, or loss for a particular year generally is not treated as ECI if the foreign person is not engaged in a U.S. trade or business in that year.⁹⁶ If, however, income or gain taken into account for a taxable year is attributable to the sale or exchange of property, the performance of services, or any other transaction that occurred in a prior taxable year, the determination whether the income or gain is taxable on a net basis is made as if the income were taken into account in the earlier year and without regard to the requirement that the taxpayer be engaged in a trade or business within the United States during the later taxable year.⁹⁷ If any property ceases to be used or held for use in connection with the conduct of a U.S. trade or business and the property is disposed of within 10 years after the cessation, the determination whether any income or gain attributable to the disposition of the property is taxable on a net basis is made as if the disposition occurred immediately before the property ceased to be used or held for use in connection with the conduct of a U.S. trade or business and without regard to the requirement that the taxpayer be engaged in a U.S. business during the taxable year for which the income or gain is taken into account.⁹⁸

Allowance of deductions

Taxable ECI is computed by taking into account deductions associated with gross ECI. For this purpose, the apportionment and allocation of deductions is addressed in detailed regulations. The regulations applicable to deductions other than interest expense set forth general guidelines for allocating deductions among classes of income and apportioning deductions between ECI and non-ECI. In some circumstances, deductions may be allocated on the basis of units sold, gross sales or receipts, costs of goods sold, profits contributed, expenses incurred, assets used, salaries paid, space used, time spent, or gross income received. More specific guidelines are provided for the allocation and apportionment of research and experimental expenditures, legal and accounting fees, income taxes, losses on dispositions of property, and net operating losses. Detailed regulations under section 861 address the allocation and apportionment of interest deductions. In general, interest is allocated and apportioned based on assets rather than income.

⁹⁴ Sec. 864(c)(5)(B).

⁹⁵ Sec. 864(c)(4)(C).

⁹⁶ Sec. 864(c)(1)(B).

⁹⁷ Sec. 864(c)(6).

⁹⁸ Sec. 864(c)(7).

4. Special rules⁹⁹

Branch taxes

A domestic corporation owned by foreign persons is subject to U.S. income tax on its net income. The earnings of the domestic corporation are subject to a second tax, this time at the shareholder level, when dividends are paid. As described previously, when the shareholders are foreign, the second-level tax is imposed at a flat rate and collected by withholding. Unless the portfolio interest exemption or another exemption applies, interest payments made by a domestic corporation to foreign creditors are likewise subject to U.S. withholding tax. To approximate these second-level withholding taxes imposed on payments made by domestic subsidiaries to their foreign parent corporations, the United States taxes a foreign corporation that is engaged in a U.S. trade or business through a U.S. branch on amounts of U.S. earnings and profits that are shifted out of, or amounts of interest that are deducted by, the U.S. branch of the foreign corporation. These branch taxes may be reduced or eliminated under an applicable income tax treaty.¹⁰⁰

The United States imposes a tax of 30 percent on a foreign corporation's "dividend equivalent amount."¹⁰¹ The dividend equivalent amount generally is the earnings and profits of a U.S. branch of a foreign corporation attributable to its ECI.¹⁰² Limited categories of earnings and profits attributable to a foreign corporation's ECI are excluded in calculating the dividend equivalent amount.¹⁰³

In arriving at the dividend equivalent amount, a branch's effectively connected earnings and profits are adjusted to reflect changes in a branch's U.S. net equity (that is, the excess of the branch's assets over its liabilities, taking into account only amounts treated as connected with its U.S. trade or business).¹⁰⁴ The first adjustment reduces the dividend equivalent amount to the extent the branch's earnings are reinvested in trade or business assets in the United States (or reduce U.S. trade or business liabilities). The second adjustment increases the dividend equivalent amount to the extent prior reinvested earnings are considered remitted to the home office of the foreign corporation.

⁹⁹ For legislative background to the rules described below, see Joint Committee on Taxation, *Present Law and Background Related to U.S. Activities of Foreign Persons* (JCX-37-11), June 22, 2011, pp. 30, 34-39.

¹⁰⁰ See Treas. Reg. sec. 1.884-1(g), -5.

¹⁰¹ Sec. 884(a).

¹⁰² Sec. 884(b).

¹⁰³ See sec. 884(d)(2) (excluding, for example, earnings and profits attributable to gain from the sale of U.S. real property interests described in section 897 (discussed below)).

¹⁰⁴ Sec. 884(b).

Interest paid by a U.S. trade or business of a foreign corporation generally is treated as if paid by a domestic corporation and therefore is subject to U.S. 30-percent withholding tax (if the interest is paid to a foreign person and a Code or treaty exemption or reduction would not be available if the interest were actually paid by a domestic corporation).¹⁰⁵ Certain “excess interest” of a U.S. trade or business of a foreign corporation is treated as if paid by a U.S. corporation to a foreign parent and, therefore, is subject to U.S. 30-percent withholding tax.¹⁰⁶ For this purpose, excess interest is the excess of the interest expense of the foreign corporation apportioned to the U.S. trade or business over the amount of interest paid by the trade or business.

Foreign Investment in Real Property Tax Act of 1980 (“FIRPTA”)

A foreign person that is not engaged in business in the United States (and is not an individual who is present in the United States at least 183 days in the year) generally is not subject to any U.S. tax on capital gain from U.S. sources.¹⁰⁷

The Foreign Investment in Real Property Tax Act of 1980 (“FIRPTA”)¹⁰⁸ generally treats a foreign person’s gain or loss from the disposition of a U.S. real property interest (“USRPI”) as ECI and, therefore, as taxable at the income tax rates applicable to U.S. persons, including the rates for net capital gain. A foreign person subject to tax on this income is required to file a U.S. tax return under the normal rules relating to receipt of ECI.¹⁰⁹ In the case of a foreign corporation, the gain from the disposition of a USRPI may also be subject to the branch profits tax at a 30-percent rate (or lower treaty rate).

The payor of income that FIRPTA treats as ECI (“FIRPTA income”) is generally required to withhold U.S. tax from the payment. Withholding is generally 10 percent of the sales price, in the case of a direct sale by the foreign person of a USRPI, and 35 percent of the amount of a distribution to a foreign person of proceeds attributable to such sales from an entity such as a partnership, real estate investment trust (“REIT”) or regulated investment company (“RIC”).¹¹⁰ The foreign person can request a refund with its U.S. tax return, if appropriate, based on that person’s total ECI and deductions (if any) for the taxable year.

¹⁰⁵ Sec. 884(f)(1)(A).

¹⁰⁶ Sec. 884(f)(1)(B).

¹⁰⁷ Secs. 871(b), 882(a).

¹⁰⁸ Pub. L. No. 96-499. The rules governing the imposition and collection of tax under FIRPTA are contained in a series of provisions enacted in 1980 and subsequently amended. See secs. 897, 1445, 6039C, 6652(f).

¹⁰⁹ Sec. 897(a). In addition, section 6039C authorizes regulations that would require a return reporting foreign direct investments in U.S. real property interests. No such regulations have been issued, however.

¹¹⁰ Sec. 1445 and Treasury regulations thereunder. The Treasury Department is authorized to issue regulations that would reduce the 35 percent withholding on distributions to 15 percent during the time that the maximum income tax rate on dividends and capital gains of U.S. persons is 15 percent.

USRPIs include interests in real property located in the United States or the U.S. Virgin Islands, and interests (other than any interest solely as a creditor) in a domestic U.S. real property holding corporation (“USRPHC”), generally defined as any corporation, unless the taxpayer establishes that the fair market value of the corporation’s USRPIs was less than 50 percent of the combined fair market value of all its real property interests (U.S. and worldwide) and of all its assets used or held for use in a trade or business, at all times during the shorter of the taxpayer’s ownership of the stock or the five-year period ending on the date of disposition of the stock.¹¹¹ However, any class of stock that is regularly traded on an established securities market is treated as a USRPI only if the seller held more than five percent of the stock at any time during such period.¹¹²

Under these rules, for example, if a foreign person directly owns U.S. real estate, or owns U.S. real estate through a partnership, gain from the sale of the real estate is subject to tax as FIRPTA income. Alternatively, if a foreign person owns U.S. real estate through a corporation that is a USRPHC that is not publicly traded (or owns more than five percent of the stock of a publicly traded USRPHC during the relevant period), gain from sale of the corporate stock is generally subject to tax as FIRPTA income.

Special rules apply to real estate investment trusts (“REITs”) and to regulated investment companies (“RICs” or mutual funds) that predominantly own USRPIs.¹¹³

Earnings stripping

Foreign corporations are limited in their ability to reduce the U.S. tax on the income derived from their U.S. subsidiaries’ operations through certain earnings stripping transactions involving interest payments. If the payor’s debt-to-equity ratio exceeds 1.5 to 1 (a debt-to-equity ratio of 1.5 to 1 or less is considered a “safe harbor”), a deduction for “disqualified interest” paid or accrued by the payor in a taxable year is generally disallowed to the extent of the payor’s “excess interest expense.”¹¹⁴ Disqualified interest includes interest paid or accrued to related parties when no Federal income tax is imposed with respect to such interest;¹¹⁵ to unrelated parties in certain instances in which a related party guarantees the debt (“guaranteed debt”); or to a REIT by a taxable REIT subsidiary of that REIT. Excess interest expense is the amount by

¹¹¹ Secs. 897(c)(1)(A)(ii), 897(c)(2).

¹¹² Sec. 897(c)(3). Constructive ownership rules apply under section 897(c)(6)(C).

¹¹³ Sec. 897(h). REITs and these RICs are referred to in section 897(h) as “qualified investment entities.” The IRS has issued guidance clarifying that tax under FIRPTA applies when a foreign government receives a distribution from a qualified investment entity that is attributable to the entity’s gain from the sale of USRPIs. Notice 2007-55, 2007-2 C.B. 13 (July 2, 2007).

¹¹⁴ Sec. 163(j).

¹¹⁵ If a tax treaty reduces the rate of tax on interest paid or accrued by the taxpayer, the interest is treated as interest on which no Federal income tax is imposed to the extent of the same proportion of such interest as the rate of tax imposed without regard to the treaty, reduced by the rate of tax imposed under the treaty, bears to the rate of tax imposed without regard to the treaty. Sec. 163(j)(5)(B).

which the payor's "net interest expense" (that is, the excess of interest paid or accrued over interest income) exceeds 50 percent of its "adjusted taxable income" (generally taxable income computed without regard to deductions for net interest expense, net operating losses, domestic production activities under section 199, depreciation, amortization, and depletion). Interest amounts disallowed under these rules can be carried forward indefinitely and are allowed as a deduction to the extent of excess limitation in a subsequent tax year. In addition, any excess limitation (that is, the excess, if any, of 50 percent of the adjusted taxable income of the payor over the payor's net interest expense) can be carried forward three years.

Example.

The operation of these rules is illustrated by the following example. ForCo, a corporation organized in country A, wholly owns USCo, a corporation organized in the United States. ForCo's investment in USCo stock totals \$6.5 million. In addition, USCo has borrowed \$8 million from ForCo and \$5 million from Bank, an unrelated bank. In 20XX, USCo's first year of operation, USCo's adjusted taxable income is \$1 million (none of which is from interest income), and it also pays \$400,000 of interest to ForCo and \$300,000 of interest to Bank. Under the U.S.-country A income tax treaty, no tax is owed to the United States on the interest payments made by USCo to ForCo.

USCo has a 2:1 debt-to-equity ratio (total borrowings of \$13 million (\$8 million + \$5 million) and total equity of \$6.5 million), so USCo's deduction for the \$700,000 (\$400,000 + \$300,000) of interest it paid may be limited.

USCo's disqualified interest is \$400,000 (the amount of interest paid to a related party on which no Federal income tax is imposed).

USCo's excess interest expense is \$200,000 ($\$700,000 - (\$1 \text{ million} \times 50\%)$).

Accordingly, USCo may deduct only \$500,000 ($\$700,000 - \$200,000$) for interest expense in year 20XX.

The \$200,000 of excess interest expense may be carried forward and deducted in a subsequent tax year with excess limitation.

C. U.S. Tax Rules Applicable to Foreign Activities of U.S. Persons (Outbound)

1. In general

The United States has a worldwide tax system under which U.S. citizens, resident individuals, and domestic corporations generally are taxed on all income, whether derived in the United States or abroad. Income earned by a domestic parent corporation from foreign operations conducted by foreign corporate subsidiaries generally is subject to U.S. tax when the income is distributed as a dividend to the domestic parent corporation. Until that repatriation, the U.S. tax on the income generally is deferred. However, certain anti-deferral regimes may cause the domestic parent corporation to be taxed on a current basis in the United States on certain categories of passive or highly mobile income earned by its foreign corporate subsidiaries, regardless of whether the income has been distributed as a dividend to the domestic parent corporation. The main anti-deferral regimes in this context are the controlled foreign corporation rules of subpart F¹¹⁶ and the passive foreign investment company rules.¹¹⁷ A foreign tax credit generally is available to offset, in whole or in part, the U.S. tax owed on foreign-source income, whether the income is earned directly by the domestic corporation, repatriated as an actual dividend, or included in the domestic parent corporation's income under one of the anti-deferral regimes.¹¹⁸

2. Foreign tax credit

Subject to certain limitations, U.S. citizens, resident individuals, and domestic corporations are allowed to claim credit for foreign income taxes they pay. A domestic corporation that owns at least 10 percent of the voting stock of a foreign corporation is allowed a "deemed-paid" credit for foreign income taxes paid by the foreign corporation that the domestic corporation is deemed to have paid when the related income is distributed or included in the domestic corporation's income under the anti-deferral rules.¹¹⁹

The foreign tax credit generally is limited to a taxpayer's U.S. tax liability on its foreign-source taxable income (as determined under U.S. tax accounting principles). This limit is intended to ensure that the credit serves its purpose of mitigating double taxation of foreign-source income without offsetting U.S. tax on U.S.-source income.¹²⁰ The limit is computed by multiplying a taxpayer's total U.S. tax liability for the year by the ratio of the taxpayer's foreign-source taxable income for the year to the taxpayer's total taxable income for the year. If the total amount of foreign income taxes paid and deemed paid for the year exceeds the taxpayer's

¹¹⁶ Secs. 951-964.

¹¹⁷ Secs. 1291-1298.

¹¹⁸ Secs. 901, 902, 960, 1291(g).

¹¹⁹ Secs. 901, 902, 960, 1295(f).

¹²⁰ Secs. 901, 904.

foreign tax credit limitation for the year, the taxpayer may carry back the excess foreign taxes to the previous year or carry forward the excess taxes to one of the succeeding 10 years.¹²¹

The computation of the foreign tax credit limitation requires a taxpayer to determine the amount of its taxable income from foreign sources in each category by allocating and apportioning deductions between U.S.-source gross income, on the one hand, and foreign-source gross income in each limitation category (described below), on the other.¹²² In general, deductions are allocated and apportioned to the gross income to which the deductions factually relate.¹²³ However, subject to certain exceptions, deductions for interest expense and research and experimental expenses are apportioned based on taxpayer ratios.¹²⁴ In the case of interest expense, this ratio is the ratio of the corporation's foreign or domestic (as applicable) assets to its worldwide assets. In the case of research and experimental expenses, the apportionment ratio is based on either sales or gross income. All members of an affiliated group of corporations generally are treated as a single corporation for purposes of determining the apportionment ratios.¹²⁵

The term “affiliated group” is determined generally by reference to the rules for determining whether corporations are eligible to file consolidated returns.¹²⁶ These rules exclude foreign corporations from an affiliated group.¹²⁷ The American Jobs Creation Act of 2004 (“AJCA”)¹²⁸ modified the interest expense allocation rules for taxable years beginning after December 31, 2008.¹²⁹ The effective date of the modified rules has been delayed to January 1, 2021.¹³⁰ The new rules permit a U.S. affiliated group to apportion the interest expense of the members of the U.S. affiliated group on a worldwide-group basis (that is, as if all domestic and foreign affiliates are a single corporation). A result of this rule is that interest expense of foreign

¹²¹ Sec. 904(c).

¹²² Subject to applicable limitations, deductions allocated and apportioned to foreign-source gross income are deductible on a current basis irrespective of whether the related foreign income is taken into account currently or is deferred. To the extent that foreign income is deferred indefinitely or permanently, this treatment could create a situation in which there is effectively a negative tax rate because expenses that are deducted are never matched up to the corresponding — but untaxed — income they produce.

¹²³ Treas. Reg. sec. 1.861-8(b) and Temp. Treas. Reg. sec. 1.861-8T(c).

¹²⁴ Temp. Treas. Reg. sec. 1.861-9T and Treas. Reg. sec. 1.861-17.

¹²⁵ Sec. 864(e)(1), (6); Temp. Treas. Reg. sec. 1.861-14T(e)(2).

¹²⁶ Secs. 864(e)(5), 1504.

¹²⁷ Sec. 1504(b)(3).

¹²⁸ Pub. L. No. 108-357.

¹²⁹ AJCA, sec. 401.

¹³⁰ Hiring Incentives to Restore Employment Act, Pub. L. No. 111-147, sec. 551(a).

members of a U.S. affiliated group is taken into account in determining whether a portion of the interest expense of the domestic members of the group must be allocated to foreign-source income. An allocation to foreign-source income generally is required only if, in broad terms, the domestic members of the group are more highly leveraged than is the entire worldwide group. The new rules are generally expected to reduce the amount of the U.S. group's interest expense that is allocated to foreign-source income.

The foreign tax credit limitation is applied separately to "passive category income" and to "general category income."¹³¹ Passive category income includes passive income, such as portfolio interest and dividend income, and certain specified types of income. General category income includes all other income. Passive income is treated as general category income if it is earned by a qualifying financial services entity. Passive income is also treated as general category income if it is highly taxed (that is, if the foreign tax rate is determined to exceed the highest rate of tax specified in Code section 1 or 11, as applicable). Dividends (and subpart F inclusions), interest, rents, and royalties received by a 10-percent U.S. shareholder from a controlled foreign corporation are assigned to a separate limitation category by reference to the category of income out of which the dividends or other payments were made.¹³² Dividends received by a 10-percent corporate shareholder of a foreign corporation that is not a controlled foreign corporation are also categorized on a look-through basis.¹³³

Application of the foreign tax credit limitation separately to passive category income (generally considered to be low-taxed income) and general category income is intended to limit cross-crediting (that is, the use of foreign taxes imposed at high foreign tax rates to reduce the residual U.S. tax on low-taxed foreign-source income). However, even with these constraints, the current system allows cross-crediting. For example, excess foreign taxes, such as those arising in connection with the receipt of dividends from a high-taxed controlled foreign corporation, may be used to offset U.S. tax on royalties received for the use of intangible property in a low-tax country.

¹³¹ Sec. 904(d). AJCA generally reduced the number of income categories from nine to two, effective for tax years beginning in 2006. Before AJCA, the foreign tax credit limitation was applied separately to the following categories of income: (1) passive income, (2) high withholding tax interest, (3) financial services income, (4) shipping income, (5) certain dividends received from noncontrolled section 902 foreign corporations (also known as "10/50 companies"), (6) certain dividends from a domestic international sales corporation or former domestic international sales corporation, (7) taxable income attributable to certain foreign trade income, (8) certain distributions from a foreign sales corporation or former foreign sales corporation, and (9) any other income not described in items (1) through (8) (so-called "general basket" income). A number of other provisions of the Code, including several enacted in 2010 as part of Pub. L. No. 111-226, create additional separate categories in specific circumstances or limit the availability of the foreign tax credit in other ways. See, for example, secs. 865(h), 901(j), 904(d)(6), and 904(h)(10).

¹³² Sec. 904(d)(3). The subpart F rules applicable to controlled foreign corporations and their 10-percent U.S. shareholders are described below.

¹³³ Sec. 904(d)(4).

3. Anti-deferral regimes

In general

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

Subpart F

Generally

Subpart F,¹³⁴ 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 (“CFC”) generally is defined as any foreign corporation if U.S. persons own (directly, indirectly, or constructively) more than 50 percent of the corporation’s stock (measured by vote or value), taking into account only those U.S. persons that own at least 10 percent of the stock (measured by vote only).¹³⁵ Under the subpart F rules, the United States generally taxes the 10-percent U.S. shareholders of a CFC on their pro rata shares of certain income of the CFC (referred to as “subpart F income”), without regard to whether the income is distributed to the shareholders.¹³⁶

With exceptions described below, 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,¹³⁷ insurance income,¹³⁸ and certain income relating to international boycotts and other violations of public policy.¹³⁹ Foreign base company income consists of foreign personal holding company income, which includes passive income such as dividends, interest, rents, and royalties, and a number of categories of income from

¹³⁴ Secs. 951-964.

¹³⁵ Secs. 951(b), 957, 958.

¹³⁶ Sec. 951(a).

¹³⁷ Sec. 954.

¹³⁸ Sec. 953.

¹³⁹ Sec. 952(a)(3)-(5).

business operations, including foreign base company sales income, foreign base company services income, and foreign base company oil-related income.¹⁴⁰

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

The 10-percent U.S. shareholders of a CFC also are required to include currently in income for U.S. tax purposes their pro rata shares of the corporation's untaxed earnings invested in certain items of U.S. property.¹⁴¹ This U.S. property generally includes tangible property located in the United States, stock of a U.S. corporation, an obligation of a U.S. person, and certain intangible assets, such as patents and copyrights, acquired or developed by the CFC for use in the United States.¹⁴² There are specific exceptions to the general definition of U.S. property, including for bank deposits, certain export property, and certain trade or business obligations.¹⁴³ The inclusion rule for investment of earnings in U.S. property is intended to prevent taxpayers from avoiding U.S. tax on dividend repatriations by repatriating CFC earnings through non-dividend payments, such as loans to U.S. persons.

Exceptions: CFC look-through and active financing income

A temporary provision enacted in 2006 (colloquially referred to as the "CFC look-through" rule) excludes from foreign personal holding company income dividends, interest, rents, and royalties received or accrued by one CFC from a related CFC (with relation based on control) to the extent attributable or properly allocable to non-subpart-F income of the payor.¹⁴⁴ The exclusion originally applied for taxable years beginning after 2005 and before 2009 and has been extended most recently to apply for taxable years of the foreign corporation beginning before 2012.¹⁴⁵

Under a provision enacted in 1997 and originally applicable only for one taxable year,¹⁴⁶ there is an exclusion from subpart F income for certain income of a CFC that is derived in the active conduct of a banking or financing business ("active financing income").¹⁴⁷ Congress has

¹⁴⁰ Sec. 954. AJCA eliminated the category of foreign base company shipping income.

¹⁴¹ Secs. 951(a)(1)(B), 956.

¹⁴² Sec. 956(c)(1).

¹⁴³ Sec. 956(c)(2).

¹⁴⁴ Sec. 954(c)(6).

¹⁴⁵ Sec. 954(c)(6)(C). Tax Relief, Unemployment Insurance Reauthorization, and Job Creation Act of 2010, Pub. L. No. 111-312, sec. 751(a).

¹⁴⁶ Taxpayer Relief Act of 1997, Pub. L. No. 105-34, sec. 1175.

¹⁴⁷ Sec. 954(h).

extended the application of section 954(h) several times, most recently in 2010.¹⁴⁸ The exception from subpart F for active financing income now applies to taxable years of foreign corporations starting before January 1, 2012 (and to taxable years of 10-percent U.S. shareholders with or within which those corporate taxable years end).¹⁴⁹

AJCA expanded the scope of the active financing income exclusion from subpart F. Income is treated as active financing income (and was so treated before AJCA) only if, among other requirements, it is derived by a CFC or by a qualified business unit of that CFC. After the enactment of AJCA, certain activities conducted by persons related to the CFC or its qualified business unit are treated as conducted directly by the CFC or qualified business unit.¹⁵⁰ An activity qualifies under this rule if the activity is performed by employees of the related person and if the related person is an eligible CFC the home country of which is the same as the home country of the related CFC or qualified business unit; the activity is performed in the home country of the related person; and the related person receives arm's-length compensation that is treated as earned in the home country. Income from an activity qualifying under this rule is excepted from subpart F income so long as the other active financing requirements are satisfied.

Other exclusions from foreign personal holding company income include exceptions for dividends and interest received by a CFC from a related corporation organized and operating in the same foreign country in which the CFC is organized and for rents and royalties received by a CFC from a related corporation for the use of property within the country in which the CFC is organized.¹⁵¹ These exclusions do not apply to the extent the payments reduce the subpart F income of the payor. There is an exception from foreign base company income and insurance income for any item of income received by a CFC if the taxpayer establishes that the income was subject to an effective foreign income tax rate greater than 90 percent of the maximum U.S. corporate income tax rate (that is, more than 90 percent of 35 percent, or 31.5 percent).¹⁵²

Passive foreign investment companies

The Tax Reform Act of 1986 established an anti-deferral regime for passive foreign investment companies ("PFICs"). A PFIC generally is defined as any foreign corporation if 75 percent or more of its gross income for the taxable year consists of passive income, or 50 percent or more of its assets consists of assets that produce, or are held for the production of, passive income.¹⁵³ Alternative sets of income inclusion rules apply to U.S. persons that are shareholders

¹⁴⁸ Tax Relief, Unemployment Insurance Reauthorization, and Job Creation Act of 2010, Pub. L. No. 111-312, sec. 750(a); Pub. L. No. 107-147, sec. 614 (2002); Pub. L. No. 106-170, sec. 503 (1999); Pub. L. No. 105-277 (1998).

¹⁴⁹ TIPRA sec. 103(a)(2); Code sec. 954(h)(9).

¹⁵⁰ AJCA sec. 416; Code sec. 954(h)(3)(E).

¹⁵¹ Sec. 954(c)(3).

¹⁵² Sec. 954(b)(4).

¹⁵³ Sec. 1297.

in a PFIC, 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.¹⁵⁴ 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.¹⁵⁵ A third set of rules applies to PFIC stock that is marketable, under which electing U.S. shareholders currently take into account as income (or loss) the difference between the fair market value of 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.”¹⁵⁶

Other anti-deferral rules

The subpart F and PFIC rules are not the only anti-deferral regimes. Other rules that impose current U.S. taxation on income earned through corporations include the accumulated earnings tax rules¹⁵⁷ and the personal holding company rules.¹⁵⁸ Until the enactment of AJCA, the Code included two other sets of anti-deferral rules, those applicable to foreign personal holding companies and those for foreign investment companies.¹⁵⁹ Because the overlap among the various anti-deferral regimes was seen as creating complexity, often with no ultimate tax consequences, AJCA repealed the foreign personal holding company and foreign investment company rules.¹⁶⁰

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 PFIC with respect to a particular shareholder if the corporation is also a CFC and the shareholder is a 10-percent U.S. shareholder. Thus, subpart F is allowed to trump the PFIC rules.

¹⁵⁴ Secs. 1293-1295.

¹⁵⁵ Sec. 1291.

¹⁵⁶ Sec. 1296.

¹⁵⁷ Secs. 531-537.

¹⁵⁸ Secs. 541-547. The accumulated earnings tax rules and the personal holding company rules apply in respect of both U.S.-source and foreign-source income.

¹⁵⁹ Secs. 551-558, 1246-1247.

¹⁶⁰ AJCA sec. 413.

4. Other special rules

Temporary dividends received deduction for repatriated foreign earnings

AJCA section 421 added to the Code section 965, a temporary provision intended to encourage U.S. multinational companies to repatriate foreign earnings. Under section 965, for one taxable year certain dividends received by a U.S. corporation from its CFCs were eligible for an 85-percent dividends-received deduction. At the taxpayer's election, this deduction was available for dividends received either during the taxpayer's first taxable year beginning on or after October 22, 2004, or during the taxpayer's last taxable year beginning before such date.

The temporary deduction was subject to a number of general limitations. First, it applied only to cash repatriations generally in excess of the taxpayer's average repatriation level calculated for a three-year base period preceding the year of the deduction. Second, the amount of dividends eligible for the deduction was generally limited to the amount of earnings shown as permanently invested outside the United States on the taxpayer's recent audited financial statements. Third, to qualify for the deduction, dividends were required to be invested in the United States according to a domestic reinvestment plan approved by the taxpayer's senior management and board of directors.¹⁶¹

No foreign tax credit (or deduction) was allowed for foreign taxes attributable to the deductible portion of any dividend.¹⁶² For this purpose, the taxpayer was permitted to specifically identify which dividends were treated as carrying the deduction and which dividends were not. In other words, the taxpayer was allowed to choose which of its dividends were treated as meeting the base-period repatriation level (and thus carry foreign tax credits, to the extent otherwise allowable), and which of its dividends were treated as part of the excess eligible for the deduction (and thus subject to proportional disallowance of any associated foreign tax credits).¹⁶³ Deductions were disallowed for expenses that were directly allocable to the deductible portion of any dividend.¹⁶⁴

Corporate inversions

The U.S. tax treatment of a multinational corporate group depends significantly on whether the parent corporation of the group is domestic or foreign. For purposes of U.S. tax law, a corporation is treated as domestic if it is incorporated under the laws of the United States or of

¹⁶¹ Section 965(b)(4). The plan was required 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, and the financial stabilization of the corporation for the purposes of job retention or creation.

¹⁶² Section 965(d)(1).

¹⁶³ Accordingly, taxpayers generally were expected to pay regular dividends out of high-taxed CFC earnings (thereby generating deemed-paid credits available to offset foreign-source income) and section 965 dividends out of low-taxed CFC earnings (thereby availing themselves of the 85-percent deduction).

¹⁶⁴ Section 965(d)(2).

any State.¹⁶⁵ All other corporations (that is, those incorporated under the laws of foreign countries) are treated as foreign.¹⁶⁶ Thus, place of incorporation determines whether a corporation is treated as domestic or foreign for purposes of U.S. tax law, irrespective of other factors that might be thought to bear on a corporation's "nationality," such as the location of the corporation's management activities, employees, business assets, operations, revenue sources, the exchanges on which the corporation's stock is traded, or the residence of the corporation's shareholders. Only domestic corporations are subject to U.S. tax on a worldwide basis. Foreign corporations are taxed only on income that has a sufficient connection with the United States.

Until enactment of AJCA, a U.S. parent corporation could reincorporate in a foreign jurisdiction, potentially without any exit tax to compensate the United States for the loss of future tax revenue from the departing company.¹⁶⁷ It was not always clear, however, whether the reincorporations had a significant non-tax purpose or effect, or whether the corporate group had a significant business presence in the new country of incorporation. These transactions were commonly referred to as inversions. Under prior law, inversion transactions could produce a variety of tax benefits, including the removal of a group's foreign operations from U.S. tax jurisdiction and the potential for reduction of U.S. tax on U.S.-source income through subsequent earnings stripping transactions (for example, subject to rules described immediately above, large payments of interest or royalties from a U.S. subsidiary to the new foreign parent).

AJCA included provisions designed to curtail inversion transactions. Most significantly, section 801 of AJCA added section 7874 to the Code, which denies certain tax benefits of a typical inversion transaction by deeming the new top-tier foreign corporation to be a domestic corporation for all Federal tax purposes. This sanction generally applies to a transaction in which, pursuant to a plan or a series of related transactions: (1) a U.S. corporation becomes a subsidiary of a foreign-incorporated entity or otherwise transfers substantially all of its properties to such an entity in a transaction completed after March 4, 2003; (2) the former shareholders of the U.S. corporation hold (by reason of the stock they had held in the U.S. corporation) 80 percent or more (by vote or value) of the stock of the foreign-incorporated entity after the transaction; and (3) the foreign-incorporated entity, considered together with all companies connected to it by a chain of greater than 50 percent ownership (that is, the "expanded affiliated group"), does not have substantial business activities in the entity's country of incorporation, compared to the total worldwide business activities of the expanded affiliated group.¹⁶⁸

¹⁶⁵ Sec. 7701(a)(4).

¹⁶⁶ Sec. 7701(a)(5).

¹⁶⁷ For a description of the possible tax consequences of a reincorporation transaction before AJCA, see Joint Committee on Taxation, *Background and Description of Present-Law Rules and Proposals Relating to Corporate Inversion Transactions* (JCX-52-02), June 5, 2002, p. 4.

¹⁶⁸ AJCA also provides for a lesser set of sanctions with respect to a transaction that would meet the definition of an inversion transaction described above, except that the 80 percent ownership threshold is not met. In such a case, if at least a 60 percent ownership threshold is met, then a second set of rules applies to the inversion. Under these rules, the inversion transaction is respected (that is, the foreign corporation is treated as foreign), but any applicable corporate-level "toll charges" for establishing the inverted structure are not offset by tax attributes

5. Foreign earned income exclusion

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 that income by the foreign country. As a practical matter, the United States generally cedes the primary right to tax a U.S. citizen's foreign source income to the foreign country in which the income is derived.¹⁶⁹ This concession is effected by the allowance of a credit against the U.S. income tax imposed on foreign-source income for foreign taxes paid on that income. As described previously, the amount of the credit for foreign income tax paid on foreign-source income generally is limited to the amount of U.S. tax otherwise owed on that income. Accordingly, if the amount of foreign tax paid on foreign-source income is less than the amount of U.S. tax owed on that income, a foreign tax credit generally is allowed in an amount not exceeding the amount of the foreign tax, and a residual U.S. tax liability remains.¹⁷⁰

A U.S. citizen or resident living abroad may be eligible to exclude from U.S. taxable income certain foreign earned income and foreign housing costs.¹⁷¹ This exclusion applies regardless of whether any foreign tax is paid on the foreign earned income or housing costs. To qualify for these exclusions, an individual (a "qualified individual") must have his or her tax home in a foreign country and must be either (1) a U.S. citizen¹⁷² who is a bona fide resident of a foreign country or countries for an uninterrupted period that includes an entire taxable year, or (2) a U.S. citizen or resident present in a foreign country or countries for at least 330 full days in any 12-consecutive-month period.

The maximum amount of foreign earned income that an individual may exclude in 2011 is \$92,900.¹⁷³ Under changes enacted in TIPRA, the maximum amount of foreign housing costs that an individual may exclude in 2011 is, in the absence of Treasury adjustment for geographic differences in housing costs, \$13,006.¹⁷⁴ The combined foreign earned income exclusion and

such as net operating losses or foreign tax credits. AJCA also subjects certain partnership transactions to the new inversion rules.

¹⁶⁹ In a provision referred to as the "saving clause," the United States reserves the right to tax its citizens as citizens under bilateral income tax treaties.

¹⁷⁰ The foreign tax credit rules are described above in section II.C.2.

¹⁷¹ Sec. 911.

¹⁷² Generally, only U.S. citizens may qualify under the bona fide residence test. A U.S. resident alien who is a citizen of a country with which the United States has a tax treaty may, however, qualify for the section 911 exclusions under the bona fide residence test by application of a nondiscrimination provision of the treaty.

¹⁷³ Sec. 911(b)(2)(D)(i). This amount is adjusted annually for inflation.

¹⁷⁴ Sec. 911(c)(1), (2). In TIPRA, section 515(b)(2)(B), the Treasury Secretary was given authority to issue guidance making geographic cost-based adjustments. Sec. 911(c)(2)(B). The Secretary has exercised this authority annually. The most recent guidance, Notice 2011-8, 2011-8 I.R.B. 503 (Jan. 1, 2011), includes adjustments for many locations; the maximum housing cost exclusion is \$103,636, for expenses for housing in Tokyo, Japan.

housing cost exclusion may not exceed the taxpayer's total foreign earned income for the taxable year. The taxpayer's foreign tax credit is reduced by the amount of the credit that is attributable to excluded income.

III. ISSUES RELATED TO PRESENT LAW

A. Issues Applicable to U.S. Activities of Non-U.S. Persons

1. Earnings stripping

A domestic corporation with a foreign parent may reduce the U.S. tax on the income derived from its U.S. operations through the payment of deductible amounts such as interest, rents, royalties, premiums, and management service fees to the foreign parent or other foreign affiliates that are not subject to U.S. tax on the receipt of such payments.¹⁷⁵ Generating excessively large U.S. tax deductions in this manner is known as “earnings stripping.” Although foreign corporations generally are subject to a gross-basis U.S. tax at a flat 30-percent rate on the receipt of such payments if they are from sources within the United States, this tax may be reduced or eliminated under an applicable income tax treaty.

Although the term “earnings stripping” may be broadly applied to the generation of excessive deductions for interest, rents, royalties, premiums, management fees, and similar types of payments in the circumstances described above, more commonly it refers only to the generation of excessive interest deductions.¹⁷⁶ In general, earnings stripping provides a net tax benefit only to the extent that the foreign recipient of the interest income is subject to a lower amount of foreign tax on such income than the net value of the U.S. tax deduction applicable to the interest, i.e., the amount of U.S. deduction times the applicable U.S. tax rate, less the U.S. withholding tax. That may be the case if the country of the interest recipient provides a low general corporate tax rate, a territorial system with respect to interest, or reduced taxes on financing structures.

As described above, U.S. law limits the ability of foreign corporations to reduce the U.S. tax on the income derived from their U.S. subsidiaries’ operations through earnings stripping transactions. Nevertheless, the number of corporate inversion transactions prior to the enactment of section 7874 led some, including the Treasury Department, to question the efficacy of the present-law earnings stripping rules.¹⁷⁷ In the case of some prominent corporate inversions that occurred prior to AJCA, it appeared that the earnings stripping benefit achieved when a U.S. subsidiary paid deductible amounts to its new foreign parent or other foreign affiliates

¹⁷⁵ It is also possible for U.S.-controlled corporations to reduce their U.S. taxable income by making excessive deductible payments to foreign corporations that they control. In general, however, this type of tax planning is greatly limited by the anti-deferral rules of subpart F.

¹⁷⁶ Herein, except when noted otherwise, “earnings stripping” refers to the generation of excessive interest deductions.

¹⁷⁷ See, e.g., U.S. Department of the Treasury, *General Explanations of the Administration’s Fiscal Year 2004 Revenue Proposals*, p. 104 (2003) (“Under current law, opportunities are available to reduce inappropriately the U.S. tax on income earned from U.S. operations through the use of foreign related-party debt. Tightening the rules of section 163(j) is necessary to eliminate these inappropriate income-reduction opportunities.”); Office of Tax Policy, U.S. Department of the Treasury, *Corporate Inversion Transactions: Tax Policy Implications*, Part VII.A (2002) (“The prevalent use of foreign related-party debt in inversion transactions is evidence that [the rules of section 163(j)] should be revisited.”).

constituted the primary intended tax benefit of the inversion transaction, which should not have been the case if the earnings stripping rules had been functioning properly.¹⁷⁸ Thus, AJCA required the Secretary of the Treasury to submit a report to the Congress by June 30, 2005, examining the effectiveness of the earnings stripping provisions of present law, including specific recommendations as to how to improve the provisions of the Code applicable to earnings stripping.¹⁷⁹ The report, which was submitted to Congress on November 28, 2007,¹⁸⁰ is discussed in more detail below.¹⁸¹

In summary, however, the 2007 Treasury report concludes that “[t]here is strong evidence that [inverted corporations] are stripping a significant amount of earnings out of their U.S. operations and, consequently, it would appear that section 163(j) is ineffective in preventing them from engaging in earnings stripping.”¹⁸² In reaching this conclusion, the report largely relies on an outside study of 12 inverted corporations¹⁸³ and a supplemental Treasury

¹⁷⁸ See, e.g., Office of Tax Policy, U.S. Department of the Treasury, *Corporate Inversion Transactions: Tax Policy Implications*, Part VII.A (2002); Joint Committee on Taxation, *Background and Description of Present-Law Rules and Proposals Relating to Corporate Inversion Transactions* (JCX-52-02), June 5, 2002, pp. 3-4.

¹⁷⁹ Pub. L. No. 108-357, sec. 424 (2004). The report also includes AJCA-mandated studies on transfer pricing and U.S. income tax treaties. Pub. L. No. 108-357, sec. 806(a), (b) (2004).

¹⁸⁰ U.S. Department of the Treasury, *Report to the Congress on Earnings Stripping, Transfer Pricing and U.S. Income Tax Treaties* (2007) (hereinafter 2007 Treasury report). Throughout the remainder of this part, “Treasury earnings stripping report” is used to refer to chapter II of this 2007 Treasury report, which specifically addresses earnings stripping, while “Treasury income tax treaty report” is used to refer to chapter IV of this 2007 Treasury report, which specifically addresses U.S. income tax treaties.

¹⁸¹ Subsequent to the issuance of its Report to the Congress on Earnings Stripping, Transfer Pricing and U.S. Income Tax Treaties, the Treasury Department’s Office of Tax Analysis issued a paper that focuses solely on earnings stripping using the same 2004 dataset. The report reaches some of the same general conclusions as the Report with respect to its comparison of foreign-controlled domestic corporations to domestic-controlled corporations. Harry Grubert, “Debt and the Profitability of Foreign-Controlled Domestic Corporations in the United States,” OTA Technical Working Paper 1 (2008).

¹⁸² U.S. Department of the Treasury, *Report to the Congress on Earnings Stripping, Transfer Pricing and U.S. Income Tax Treaties* (2007), p. 26. The 2007 Treasury report acknowledges that section 806 of AJCA requires the Treasury Department to conduct a study of the effectiveness of the provisions of AJCA relating to corporate expatriation, including the formulation of recommendations on improving the effectiveness of those provisions. The Treasury Department intends to separately issue to the Congress the report on that study. Nonetheless, the 2007 Treasury report states that “section 7874 appears to have been successful in curtailing inversion transactions by large, publicly traded corporations.” *Ibid.*, p. 3.

¹⁸³ Jim A. Seida and William F. Wempe, “Effective Tax Rate Changes and Earnings Stripping Following Corporate Inversion,” *National Tax Journal* 57 (2004): 805-28 (hereafter, Seida and Wempe, “Effective Tax Rate Changes and Earnings Stripping Following Corporate Inversion”). Seida and Wempe found that the 12 inverted corporations had a significantly larger increase in foreign income and a significantly larger decrease in U.S. profit margin and effective tax rate than a control group of corporations. Seida and Wempe also more closely examined four inverted corporations for which detailed information on the levels of intercompany debt and interest and fee expense were readily available, and found that these levels increased significantly post-inversion. Moreover, for three of those four corporations, information could be determined regarding the geographic location of these attributes, and with respect to those three, most of the long-term debt, interest, and fee expense was attributable to

Department analysis of payments declared on Form 5472.¹⁸⁴ The Treasury earnings stripping report also concludes, however, that the evidence that foreign-controlled domestic corporations are engaged in earnings stripping is not conclusive,¹⁸⁵ and that it is not possible to determine with precision whether section 163(j) is effective generally in preventing earnings stripping by foreign-controlled domestic corporations.¹⁸⁶

Earnings stripping by foreign-controlled domestic corporations—the conclusions of the Treasury report

The Treasury earnings stripping report presents three separate analyses using tax data to test whether foreign-controlled domestic corporations are engaging in earnings stripping outside the context of inversion transactions. First, the report examines the relative profitability of foreign-controlled domestic corporations and domestic-controlled corporations by comparing the ratios of net income to total receipts, concluding that foreign-controlled domestic corporations are generally less profitable than their domestic-controlled counterparts.¹⁸⁷

Second, the Treasury earnings stripping report compares the ratios of “operating income” to total receipts for foreign-controlled domestic corporations to the corresponding ratios for domestic-controlled corporations. Operating income is defined as net income plus interest expense, depreciation, and similar items, and minus interest income, dividends, and royalties received. The report finds that, after adjusting for these items, foreign-controlled domestic corporations are generally more profitable than their domestic-controlled counterparts.¹⁸⁸ The

the U.S. operations. U.S. Department of the Treasury, *Report to the Congress on Earnings Stripping, Transfer Pricing and U.S. Income Tax Treaties* (2007), pp. 21-22.

¹⁸⁴ Form 5472 is an information return of (1) a U.S. corporation owned 25 percent or more by one foreign person, or (2) a foreign corporation engaged in a trade or business within the United States. Such reporting is required under sections 6038A and 6038C. Form 5472 includes information on cross-border payments, including fees, interest, and royalties, between the reporting corporation and foreign-related persons.

¹⁸⁵ U.S. Department of the Treasury, *Report to the Congress on Earnings Stripping, Transfer Pricing and U.S. Income Tax Treaties* (2007), p. 25.

¹⁸⁶ *Ibid.*, p. 26.

¹⁸⁷ *Ibid.*, p. 13. These analyses were separately performed for the nonfinancial and financial sectors. In addition, a separate analysis was done for the manufacturing industry, which is a component of the nonfinancial sector.

¹⁸⁸ *Ibid.*, pp. 15-16. These analyses were separately performed for the nonfinancial and manufacturing sectors. The Treasury earnings stripping report’s measure of operating income is reduced by non-interest expenses, such as research and experimentation, stewardship, and State and local taxes, which the taxpayer must allocate or apportion to foreign-source income for foreign tax credit purposes. Because by definition the foreign-source income associated with these expenses is generally excluded from operating income, adding back such expenses may provide the basis for a more valid comparison between foreign-controlled domestic corporations and domestic-controlled corporations.

data in this part of the study show that domestic-controlled corporations have greater interest expense as a proportion of total receipts than do foreign-controlled domestic corporations.¹⁸⁹

It is unclear whether these findings with respect to profitability tend to support or refute the proposition that foreign-controlled domestic corporations engage in earnings stripping. Some might argue that even if the findings with respect to operating income suggest that foreign-controlled domestic corporations in the nonfinancial and, more specifically, the manufacturing sectors are more profitable than comparable domestic-controlled corporations before interest income and expense (and other non-operating items) are taken into account, the data presented do not identify how much of the interest income is received from, and interest expense is paid to, foreign-related parties, and, therefore, it is difficult to conclude that foreign-controlled domestic corporations are engaging in earnings stripping rather than utilizing third-party debt.¹⁹⁰

Third, the Treasury earnings stripping report analyzes the relationship between interest expense and cash flow.¹⁹¹ The report determines that, on average, foreign-controlled domestic corporations in the nonfinancial sector and the manufacturing industry have interest expense relative to cash flow that is virtually the same as comparable domestic-controlled corporations. The report also determines that foreign-controlled domestic corporations in these sectors are less likely to be above the section 163(j) threshold of 50 percent of adjusted taxable income than are comparable domestic-controlled corporations.¹⁹² In the financial sector, the report determines that foreign-controlled domestic corporations in some industries appear to have significantly higher interest expense relative to cash flow than their domestic-controlled counterparts. However, the Treasury earnings stripping report states that “the comparison is not completely

¹⁸⁹ See *ibid.*, p. 15, table 2.2. This data, particularly the ratio of interest paid to total receipts, may suggest that foreign-controlled domestic corporations are not engaged in earnings stripping. However, it should be noted that it would be possible for a domestic-controlled corporation and a foreign-controlled domestic corporation to have similar interest expense burdens but have dissimilar reasons underlying their equivalent burdens. For example, a domestic-controlled corporation is more likely than a foreign-controlled domestic corporation to incur significant interest expense in the United States that may be linked (or, in technical terms of the Code, allocable or apportionable) to foreign-source income (and such income may be currently includible in U.S. taxable income or deferred), reflecting that foreign-controlled domestic corporations are more likely to incur interest expense solely for the purpose of financing economic activity conducted in the United States, while domestic-controlled corporations often incur interest expense in connection with the financing of both domestic and foreign entities in the overall corporate group. The same data issue may exist with respect to the interest expense and cash flow analysis set forth in Table 2.3 of U.S. Department of the Treasury, *Report to the Congress on Earnings Stripping, Transfer Pricing and U.S. Income Tax Treaties* (2007), p. 18.

¹⁹⁰ Unfortunately, the Treasury earnings stripping report does not analyze the data from Form 5472 regarding interest payments from foreign-controlled domestic corporations to their foreign owners (i.e., disqualified interest). That analysis might have shed some light on the extent of any earnings stripping.

¹⁹¹ The numerator, interest paid, used by the Treasury Department in Table 2.3 of U.S. Department of the Treasury, *Report to the Congress on Earnings Stripping, Transfer Pricing and U.S. Income Tax Treaties* (2007), p. 18, takes into account interest expense linked to deferred income (both foreign- and domestic-source income), while neither cash flow nor total receipts, the alternative denominators, reflects this deferral. This asymmetry may affect the comparison of results for foreign-controlled domestic corporations and domestic-controlled corporations.

¹⁹² *Ibid.*, p. 19.

unambiguous and it is difficult to draw firm conclusions from the data because of the possibility of alternative explanations and the problems with using domestic-controlled corporations as a comparison group.”¹⁹³

Thus, the Treasury earnings stripping report concludes that the evidence that foreign-controlled domestic corporations are engaged in earnings stripping is not conclusive,¹⁹⁴ and that it is not possible to determine with precision whether section 163(j) is effective in preventing earnings stripping by foreign-controlled domestic corporations.¹⁹⁵ The Treasury Department recommends gathering additional information from taxpayers relating to earnings stripping to determine whether it would be appropriate to modify the proposal with respect to foreign-controlled domestic corporations. Accordingly, on November 28, 2007, the Treasury Department and the IRS issued a proposed tax form, Form 8926, Disqualified Corporate Interest Expense Disallowed Under Section 163(j) and Related Information, to gather additional information from corporate taxpayers relating to the determinations and computations under section 163(j).¹⁹⁶ In December 2008, Form 8926 was issued in final form.

Discussion of wider points raised by Treasury earnings stripping report

Effects of debt financing

Like any business, a foreign corporation has the option of financing its U.S. subsidiaries through equity or some combination of debt and equity. There are certain advantages to utilizing some degree of debt financing—for example, debt financing may allow a business to raise funds at a lower cost (for example, the return to investors may be lower because debt is a less risky investment than an equity investment in the same business) and without surrendering ownership. Depending on the differences between the U.S. tax rate and the rate of tax imposed on the recipient of the interest by the applicable foreign country, the use of substantial debt financing, even if not rising to the level of earnings stripping, may facilitate lowering the aggregate burden of U.S. tax on the U.S. operations, thereby lowering the foreign parent corporation’s overall tax rate on its worldwide operations. Moreover, even if the full 30-percent U.S. withholding tax is imposed upon the interest payment, there remains a five-percent taxpayer-favorable difference, if the interest expense is deductible at the highest U.S. corporate rate of 35 percent. In addition, the interest recipient may be able to take a credit for the U.S. withholding tax, in whole or in part, against its tax in the applicable foreign country, or the interest may be tax-exempt in such country. Although a foreign tax credit might also be available for withheld taxes on a dividend and the underlying U.S. corporate tax, in general there is a greater possibility of double taxation in the case of dividends paid by foreign-controlled domestic corporations to their parents than in the case of interest. Moreover, debt principal may be repaid on a tax-free basis, while

¹⁹³ *Ibid.*, p. 21.

¹⁹⁴ *Ibid.*, p. 25.

¹⁹⁵ *Ibid.*, p. 26.

¹⁹⁶ See Announcement 2007-114, 2007-2 C.B. 1176.

redemption of equity by a foreign parent is generally treated as a dividend distribution unless the corporation paying the dividend has no earnings and profits.¹⁹⁷

Studies have determined that, with some exceptions, greater investment is linked to overall higher labor compensation.¹⁹⁸ The Treasury earnings stripping report suggests that income shifting may support increased investment into high-tax jurisdictions (such as the United States) by lowering the effective tax rate.¹⁹⁹ Whether the ability of U.S. businesses to pay interest to related foreign debt-holders should be further abated may be part of a larger policy discussion that balances revenue and other needs in an international context.²⁰⁰ It is difficult to determine the optimal rate of U.S. tax on foreign-controlled domestic corporations (or conversely, the appropriate level of leverage) that would maximize the overall economic benefit to the United States. However, the best way to encourage increased investment in the United States (by foreign or domestic investors) is to increase the after-tax return to investment, and that outcome is more efficiently achieved by, for example, lowering the U.S. corporate income tax rate than by narrower policies such as the facilitation of earnings stripping.

Earnings stripping and tax treaties

As mentioned above, earnings stripping generally provides a net tax benefit only to the extent that the foreign recipient of the interest income is subject to a lower amount of foreign tax on such income than the net value of the U.S. tax deduction applicable to the interest, i.e., the amount of U.S. deduction times the applicable U.S. tax rate, less the U.S. withholding tax. That may be the case if the country of the interest recipient provides a low general corporate tax rate, a territorial system with respect to interest, or a special tax regime for financing structures, and if that country has entered into a tax treaty with the United States that provides a reduced U.S. withholding tax rate on interest.

¹⁹⁷ See secs. 301, 302(d). If certain narrow exceptions are met, the distribution may be treated as a distribution in exchange for the stock. See sec. 302(b).

¹⁹⁸ Recent references to this linkage include David L. Brumbaugh, Congressional Research Service, *Tax Treaty Legislation in the 110th Congress: Explanation and Economic Analysis* (CRS Report RL34245) (2008), p. 8.

¹⁹⁹ U.S. Department of the Treasury, *Report to the Congress on Earnings Stripping, Transfer Pricing and U.S. Income Tax Treaties* (2007), p. 24. Existing empirical research does not address this question. *Ibid.* The linkage between foreign investment and labor compensation requires that a number of things be held constant—for example, that any potential loss of revenue associated with income shifting not also “crowd out” investment in the United States by either domestic or foreign investors.

²⁰⁰ Notwithstanding that the two issues have historically been analyzed separately, a recent paper suggests that the determination of allowable interest deductions in the inbound and outbound contexts be coordinated through a multilateral agreement under which each country would allocate interest deductions to assets on a uniform worldwide basis and allow a proportionate amount of interest expense to be deducted against income earned domestically, without regard to where the borrowing occurs. The effect of such a system would be to deny interest deductions only when borrowing in one country is disproportionately higher than in the rest of the world. Michael Graetz, “A Multilateral Solution for the Income Tax Treatment of Interest Expenses,” *IBFD, 62 Bulletin for International Taxation* (November 2008), p. 486.

Thus, the applicable foreign tax rate and the U.S. withholding tax rate on the interest payment are two factors that affect the ability of foreign-controlled domestic corporations to effectively engage in earnings stripping. These two factors are interrelated. While a low foreign tax rate relative to the U.S. rate is critical to effective earnings stripping, if the general foreign tax rate is zero, it is not likely that the United States would now enter into a tax treaty with that foreign country that lowers the U.S. withholding tax rate on interest. Therefore, such a foreign corporation may attempt to utilize a U.S. tax treaty with another foreign country to obtain a lower U.S. withholding tax rate. This practice is known as treaty shopping.²⁰¹

As described in detail in the Treasury income tax treaty report issued with the Treasury earnings stripping report, the Treasury Department has taken significant steps since 2000 to combat treaty shopping by negotiating new and stricter limitation-on-benefit (“LOB”) provisions with several U.S. treaty partners, as well as including a similar new LOB provision in the United States Model Income Tax Convention of November 15, 2006. These stricter LOB provisions include a series of complex objective tests to determine whether a resident of a treaty country is sufficiently connected economically to that country to warrant receiving treaty benefits.²⁰²

Need to strengthen earnings stripping rules

Section 7874 appears to have significantly reduced the opportunity for domestic-controlled corporations to engage in earnings stripping by engaging in new inversion transactions.²⁰³ However, both incentive and opportunity remain for foreign-controlled domestic

²⁰¹ Treaty shopping is not limited to withholding on interest payments. A person may engage in treaty shopping to obtain other benefits under a U.S. tax treaty, for example, to lower withholding on royalty or dividend payments, or to exempt income from a U.S. trade or business that is not attributable to a permanent establishment in the United States.

²⁰² See U.S. Department of the Treasury, *Report to the Congress on Earnings Stripping, Transfer Pricing and U.S. Income Tax Treaties* (2007), pp. 78-82.

²⁰³ The 2007 Treasury report states, “[s]ection 7874 appears to have been successful in curtailing inversion transactions by large, publicly traded corporations.” U.S. Department of the Treasury, *Report to the Congress on Earnings Stripping, Transfer Pricing and U.S. Income Tax Treaties* (2007), p. 3. However, the IRS and Treasury Department have since issued temporary and proposed regulations addressing the application of section 7874 in certain circumstances. T.D. 9453, 74 Fed. Reg. 27,920 (June 12, 2009) (temporary regulations); 74 Fed. Reg. 27,947 (June 12, 2009) (proposed regulations). The preamble to the temporary regulations states that the IRS and Treasury Department have become aware of certain transactions that are intended to avoid section 7874, but that they believe present the same policy concerns that prompted the enactment of section 7874. Thus, the temporary and proposed regulations clarify that such transactions are still within the scope of section 7874. In particular, the temporary and proposed regulations address transactions that utilize multiple foreign corporations to make acquisitions of substantially all of the properties held by a domestic corporation or substantially all of the properties constituting a trade or business of a domestic partnership, transactions involving one foreign corporation acquiring substantially all of the properties of multiple domestic corporations or partnerships, and transactions involving an insolvent domestic corporation in which the creditors of the corporation claim not to be shareholders. In addition, in September 2009, the IRS issued a notice providing guidance on additional transactions involving a transfer of cash (or certain other assets) to a foreign corporation to limit the application of section 7874. Notice 2009-78, 2009-2 C.B. 452. The notice also indicated that the IRS and the Treasury Department intend to issue further regulations under section 7874 addressing these and other transactions.

corporations (including new enterprises that opt out of U.S. residence for their top-tier entities), corporations that engage in 60-percent inversions, and corporations that inverted on or before March 4, 2003, to engage in earnings stripping.

Although recent legislative and treaty developments have removed some significant opportunities for earnings stripping, and notwithstanding that the Treasury earnings stripping report does not conclusively determine that foreign-controlled domestic corporations that are not expatriated entities are engaging in earnings stripping, some argue that, as a matter of tax policy, the earnings stripping rules should be strengthened for all foreign-controlled domestic corporations (including expatriated entities) because they all have the same incentives and capabilities to erode the U.S. tax base, and may do so in the same manner. Proponents of this argument observe that it should not be surprising that the available information clearly demonstrates that expatriated entities are engaging in earnings stripping because expatriated entities comprise an easily-identifiable subclass of foreign-controlled domestic corporations and have demonstrated a propensity for aggressive tax planning. Proponents of stricter across-the-board earnings stripping rules also argue that there is sufficient evidence of earnings stripping to justify implementing such a regime, and that significant erosion of the U.S. tax base will continue until the earnings stripping rules are strengthened for all foreign-controlled domestic corporations.

Others agree with the conclusion of the Treasury earnings stripping report that there is insufficient evidence to justify legislative action at this time, and that it would be more prudent to await the receipt and analysis of taxpayer data on earnings stripping submitted through the new Form 8926. Proponents of this view may also believe that the implementation of the new form should increase compliance with section 163(j). In response, some argue that it will be at least several years before careful analyses can be performed on any data submitted through Form 8926, and that there is currently sufficient concern and anecdotal evidence regarding earnings stripping by foreign-controlled domestic corporations to justify strengthening the substantive earnings stripping rules now, while continuing to analyze data as it becomes available.

Other types of earnings stripping

U.S. law does not address earnings stripping transactions involving the payment of deductible amounts (by expatriated entities or foreign-controlled domestic corporations) other than interest (e.g., rents, royalties, and service fees), or the payment of deductible amounts by taxpayers other than corporations. These transactions also may erode the U.S. tax base, and thus some argue that a more comprehensive response to earnings stripping is needed. The Treasury Department's examination of payments declared on Form 5472 by seven expatriated entities suggests that, although the majority of earnings stripping by expatriated entities is through interest, some earnings stripping occurs through royalties.²⁰⁴ However, earnings stripping may

²⁰⁴ U.S. Department of the Treasury, *Report to the Congress on Earnings Stripping, Transfer Pricing and U.S. Income Tax Treaties* (2007), p. 22.

be more readily achieved through the use of debt than through other means, so the present law focus on deductible interest payments may be appropriate.²⁰⁵

2. Effect of inbound foreign direct investment on U.S. employment, research and development, and trade

In 2009, majority-owned U.S. affiliates of foreign persons employed 5.3 million people. From 1997 (the first year data is available) to 2009, majority-owned U.S.-affiliate employment has increased by 21 percent and has climbed as a percentage of U.S. private industry employment from 4.1 to 4.7 percent. There was a sharp increase in employment between 1997 and 2002 due to many acquisitions of U.S. businesses by foreign persons in 1999 and 2000. During the 1997 to 2002 period, affiliate employment increased by over 27 percent, which was much faster than the six percent increase total U.S. private industry employment experienced over those years. Since 2002, affiliate employment and total U.S. private industry employment have grown at about the same pace.

However, it is difficult to say what the exact effect of in-bound foreign direct investment is on U.S. employment since, to do so, it would be necessary to know what employment would be without foreign direct investment. It is especially unclear what the effect of foreign direct investment is on employment because much of in-bound foreign direct investment consists of acquisitions of existing U.S. businesses. While these acquisitions probably help to sustain employment, it is not clear how much new employment is created by foreign acquisitions.

The industries accounting for the largest shares of employment by U.S. affiliates in 2009 were mining and manufacturing at 16 percent and 14 percent respectively, and these industries have had the largest shares for several years.²⁰⁶ Within manufacturing, motor vehicles, bodies and trailers, and parts (32.5 percent) and chemicals (31.5 percent) account for the most employment by U.S. affiliates. About half of affiliate employment in chemicals is in the pharmaceutical industry.

Majority-owned U.S. affiliates performed research and development totaling \$43.4 billion in 2009. Close to 70 percent of research and development was done by manufacturing affiliates. Within manufacturing, affiliates in the chemicals (\$16 billion) and computer and electronic products (\$4 billion) industries performed the most research and development.

²⁰⁵ The Treasury Department notes that capitalizing a foreign-controlled domestic corporation with a disproportionate amount of debt to engage in earnings stripping does not generally require any real movement of assets or a change in the business operations of the corporation. In contrast, the use of royalties or other deductible payments may require a real change in business operations. See *ibid.*, p. 7 & n.1.

²⁰⁶ Mining does not include oil and gas extraction. Employees engaged in oil and gas extraction are classified as manufacturing employees. The Bureau of Economic Analysis classifies employees this way because a large portion of U.S.-affiliate employment in petroleum and coal products manufacturing is accounted for by integrated petroleum companies that have employees engaged in both manufacturing and petroleum extraction. Since these employees cannot be identified separately, they are all included in the petroleum and coal products manufacturing industry. Therefore, for consistency reasons, the Bureau of Economic Analysis classifies employees of affiliates in oil and gas extraction in petroleum and coal products manufacturing rather than in mining.

Research and development spending by U.S. affiliates has increased steadily since 1997 when it was \$17.2 billion and accounted for 10.9 percent of total research and development performed by U.S. businesses. In 2008, the most recent year for which this statistic is available, the share of total R&D performed by U.S. affiliates had climbed to 14.4 percent.

Research and development intensity is a measure of affiliates' propensity to conduct research and development, and it is defined as research and development spending divided by value added. Since 1997, U.S. affiliates of foreign persons have had a higher research and development intensity than U.S. businesses as a whole. In 2008, the research and development intensity of U.S. affiliates of foreign persons was 6.8 percent compared to 2.3 percent for all U.S. businesses. Within the manufacturing industry, however, there is not such a large gap in favor of U.S. affiliates. The research and development intensity of manufacturing affiliates was 9.5 percent in 2008, and it was 11.5 percent for all U.S. businesses in manufacturing.

U.S. affiliates also account for a large percentage of U.S. trade -- 21 percent of U.S. exports of goods and 31 percent of U.S. imports of goods were shipped from and to majority-owned U.S. affiliates in 2009. These large shares of foreign trade reflect both the international orientation of foreign-owned companies and also the production and distribution ties affiliates have to their foreign parents. Much of the trade of U.S. foreign affiliates is intrafirm trade, i.e., trade between the foreign affiliate and their foreign parent or another company related to their parent. About 50 percent of exports and 80 percent of imports by foreign affiliates are intrafirm transactions.

Exports of goods shipped by affiliates totaled \$219 billion in 2009, while imports shipped to affiliates were valued at \$484 billion. Imports to U.S. affiliates have long been higher than their exports. Two-thirds of this gap in 2009 was accounted for by wholesale trade affiliates, which import goods manufactured abroad by their foreign parents. The rest of the gap was largely due to manufacturing affiliates, some of which engage in wholesale trade and many of which import parts from their foreign parent companies.

3. Effect of withholding taxes and reporting on cross-border investment

Purpose of withholding taxes

As described earlier, the Code imposes a 30-percent withholding tax on U.S.-source dividends, rents, royalties, and other amounts derived by nonresidents. As a practical matter, such a withholding tax is the only viable collection mechanism for taxing foreign investors with respect to these types of passive U.S.-source income. This observation begs the question, however, of why the United States should seek to tax this income in the first place. Some commentators have described a longstanding global consensus in the general allocation of rights to tax cross-border income. Under this norm, in broad terms business income is taxed by the country in which it is derived (the source country) and passive or portfolio income is taxed by the country in which the recipient of the income resides (the residence country).²⁰⁷ Unlike, for

²⁰⁷ See, e.g., Reuven S. Avi-Yonah, "The Structure of International Taxation: A Proposal for Simplification," *Texas Law Review* 74 (1996), pp. 1301, 1305-08; Michael J. Graetz and Itai Grinberg, "Taxing International Portfolio Income," *Tax Law Review* 56 (Summer 2003), pp. 537, 540-41. Source countries typically

example, a corporation operating a business in a source country, a portfolio investor may have no ties to the source country other than the investor's passive holding of the investment. The source country therefore may have no clear economic claim to the income.

Notwithstanding the broad international tax framework of source-based taxation of business income and residence-based taxation of passive income, there are a few possible explanations for the persistence of these withholding taxes under domestic law. A practical explanation is that source-based withholding taxes generate revenue.²⁰⁸

Another possible explanation is the difficulty of enforcing residence-based taxation of foreign-source passive income.²⁰⁹ This passive income may be truly foreign source as, for example, when a Mexican resident owns shares of stock in U.S. companies, either directly or perhaps through an entity organized in a tax haven jurisdiction. Alternatively, the passive income may be foreign source in formal terms only as, for example, when a U.S. resident forms a foreign corporation or other entity for investing into the United States. In either case, the residence country (Mexico in the first example and the United States in the second example) may not be able to enforce residence-based taxation under its regular income tax rules. In this circumstance, tax collected at the source may be the only tax imposed on the income.

This concern is addressed somewhat differently when the U.S. Treasury Department negotiates bilateral income tax treaties. In those negotiations, the Treasury Department will agree to reductions in the 30-percent statutory withholding rate, but always insists that the treaty contains robust exchange of information provisions. Such provisions make it easier for the treaty countries to enforce their tax rules, including any residence-based taxation of passive income, by providing a country access to information that the other country may have about income earned in that second country by residents of the first country.

retain the right to impose withholding taxes on portfolio income, and residence countries generally allow relief from their own income taxes for these withholding taxes, but withholding taxes are often reduced or eliminated under income tax treaties.

²⁰⁸ For tax year 2005, foreign payees received \$378.4 billion of U.S.-source income, as reported on Form 1042-S, and \$333.2 billion (88 percent) of this income was exempt from withholding. (These figures do not include interest income paid by U.S. banking businesses to foreign depositors). A total of \$6.7 billion in withholding tax was collected on the remaining \$45.3 billion of U.S.-source income subject to withholding. This amount of withholding tax represented approximately two percent of the total amount of U.S.-source income reported on Form 1042-S. Internal Revenue Service, *Statistics of Income Bulletin*, Winter 2009, p. 100.

²⁰⁹ See, e.g., Reuven S. Avi-Yonah, "Memo to Congress: It's Time to Repeal the U.S. Portfolio Interest Exemption," *Tax Notes International*, December 7, 1998, p. 1817; Graetz and Grinberg, *supra*, p. 578. Graetz and Grinberg argue against source-based withholding taxes and contend that residence-based taxation of foreign portfolio income is possible through continued unilateral and multilateral enforcement and information exchange efforts. For a general discussion of the difficulties in collecting residence-based taxes given globalization and technological developments such as electronic commerce and money, see Vito Tanzi, "Globalization, Technological Developments, and the Work of Fiscal Termites," *Brooklyn Journal of International Law* 26 (2001), p. 1261.

Do withholding taxes affect cross-border investment?

The United States has the opportunity to consider this question each time the Treasury Department negotiates a bilateral income tax treaty and the U.S. Senate decides to ratify any such treaty. As was described previously, U.S. bilateral income tax treaties generally allow reduced rates of U.S. withholding tax on dividends, rents, royalties, and non-portfolio interest derived by qualified residents of the other treaty countries in exchange for similar benefits for U.S. residents with investments in those countries.

Generally, a treaty-based reduction in withholding rates will increase the after-tax returns to foreign persons resident in the treaty country from their investments in the United States and will increase the after-tax returns to investments by U.S. persons in the treaty country.²¹⁰ In principle, both inbound and outbound investments, and resulting cross-border income flows, should increase. However, this simple analysis is incomplete. A complete analysis of a withholding change, or any other change in a treaty, would account for both tax and nontax related factors, such as portfolio capital needs in the affected countries, and the corresponding relation between current and financial accounts. The potential for future growth in each country is an important determinant of cross-border investment decisions. In sum, even in the short run, the larger macroeconomic outlook, compared to treaty modifications, is likely to be a more important determinant of future cross-border income and investment flows and the related tax collections.

Does reporting affect cross-border investment?

As discussed above, the United States imposes various information reporting requirements, which may apply to cross-border investments. These reporting requirements generally go hand-in-hand with the various withholding rules to ensure that both U.S. persons and foreign persons pay the appropriate amount of U.S. tax on their cross-border investments.

Nevertheless, to the extent that some investment in the United States by foreign persons results from a view that the U.S. tax rules make it an attractive place for such persons to invest (by generally exempting portfolio investments from U.S. tax), some might ask whether requiring reporting of income earned on those investments may reduce the amount of such investment.²¹¹ The Treasury Department has recently stated that it is aware of such concerns, but, at least with respect to increasing certain information reporting requirements pertaining to nonresident aliens, does not believe that doing so will result in any significant reduction in investment.²¹² The

²¹⁰ To the extent that U.S. or foreign persons may claim a foreign tax credit for withholding taxes paid, there may be no change in net returns.

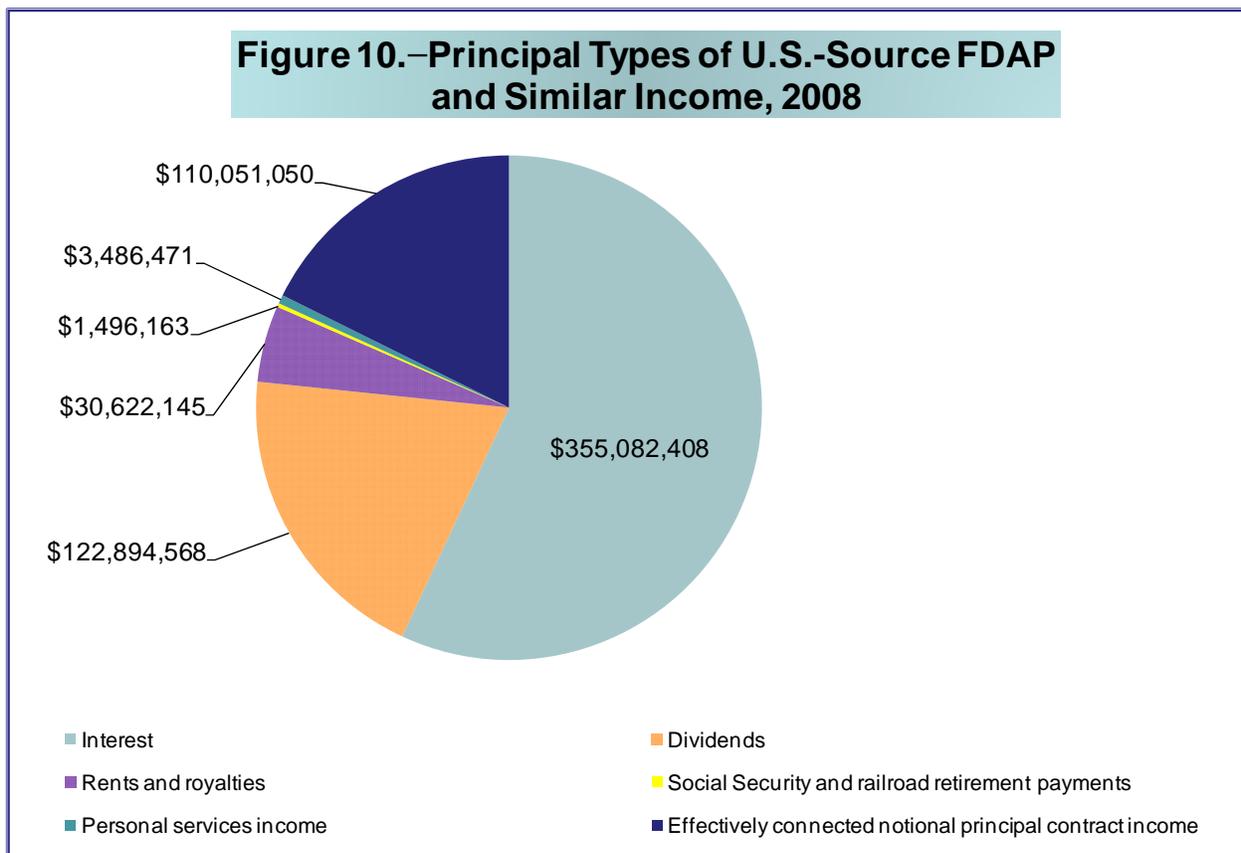
²¹¹ In fact, recently proposed regulations that would require certain U.S. financial institutions to begin to file information reports with respect to the interest that they pay nonresident aliens, see 76 Fed. Reg. 1105 (January 7, 2011); 76 Fed. Reg. 2852 (January 18, 2011), have caused various commentators to raise this precise concern, see, e.g., Marie Sapirie, "Reporting on Nonresident Aliens Redux," 2011 *Tax Notes Today* 51-1 (March 16, 2011).

²¹² Letter from Emily S. McMahon, Acting Assistant Secretary (Tax Policy), U.S. Department of the Treasury, to Francisco Canseco, U.S. House of Representatives (August 5, 2011), available at 2011 *Tax Notes Today* 159-20 (August 5, 2011).

Treasury Department indicated that information reporting is potentially relevant only to foreign persons resident in jurisdictions with which the United States has an information exchange relationship (through an income tax treaty or tax information exchange agreement) because the United States cannot do anything with the information it collects absent such a relationship. Moreover, the Treasury Department noted that since the regulations were proposed, foreign investment in the United States has actually increased, perhaps reflecting the fact that the economic stability of the United States and the soundness of its financial institutions make it an attractive place to invest. These features may outweigh any concerns foreign persons may have about the IRS possessing information reports about their U.S. portfolio income.

Economic data related to income subject to withholding

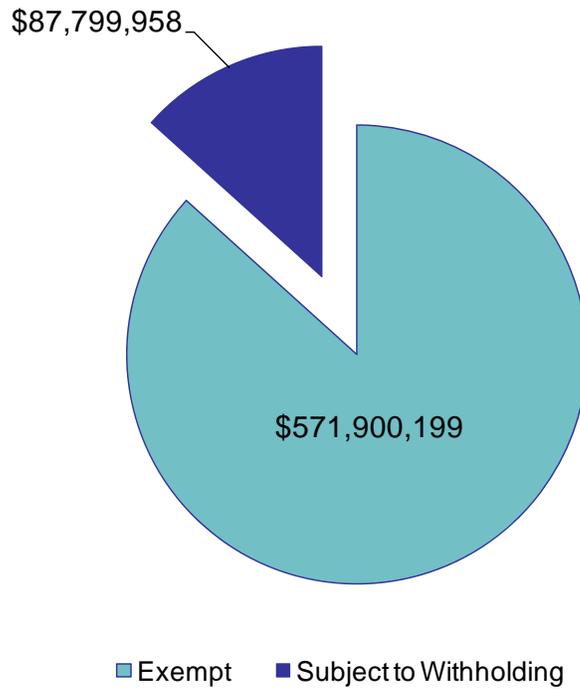
Figures 10, 11, and 12 show the principal categories of U.S.-source FDAP and similar income, the amounts of that income subject to, and exempt from, withholding, and the principal countries of residences of the recipients of that income. As Figure 11 illustrates, much FDAP and similar income is exempt from withholding (because, for instance, it is portfolio interest). Of the approximately \$87.8 billion subject to withholding (as shown in Figure 11), only approximately \$9.2 billion of U.S. tax was withheld. The average withholding tax rate imposed on this non-exempt FDAP and similar income (approximately 10.5 percent) is significantly below 30 percent because rates of withholding tax are often reduced under treaties (described below).



Source: Internal Revenue Service, Statistics of Income Division.

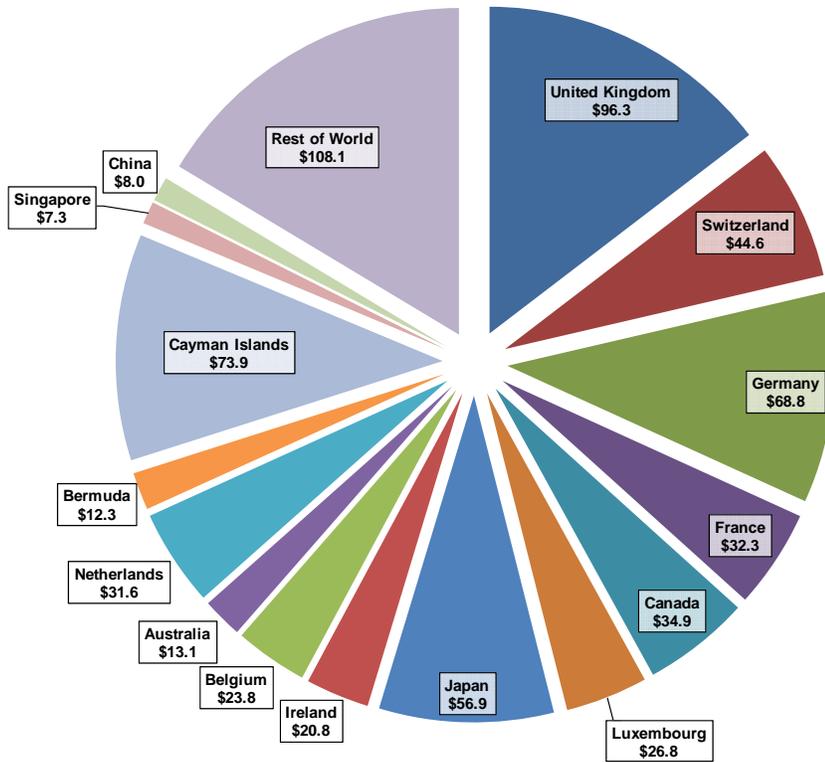
The \$624 billion of U.S.-source FDAP and similar income reported on IRS Form 1042-S in 2008 does not include bank deposit interest or capital gains. These amounts are not required to be reported.

Figure 11.—U.S.-Source FDAP and Similar Income, Exempt and Subject to Withholding, 2008



Source: Internal Revenue Service, Statistics of Income Division.

Figure 12.—Countries of Residence of Recipients of U.S.-Source FDAP and Similar Income, 2008 (Dollars in Billions)



B. Issues Applicable to Foreign Activities of U.S. Persons

1. Background

If cross-border business income is taxed in the country in which it is derived (the source country), the residence country has two broad options for relieving potential double taxation of this income. It can exempt the income from home-country taxation (an exemption or “territorial” system). Alternatively, it can tax the income but provide a credit against home-country taxation for foreign tax paid on that income (a “worldwide” system). As described previously, the United States taxes domestic corporations on their worldwide income but permits deferral of U.S. taxation of most foreign business income derived through foreign subsidiaries.

The U.S. system of taxing cross-border income of U.S. taxpayers reflects competing considerations. One consideration, reflected in the general rule of worldwide taxation and the granting of the foreign tax credit, is to ensure that a taxpayer’s choice whether to invest in the United States or abroad is not affected by tax considerations. A second consideration, reflected in the general rule that foreign business income derived by foreign subsidiaries of U.S. companies is not subject to U.S. tax until the income is distributed to the U.S. companies, is to ensure that the income is not subject to more tax than the income would be if derived by a resident of another jurisdiction (at least until the income is repatriated). The compromise between two competing considerations makes planning, compliance, and administration costly and creates inefficiencies in taxpayer behavior. This section describes planning and inefficiencies.

This section first describes the taxation of a U.S. multinational corporation relative to the taxation of a strictly domestic corporation and relative to the taxation of a foreign multinational corporation. This description illustrates that the U.S. multinational corporation may be taxed both less heavily than the strictly domestic U.S. corporation and more heavily than a foreign multinational corporation. This section then provides an overview of various possible effects of the U.S. rules: shifting of investment to low-tax jurisdictions; structuring investments in high-tax jurisdictions to take advantage of low rates elsewhere, including through transfer pricing strategies; erosion of the U.S. tax base; uncertain implications for U.S. investment and employment; and incentives to incorporate a business outside the United States.

2. Effect of deferral on investment decisions

Comparison of U.S. multinational corporations to domestic taxpayers

One way of assessing distortions caused by the U.S. system is to compare the U.S. taxation of a U.S. multinational corporation’s (an “MNC’s”) foreign investment through a foreign subsidiary with the U.S. taxation of a U.S. taxpayer that invests solely in the United States. If the U.S. tax rules did not distort a U.S. taxpayer’s decision whether to invest in the United States or abroad, they would satisfy capital export neutrality (“CEN”), one efficiency standard for evaluating international tax rules. U.S. tax rules could achieve CEN by taxing

residents on all income, domestic and foreign, when earned and by allowing an unlimited credit for foreign income taxes.²¹³

The principal advantage of deferral, when comparing one U.S. taxpayer's foreign investment opportunity to another U.S. taxpayer's domestic investment opportunity, is the ability to retain and invest low-taxed earnings in a foreign subsidiary on a pre-U.S. tax basis. Suppose that a U.S. taxpayer in the 35-percent tax bracket is considering whether to make an investment in an active enterprise in the United States or an equivalent investment in a country in which the income tax rate is zero. Assume the U.S. taxpayer chooses to make the investment in the foreign country through a CFC that earns \$100 of active income today, and the U.S. taxpayer defers tax on that income for five years by re-investing the income in the CFC. Assume further that the CFC can invest the money and earn a 10-percent return per year, and the income earned is not subject to foreign tax or subpart F. The taxpayer would then have \$161.05 and pay tax of \$56.37 on repatriation, for an after-tax income of \$104.68.

If, instead, the U.S. taxpayer pursues the equivalent investment opportunity in the United States, such an investment will not be eligible for deferral. As a result, the taxpayer receives \$100 in income today, pays tax of \$35, and has only \$65 to invest. The taxpayer invests that amount at an after-tax rate of 6.5 percent (this is a 10-percent pre-tax rate less 35 percent tax on the earnings each year). At the end of five years, this taxpayer will have after-tax income of only \$89.06, as compared to the foreign investment option which would generate after-tax income of \$104.68. The result is that the foreign investment that benefits from deferral of U.S. tax for five years leaves the taxpayer with \$15.62 more in wealth than the domestic investment that would require the taxpayer to pay tax on the income immediately, even though the pre-tax rate of return (10 percent) and the U.S. tax rate (35 percent) are the same for both investments. As a result, the foreign investment would be the preferred choice (all else being equal).

This disparity in after-tax effects means that there may be foreign investments that earn less on a pre-tax basis than an investment in the United States, but may, nonetheless, result in a greater return on an after-tax basis. Thus, deferral may distort the investment choice when it creates an incentive to choose an overseas investment that yields a lower pre-tax rate of return over a domestic investment that yields a higher pre-tax rate of return. When the lower earning investment is chosen, society as a whole loses the opportunity for greater total income. Economists label such an outcome a social welfare loss from an inefficient allocation of investment.

Generally, the greater the foreign effective marginal tax rate, the closer the rate of return on the investment must be to the rate on the U.S. investment to yield a superior after-tax return. As the foreign tax rate approaches the U.S. tax rate, the distortion approaches zero. By contrast,

²¹³ For discussion of CEN, see Peggy Brewer Richman (Musgrave), *The Taxation of Foreign Investment Income: An Economic Analysis* (Baltimore: Johns Hopkins Press), 1963. If CEN were satisfied across jurisdictions, capital would tend to flow to investments with the highest pre-tax (rather than after-tax) rates of return (after taking into account desired risk levels), and over time pre-tax rates of return on equivalent investments would equalize even though after-tax returns for investors in different jurisdictions might vary.

the longer the residual U.S. income tax is deferred, the less the foreign investment has to earn relative to a U.S. investment and the greater the distortion.²¹⁴

Comparison of U.S. MNCs to foreign MNCs

Another way of assessing distortions caused by the U.S. rules is to compare the tax treatment of a U.S. MNC and a foreign MNC each considering a foreign investment in a third country. If the foreign MNC is exempt from home country taxation on income from the third country investment, deferral of U.S. tax on the U.S. MNC's income from the third country investment does not provide a competitive advantage. Instead, deferral permits U.S. MNCs to approximate the home country tax results of foreign MNCs resident in jurisdictions that do not impose tax on foreign business income.

Assessing distortions by comparing the taxation of income from an investment in country C when made by an investor from country A to taxation of the same investment when made by an investor from country B is consistent with the efficiency standards capital import neutrality and capital ownership neutrality ("CIN" and "CON"). CIN focuses on minimizing distortions in the level of savings across jurisdictions; the goal is achieved if the after-tax rate of return on a given investment in a specific location is the same for all investors (although pre-tax rates of return on investments may differ across jurisdictions).²¹⁵ CON focuses on minimizing distortions in the ownership of assets, with this goal being achieved if productive assets (wherever located) are owned by persons (wherever resident) that have the ability to generate the highest pre-tax returns.²¹⁶

²¹⁴ An alternative way to think about the trade-off between the deferral period, the foreign tax rate, and the break-even rate of return on a deferred offshore investment is as follows. The longer the period of deferral, the lower the effective residual U.S. tax rate. In fact, permanent deferral would create an effective rate residual tax rate equal to zero. Thus, as deferral increases, the effective total tax rate (U.S. residual tax plus foreign host country tax) that the U.S. taxpayer faces approaches the foreign host country tax rate. Consequently, as deferral increases, the break-even return on a deferred offshore investment declines and approaches the rate of return on the foreign investment net of the foreign host country tax.

²¹⁵ Thomas Horst, "A Note on Optimal Taxation of International Investment Income," *Quarterly Journal of Economics* (June 1980), pp. 793-98.

²¹⁶ Mihir A. Desai and James R. Hines, Jr., "Evaluating International Tax Reform," 56 *National Tax Journal* 487 (September 2003); see also, Mihir Desai and James R. Hines, Jr., "Old Rules and New Realities: Corporate Tax Policy in a Global Setting," 57 *National Tax Journal* 937 (December 2004). Although the goals of both CIN and CON can generally be achieved if each country adopts a territorial tax system (that is, a system that exempts foreign income), the goals of CON can also generally be achieved if every country adopts a full-inclusion worldwide tax system and effectively harmonized rates. Because many large countries have territorial systems, proponents of CON argue that the only practical way that the United States can promote this standard is to enact a territorial regime

Other commentators contend that the arguments based on CEN, CIN, and CON do not provide meaningful guidance to policy makers because the standards are based on simple models. These commentators advocate an alternative approach that considers how the existing tax system creates behavioral distortions among taxpayers (and, to a lesser extent, governments) and whether a given proposal could mitigate distortions. These behavioral distortions include (1) the location of tangible capital, (2) the location of intangible capital, (3) the repatriation

Of the 34 countries in the Organisation for Economic Cooperation and Development (the “OECD”), 26 now have territorial tax systems, including, beginning in 2009, Japan and the United Kingdom.²¹⁷ Seven OECD countries other than the United States have worldwide tax systems (Chile, Greece, Ireland, Israel, Korea, Mexico and Poland). These seven jurisdictions have significantly less outbound foreign direct investment and lower statutory corporate tax rates (an unweighted average of 21.7 percent in 2010) than the United States.²¹⁸

As an illustration of arguments made from the perspective of CIN or CON, compare a U.S. MNC that is subject to tax in the United States at a 35-percent rate on the worldwide income it earns directly and on repatriated foreign business income with a foreign MNC that is resident in a jurisdiction that exempts foreign business income from taxation. Assume the corporate income tax rate everywhere outside the United States is 25 percent. The income of the foreign MNC from operations in the United States is taxed at the prevailing U.S. corporate income tax rate, 35 percent, as is the income earned by the U.S. MNC. On the other hand, the income earned by the foreign MNC from operations outside the United States is taxed at 25 percent. Under present law, the U.S. MNC may achieve a similar result only through deferral.

Absent deferral, however, the income earned by the U.S. MNC from operations in the United States would continue to be taxed at the prevailing U.S. corporate tax rate, generally 35 percent, and the income earned by the U.S. MNC from operations outside the United States would also be taxed at 35 percent. All else being equal, the foreign MNC may have a higher after-tax return than the U.S. corporation. Shareholders, regardless of residence, may view the shares of the foreign MNC as more valuable than shares of the U.S. MNC because the foreign MNC could pay higher dividends from its after-tax income. As a result, according to the argument from the perspective of CIN or CON, the foreign MNC may raise capital more easily than the U.S. MNC and may win competitive bids for investments. If capital investment is shifted from U.S. MNCs to foreign MNCs (for example, when U.S. persons buy shares in foreign-headquartered firms as opposed to U.S.-headquartered firms), this capital shift could mean that U.S. MNCs would have greater difficulty growing and might become more attractive acquisition targets for foreign acquirers.²¹⁹ To the extent that foreign corporations have higher

decision, (4) financing decisions, (5) income shifting, (6) incentives to lower foreign tax burdens, (7) export decisions, and (8) host government decisions regarding the taxation of U.S. companies. Grubert and Altshuler (2006).

²¹⁷ For the tax treatment of foreign dividend income in each jurisdiction, see PricewaterhouseCoopers, *Worldwide Tax Summaries: Corporate Taxes 2010/2011*, <http://www.pwc.com/gx/en/worldwide-tax-summaries/index.jhtml>; see also Ernst & Young, *The 2010 Worldwide Corporate Tax Guide*, http://www2.ey.com.ch/publications/items/tax/2010_worldwide_corporate_tax_guide/2010_EY_worldwide_corporate_tax_guide.pdf

²¹⁸ The 2010 statutory corporate income tax rate in each of these jurisdictions is as follows: (1) Chile – 17 percent; (2) Greece – 24 percent; (3) Ireland – 12.5 percent; (4) Israel – 25 percent; (5) Korea – 24.2 percent; (6) Mexico – 30 percent; and (7) Poland – 19 percent. “Taxation of Corporate and Capital Income Table II.1,” http://www.oecd.org/document/60/0,3343,en_2649_34533_1942460_1_1_1_37427,00.html#cci.

²¹⁹ Barbara Angus, Tom Neubig, Eric Solomon, and Mark Weinberger, “The U.S. International Tax System at a Crossroads,” *127 Tax Notes* 45 (April 5, 2010), pp. 61, 63.

after-tax returns than U.S. corporations on income from foreign operations, individuals and firms may be more likely to conduct new foreign business operations through foreign rather than U.S. corporations, and shareholders of existing corporations may have an incentive to reincorporate U.S. firms as foreign firms, an incentive that was reduced by the enactment in AJCA of the anti-inversions legislation described previously.

It is an empirical question whether the U.S. tax rules make it harder for U.S. MNCs to compete with foreign MNCs for capital and investment opportunities than it would be if the United States had a territorial taxing system. U.S. MNCs have large operations in foreign markets, and competitiveness concerns in some industries may result not from U.S. tax rules, but from labor cost differentials, product quality differences, regulatory differences, or other nontax factors.²²⁰

3. Multiple distortions

Economically inefficient business structures

The inefficient allocation of investment that may be caused by the U.S. system is not solely between dollars invested in the United States and dollars invested abroad, but also misallocation among investments abroad. Because the distortion arises from the differential between a foreign tax rate and deferred payment of the U.S. residual tax, a U.S. taxpayer may choose to locate an investment in lower-tax country A rather than higher-tax country B, even if the country B investment would generate a higher pre-tax rate of return, because country A's lower tax rate increases the U.S. taxpayer's benefit from deferral. Similarly, a U.S. taxpayer may choose to divide its research, manufacturing, and management functions among multiple countries to obtain specific tax benefits and higher after-tax rates of return, even if consolidating all of those activities in one location would result in a higher pre-tax rate of return.²²¹

As just described, deferral can make it advantageous to choose a relatively lower earning investment in a low-tax country rather than a higher earning investment in a high-tax country. However, U.S. taxpayers have also undertaken many investments in high-tax countries. If a high-tax country has a tax rate in excess of the U.S. tax rate, a taxpayer can plan offshore investments in both the high-tax country and in a low-tax country to enable cross-crediting of the foreign taxes paid (subject to certain limitations imposed by the foreign tax credit basket rules). A taxpayer with investments in both high-tax and low-tax countries also might engage in transactions that shift taxable income out of the high-tax country but that might not be undertaken in the absence of tax considerations. A simple transaction is the payment of a

²²⁰ See, e.g., J. Clifton Fleming Jr., Robert J. Peroni, and Stephen E. Shay, "Perspectives on the Worldwide vs. Territorial Taxation Debate," 125 *Tax Notes* 1079 (Dec. 7, 2009) p. 1086.

²²¹ Foreign MNCs operating under different home-country tax rules similarly may divide functions among multiple countries. For a review of six cases studies that identify and discuss in detail business structures that may affect a taxpayer's U.S. and worldwide tax liability, see Joint Committee on Taxation, *Present Law and Background Related to Possible Income Shifting and Transfer Pricing* (JCX-37-10), July 20, 2010.

deductible amount from the high-tax country to the low tax country.²²² This planning can extend the benefit of deferral to investments in high-tax host countries. In such a case, the policy of deferral in conjunction with the foreign tax credit limitation creates distortions of the taxpayer's investment decisions.

The incentives to adopt any of the business structures described above exist even in a world in which taxpayers and the IRS have perfect knowledge about what the appropriate transfer price is for all related-party transactions. When there is something less than perfect knowledge, however, transfer pricing can magnify the incentive for a taxpayer to choose a business structure that produces a lower pre-tax return, but a higher after-tax return, by permitting additional income to be allocated to the low-tax country. An increase in the amount of income that can be attributed to a low-tax jurisdiction is equivalent to increasing the pre-tax return to the investment.²²³ Ignoring the expense that the taxpayer and the IRS may engage in with respect to transfer pricing determinations, shifting income through transfer pricing after the decision to locate investment has been made creates no further direct loss of economic efficiency. However, the diminution of the U.S. tax base and U.S. tax receipts may result in higher taxes elsewhere in the economy. Increasing other taxes will increase the distortions caused by those other taxes.

Effect on repatriation decisions

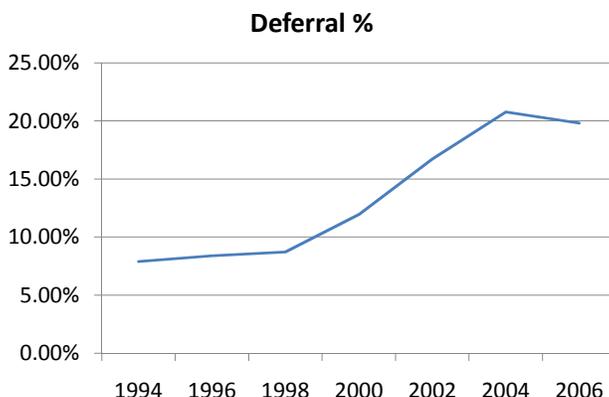
The U.S. tax rules also may distort a taxpayer's decision whether to repatriate foreign earnings to the United States. A taxpayer that repatriates earnings may be subject to residual U.S. tax on the repatriated earnings and to U.S. tax annually on income generated by the repatriated funds. The U.S. taxpayer may forgo repatriation of earnings and instead may leave funds abroad even if, on a pre-tax basis, there were greater earnings potential from investment in

²²² Two features of the U.S. tax rules facilitate shifting of income from high to low tax jurisdictions. The CFC look-through rule described previously generally excludes deductible interest and royalty payments from foreign personal holding company income. And the elective entity classification rules (the check-the-box rules) allow some foreign entities, and payments to or by those entities, to be disregarded entirely for U.S. tax purposes. As a result of these rules, payments that are deductible in high-tax jurisdictions may have no corresponding U.S. tax effect.

²²³ For an example of this point, see Harry Grubert and Joel Slemrod, "The Effect of Taxes on Investing and Income Shifting to Puerto Rico," 80 *Review of Economics and Statistics* 365 (August 1998). Grubert and Slemrod examine the interaction of income shifting and the investment decision.

the United States. This effect, which has been colloquially described as “lock-out,” can lead to very large sums of earnings being held outside the United States. Figure 13, below illustrates, a percentage of the worldwide earnings of U.S. corporations, earnings on which U.S. tax liability has been deferred more than doubled between 1994 and 2004.²²⁴

Figure 13. Deferral as Share of U.S. Corporate Worldwide Income



Source: Statistics of Income Division, IRS, and JCT staff calculations.

Congress included in AJCA the temporary low rate on dividend repatriations described previously (section 965) to encourage repatriation of foreign earnings.²²⁵

The effect of a residual U.S. tax on the decision to repatriate cannot be described in isolation. As described previously, a taxpayer’s decision to derive income abroad rather than in the United States, and thereby to have earnings eligible for repatriation, may have been encouraged in part by the ability to defer U.S. tax until the repatriation. Moreover, to the extent

²²⁴ This is a flow concept, showing the relative amount of corporate income deferred every two years from 1994 to 2006. Worldwide income is defined as total receipts minus deductions, plus constructive taxable income received from related foreign corporations, plus CFC deferred income. CFC data before 2004 included above was from a restricted sample based on U.S. parent size. CFC data is for CFCs with net earnings and profits, and is before foreign (and U.S.) tax. Corporate income includes all U.S. subchapter C corporations with net income, before tax. There may be some time lag between the CFC and U.S. corporate income data because of fiscal year reporting differences

²²⁵ For a description of section 965, see section II.C.4. Congress emphasized that this tax reduction was a temporary economic stimulus measure, and that there was no intent to make the measure permanent or to extend it or enact it again in the future. H.R. Rep. No. 108-548, p. 146 (2004); S. Rep. No. 108-192, p. 51 (2003).

a taxpayer can engage in cross-crediting – that is, use foreign tax credits in respect of income subject to high foreign tax to offset U.S. tax on foreign income that was subject to no or little foreign tax – the taxpayer may reduce or eliminate residual U.S. tax when foreign earnings are repatriated. Cross-crediting therefore reduces the lock-out effect (or, put differently, encourages repatriation).

4. Empirical studies

Most empirical research substantiates the expected negative relationship between a foreign country's tax rate and U.S. outbound investment.²²⁶ The greater the responsiveness of U.S. taxpayers to the benefit of deferral of tax on active foreign-source income the greater the distortion to the economy. At the end of 2004, accumulated earnings and profits of the approximately 75,000 CFCs that filed IRS Form 5471 were approximately \$1 trillion.²²⁷ While many other variables influence the location of investments, these same data show that accumulated earnings and profits of U.S. controlled CFCs in Ireland, a relatively low-tax country, exceeds the sum of the accumulated earnings and profits of U.S. controlled CFCs in the United Kingdom and Germany, both higher tax countries with substantially larger populations and markets.

²²⁶ A growing body of empirical work examines the responsiveness of foreign investments made by U.S. taxpayers to foreign tax rates. One of the first such studies was Harry Grubert and John Mutti, "Taxes, Tariffs and Transfer Pricing in Multinational Corporate Decision-Making," 73 *Review of Economics and Statistics* 285 (May 1991). They examined the responsiveness of outbound direct investment in plant, property, and equipment by U.S. taxpayers to foreign country average tax rates in 33 host country locations. They found a significant negative statistical relationship. In a later study Grubert and Mutti found comparable results when examining the outbound investments in over 60 countries by over 500 U.S. taxpayers. Harry Grubert and John Mutti, "Do Taxes Influence Where U.S. Corporations Invest?" 53 *National Tax Journal* 825 (December 2000). Using similar data, but different empirical specifications, Rosanne Altshuler, Harry Grubert, and T. Scott Newlon, "Has U.S. Investment Abroad Become More Sensitive to Tax Rates?" in James R. Hines, Jr., (editor), *International Taxation and Multinational Activity* (Chicago: University of Chicago Press) 2001, find similar results. Using different data encompassing all nonbank affiliates of nonbank U.S. corporations, James R. Hines, Jr. and Eric M. Rice, "Fiscal Paradise: Foreign Tax Havens and American Business," 109 *Quarterly Journal of Economics* 149 (February 1994), find an even stronger negative statistical relationship between foreign tax rates and outbound investment by U.S. taxpayers.

The preceding studies used cross sectional analysis, that is, they examined the effect of taxes on location of investment by examining data on different taxpayers and investments in one year. Mihir A. Desai, C. Fritz Foley, and James R. Hines, Jr., "Foreign Direct Investment in a World of Multiple Taxes," 88 *Journal of Public Economics* 2727 (December 2004), undertake a panel study. In this study they examine the outbound investments of U.S. taxpayers in the manufacturing sector, tracking the same taxpayers over the period 1984 to 1992. They report statistical relationships similar to those found in the cross sectional studies cited.

OECD, *Tax Effects of Foreign Direct Investment/ Recent Evidence and Policy Analysis* (Paris: Organisation for Economic Cooperation and Development), 2008, reviews a large number of empirical studies on the responsiveness of inbound and outbound foreign direct investment to taxes. The literature review suggested that the effect of taxation on foreign direct investment is complex and depends on many difficult-to-measure variables including, among other factors, non-tax characteristics of the host country.

²²⁷ Unpublished data tabulated by the Statistics of Income Division, Internal Revenue Service from Form 5471 for controlled foreign corporations. The data were collated from Form 5471 filed with some 11,000 tax returns. The data compile the accumulated earnings and profits for approximately 75,000 U.S. controlled CFCs.

Recent data compiled relating to the one-time 85-percent dividends received deduction permitted in section 965 provides possible further evidence of the magnitude of the potential distortion of investment decisions. The 85-percent dividends received deduction had the effect of reducing the highest U.S. marginal tax rate on repatriated earnings from 35 percent to 5.25 percent. The preliminary data show that approximately \$360 billion in dividends were repatriated on 2004 corporate income tax returns.²²⁸ These repatriations exceed the annual average of prior year repatriations of foreign earnings by more than \$250 billion. While without further analysis it is inappropriate to conclude that taxes alone would have kept \$250 billion or more deferred offshore, the magnitude of repatriations is suggestive of the magnitude of the amount of investment dollars subject to potentially distorted economic choices.

Patterns in financial reporting also provide context for understanding the potential distortion of investment and repatriation decisions. A designation of permanently reinvested earnings (“PRE”) is a financial accounting assertion that the taxpayer will not repatriate the designated earnings back to the United States in the foreseeable future. Joint Committee staff research has found PRE growth to have been very strong over the past decade. Cumulative PRE for the 75 largest companies in a recent Fortune 100 list showed this number growing from about \$115 billion in 2000 to about \$250 billion in 2005 (a number that would have been higher had it not been depleted by repatriations under section 965) and reaching over \$700 billion by 2010.²²⁹ It is possible that some of the PRE growth after the expiration of section 965 occurred in anticipation of, or in preparation for, a possible renewal of section 965. The large increase in PRE suggests a tension between decisions to retain earnings abroad and companies’ public statements that earnings invested abroad are needed to fund U.S. activities.

5. U.S. foreign direct investment and domestic investment

Some observers argue that the benefit of deferral may significantly diminish the U.S. tax base by encouraging investment offshore at the expense of domestic investment. For example, instead of manufacturing products in the United States and selling the products domestically, as well as 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.²³⁰ This scenario could have two effects. Diminished investment in the United States could lead to diminished growth in labor productivity, wages, and aggregate national income.

²²⁸ Melissa Redmiles, “The One-Time Received Dividend Deduction,” *Statistics of Income Bulletin*, 27, Spring 2008.

²²⁹ This growth in PRE has been noted by other commentators. Lee A. Sheppard and Martin A. Sullivan, “Multinationals Accumulate to Repatriate,” 122 *Tax Notes* 295 (January 19, 2009) (finding that accumulated PRE for 40 large companies had by the end of 2007 recovered from repatriation under section 965 during the 2004-2006 period to reach about 200 percent of the 2002 PRE amount); Rodney P. Mock and Andreas Simon, “Permanently Reinvested Earnings: Priceless,” 121 *Tax Notes* 835 (November 17, 2008) (concluding that for a sample of 81 large companies about one half of the reduction in PRE owing to section 965 was eliminated shortly after these companies elected section 965).

²³⁰ This possibility is often referred to as a “run-away plant.”

The diminution of the U.S. tax base also could result in higher taxes, and increased distortions, elsewhere in the economy.

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 might increase to sustain the increased worldwide demand.

Empirical studies have attempted to examine whether foreign direct investment is a substitute for or complement to domestic investment. Generally, these studies have found either no effect or a positive effect of overseas production in a host-country market on home-country exports to that market. One survey reports that, on average, studies find that one dollar of overseas production by U.S. affiliates generates \$0.16 of exports from the United States.²³¹ The evidence does, however, suggest that overseas production displaces certain types of domestic production, as the U.S. parent firm shifts to more capital intensive and skill intensive domestic production.²³² Similarly, foreign direct investment may change the amount or location of research activities.

There is no definitive conclusion about the effect of outbound investment on U.S. employment. The same survey concludes, "[T]he evidence suggests that the effect of overseas production on the home-country labor market involves the composition of a firm's home employment rather than the total amount. That change in composition is mainly a shift toward more managerial and technical employment"²³³ However, most of the evidence on this subject examines individual industries rather than aggregate economic effects.

²³¹ 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 later research, Lipsey reaches similar conclusions. Robert E. Lipsey, "Home and Host Country Effects of FDI," in Robert E. Baldwin and L. Alan Winters (eds.), *Challenges to Globalization* (Chicago: University of Chicago Press), 2004, p. 333-379.

²³² Lipsey, "Home and Host Country Effects of FDI."

²³³ Lipsey, "Outward Direct Investment and the U.S. Economy," *supra*, p. 31. One study does find some substitution of foreign labor for U.S. labor but characterizes the degree of employment substitution as low between domestic and foreign affiliates, finding greater labor substitution between employees in different developing countries. S. Lael Brainard and David A. Riker, "Are U.S. Multinationals Exporting U.S. Jobs?" in David Greenway and Douglas Nelson, eds., *Globalization and Labour Markets* (Cheltenham: Edward Elgar), 2001.

The results of a recent study suggest that foreign direct investment may be complementary to and not a substitute for domestic investment. This study was based on firm-level data on domestic and foreign operations of U.S. manufacturers for the period of 1982 through 2004 and found that (1) a 10-percent greater foreign investment is associated with 2.5-percent greater domestic investment; (2) a 10-percent greater foreign employee compensation is associated with 3.7-percent greater domestic employee compensation; and (3) a 10-percent greater sales by foreign affiliates is associated with 6.5-percent greater exports by U.S. parents to their foreign affiliates. Mihir Desai, C.

In the aggregate, 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.²³⁴ What is not clear is whether U.S. manufacturing employment would have fallen more, less, or the same if the United States had employed a different tax regime for foreign direct investment, or whether multinational U.S. manufacturing enterprises would have been more or less successful in developing their non-U.S. operations in such circumstances.

6. Effect of deferral on residence choice

Under the U.S. rules for taxing foreign income, only U.S. corporations are subject to U.S. tax on a worldwide basis. Foreign corporations are taxed only on income that has a sufficient connection with the United States. Until enactment of anti-inversion legislation described previously, some U.S. firms sought to take advantage of the differential treatment of U.S. and foreign domiciled top-tier companies by reincorporating abroad. The anti-inversion legislation did not, however, address the choice of residency available to new enterprises. As a result, U.S. law creates an incentive for a new firm to opt out of U.S. residence for its top-tier entity.

This incentive for a parent corporation of a multinational group to organize outside the United States may distort taxpayer behavior in two ways. First, an enterprise that in the absence of the prevailing tax policy would have chosen to incorporate in the United States incorporates elsewhere. A possible consequence of a company's decision to incorporate outside the United States is that the company will carry out its headquarters functions outside the United States and, as a result, the United States will lose spillover benefits from those functions and the company will experience reduced pre-tax rates of return. A company's decision to incorporate outside the United States creates a second distortion: by incorporating outside the United States, the enterprise removes its future non-U.S. earnings from the U.S. tax base permanently rather than subjecting the earnings to possible residual U.S. tax when repatriated to the parent corporation. The effect of this distortion on the U.S. tax base may result in higher taxes elsewhere in the economy. Increasing other taxes increases the distortions caused by those other taxes.

Fritz Foley and James R. Hines, Jr., "Domestic Effects of the Foreign Activities of U.S. Multinationals," *American Economic Journal: Economic Policy*, February 2009.

²³⁴ Lipsey, "Home and Host Country Effects of FDI," *supra*.

IV. FUNDAMENTAL INTERNATIONAL TAX REFORM

As described above, the deferral element of the United States' present system of worldwide taxation introduces significant economic inefficiencies. Deferral implies a conditionally different tax rate on active foreign business income of a CFC than the rate that applies to domestic income, and this difference appears to affect both the type and location of business investment. If a U.S. corporation is able to postpone U.S. tax indefinitely by delaying repatriation, the corporation can reduce the present value of its U.S. tax rate nearly to zero, the same outcome as under a territorial system.

There are two possible — but polar opposite — alternatives for fundamental international tax reform. The first alternative is to move toward a territorial system in which foreign business income is exempt from U.S. taxation. The second is to move towards a full inclusion system in which all foreign-source income is currently taxed without regard to whether the income is from business or investment. A territorial approach would exempt from U.S. tax foreign business earnings that are repatriated as dividends. A full inclusion approach would tax all foreign earnings currently, regardless of whether the earnings are repatriated.

Both of these alternatives would reduce the current disincentive to repatriate low-taxed foreign earnings but would do so through different mechanisms. Under either approach, the repatriation tax is eliminated, and there is no longer any U.S. tax motivation to keep low-taxed foreign income offshore. The effects of the two alternatives on the decision of where to invest are not equivalent, however.

A. Territorial System²³⁵

1. Principal features

There have been several proposals in recent years for implementing a more territorial regime in the United States.²³⁶ Although the details of the proposals differ, they generally provide that income earned abroad by a domestic corporation from foreign subsidiaries would fall into one of two categories: (1) active foreign income earned by a foreign branch or

²³⁵ For a discussion of international tax systems of selected countries, see, Joint Committee on Taxation, *Background and Selected Issues Related to the U.S. International Tax System and Systems that Exempt Foreign Branch Income*, (JCX-33-11), May 20, 2011.

²³⁶ See, e.g., National Commission on Fiscal Responsibility and Reform, *The Moment of Truth* (December 2010), pp. 28-35; U.S. Department of the Treasury, *Approaches to Improve the Competitiveness of the U.S. Business Tax System for the 21st Century*, December 20, 2007 (hereinafter, Treasury Department); President's Advisory Panel on Federal Tax Reform, *Simple, Fair and Pro-Growth: Proposals to Fix America's Tax System* (November 2005) (hereinafter, Reform Panel); Joint Committee on Taxation, *Options to Improve Tax Compliance and Reform Tax Expenditures* (JCS-02-05), January 27, 2005 (hereinafter, JCT Options Report); Michael J. Graetz and Paul W. Oosterhuis, "Structuring an Exemption System for Foreign Income of U.S. Corporations," *National Tax Journal*, vol. 54 (December 2001), p. 771 (hereinafter, Graetz and Oosterhuis), p. 781.

Although these proposals are commonly referred to as "dividend exemption" systems, they contemplate exemption of active income earned by domestic corporations through foreign branches as well.

repatriated as a dividend from a foreign subsidiary, which would generally be exempt from U.S. tax; and (2) all other income, including passive income and non-dividend payments received from foreign subsidiaries, which would be included in income by the domestic corporate shareholder on a current basis. The deferral regime and repatriation tax at the heart of the present system would be eliminated, and the foreign tax credit system would serve a more limited function than it does under present law.

For discussion purposes, the following section describes in detail the dividend exemption system outlined by the staff of the Joint Committee on Taxation in 2005 (the “JCT Option”).²³⁷ The JCT Option is similar to the dividend exemption system recommended by the U.S. President’s Advisory Panel on Federal Tax Reform as part of the Reform Panel’s recommendations for making the tax code “simpler, fairer and more conducive to economic growth”²³⁸ (the “Reform Panel Proposal,” and together with the JCT Option, the “Exemption Proposals”).²³⁹ Material differences between the two proposals are identified throughout the discussion.

Exemption of foreign business income

Foreign subsidiaries

Under the Exemption Proposals, a domestic corporate shareholder that owns 10 percent or more of the stock of a CFC would exclude from income all dividends received from the CFC.²⁴⁰ Foreign tax credits would not be allowed for foreign taxes attributable to the excluded dividend income (including both corporate-level income taxes and dividend withholding taxes). Deductions for interest and other expenses of the domestic corporation would be disallowed to the extent allocable to exempt CFC earnings.

²³⁷ See JCT Options Report, pp. 186-97. This report was prepared at the request of then Senate Finance Committee Chairman Charles Grassley and Ranking Member Max Baucus.

²³⁸ Reform Panel, p. xiii (Executive Summary).

²³⁹ The Reform Panel Proposal recommends the territorial system as part of its Simplified Income Tax Proposal. Reform Panel, p. 134. The Simplified Income Tax Proposal responds to the President’s directive that the panel submit at least one option that uses the current income tax system as the starting point for reform. *Ibid.*, p. 107. The proposal is designed as a comprehensive plan and is intended to be viewed as an integrated package. *Ibid.*, p. xv (Executive Summary). This pamphlet does not address certain features of the Reform Panel Proposal that are integrally related to other changes proposed as part of the comprehensive plan, such as integration of corporate and shareholder-level taxes.

²⁴⁰ The Reform Panel Proposal provides more generally that dividend exemption would apply to “foreign affiliates,” which it refers to as controlled foreign subsidiaries. Reform Panel, p. 134.

Any gain from a domestic corporation's sale of CFC stock would be excluded from income to the extent of undistributed exempt earnings.²⁴¹ Any excess of gain over this amount would be taxable. Deductions for losses on the sale of CFC stock would be disallowed.

A domestic corporation would be allowed to elect CFC treatment with respect to a noncontrolled section 902 corporation.²⁴² This election would render the investment eligible for dividend exemption but would also subject the domestic corporation to current taxation on its share of the CFC's subpart F income. If the dividend exemption election were not made, an investment in a noncontrolled section 902 corporation would be treated like a portfolio stock investment such that no indirect foreign tax credit would be available. Thus, a U.S. corporation would be permitted to choose between treating the noncontrolled section 902 corporation as a portfolio investment or as a direct, CFC-type investment.²⁴³

Foreign branches

Foreign branches would be treated like CFCs under rules that would treat foreign businesses conducted directly by a domestic corporation as CFCs for all U.S. Federal tax purposes. Thus, (1) income derived from a branch would be exempt to the same extent as it would be if earned by a CFC; (2) subpart F would apply; (3) branch losses would not flow directly onto a domestic corporation's U.S. income tax return; and (4) transactions between a domestic corporation and its foreign branch would be subject to the full range of rules applicable to intercompany transactions.²⁴⁴ All businesses conducted predominantly within the same country generally would be treated as a single CFC for this purpose.

Full U.S. taxation of other foreign income

Deductible payments (for example, interest, royalties, service fees, income from intercompany sales) received by a domestic corporation from a CFC²⁴⁵ would be subject to full U.S. tax, because those payments do not bear foreign net income tax. Dividends from non-

²⁴¹ The Reform Panel Proposal provides generally that "gains from the sale of assets that generate exempt income" would be exempt from U.S. tax. Reform Panel, p. 240. The extent to which gains would be exempt from tax is an issue that would need to be resolved under a territorial system. See part IV.A.3. below for a detailed discussion of this issue.

²⁴² A noncontrolled section 902 corporation — which is also referred to as a "10/50 company" — is a foreign corporation with respect to which the domestic corporation owns 10 percent or more of the stock, but which does not qualify as a CFC because ownership is less than 50 percent. Sec. 904(d)(2)(E).

²⁴³ The Reform Panel Proposal states only that rules would be needed to address noncontrolled section 902 corporations. Reform Panel, p. 240.

²⁴⁴ The Reform Panel Proposal explicitly notes that royalty income would need to be imputed to foreign branches. *Ibid.*

²⁴⁵ Unless specified otherwise, references to CFCs hereinafter in this section include foreign branches and any noncontrolled section 902 corporations with respect to which there is an election in effect.

CFCs, or from CFCs with respect to which the domestic corporation is not at least a 10 percent shareholder, would be fully subject to U.S. tax.

Subpart F would be retained in its current form. Thus, notwithstanding the general rule of dividend exemption, a domestic corporation that owns 10 percent or more of the stock of a CFC would still face current income inclusion if the CFC earned certain types of passive or highly mobile income.²⁴⁶ The PFIC rules also would be retained in their current form.

Foreign-source income received directly by a domestic corporation from unrelated persons, such as foreign-source royalties and interest, would also be subject to full U.S. tax.

The foreign tax credit would be available for foreign taxes attributable to income not eligible for exemption. For example, foreign withholding taxes imposed on a royalty received by a domestic corporation would be eligible for the credit. Similarly, a subpart F inclusion would carry with it a deemed-paid credit for foreign taxes imposed on the CFC with respect to the subpart F income. Because most high-taxed foreign business income would be exempt and thus removed from the foreign tax credit system, the separate categories for passive and general income would be repealed. As a result, the foreign tax credit limitation would be applied on an overall basis.

Allocation and apportionment of expenses

Under a territorial system, a domestic corporation might be required to allocate and apportion deductible expenses to determine the expenses that would be disallowed and to determine the foreign tax credit limitation.²⁴⁷ Under both the JCT Option and the Reform Panel Proposal, the principles of the current allocation and apportionment rules (including the worldwide affiliated group approach for interest expense) generally would be retained. Under the JCT Option, research and experimental expenses would be allocated and apportioned first between U.S.- and foreign-source income under rules similar to those of present law. The amount of research and experimental expenses allocated to foreign-source income then would be further allocated, first to taxable royalties and similar payments (for example, cost sharing or royalty-like sale payments) to the extent thereof, then to CFC earnings to the extent thereof (with this amount divided on a pro rata basis between exempt CFC earnings and taxable CFC earnings), and then finally to other foreign-source income. Under the Reform Panel Proposal,

²⁴⁶ A special rule would provide that no subpart F inclusions would be created as dividends moved up a chain of CFC, to the extent the dividends were attributable to a 10 percent or greater direct or indirect interest of a domestic corporation in the dividend-paying CFC. This rule would ensure that dividends could be repatriated from lower-tier CFCs without losing the benefit of dividend exemption, and it would also make it easier to redeploy CFC earnings in different foreign jurisdictions without triggering subpart F. The temporary CFC look-through rule of section 954(c)(6), enacted after publication of the JCT Option, would generally render this special rule unnecessary.

²⁴⁷ Many foreign jurisdictions with territorial tax systems, in lieu of allocating and disallowing expenses, provide that a small percentage of foreign dividends (e.g., five percent) is taxable.

domestic research and experimental expenses would not be allocated to exempt foreign income.²⁴⁸

2. Economic analysis

Efficiency considerations

The differing treatment of multinational groups with domestic parent corporations and those with foreign parent corporations creates an incentive to locate parent companies offshore. Under the Exemption Proposals outlined above, most foreign business income would no longer be subject to U.S. taxation, regardless of the residence of the parent corporation. Accordingly, a regime could be expected to reduce the distortions in corporate residence decisions that exist under present law. On the other hand, the continued taxation of passive income and highly mobile income under subpart F and foreign business income earned by a domestic corporation other than through a foreign subsidiary or branch (including foreign business income received by a domestic corporation in the form of deductible payments from a foreign subsidiary) could partially vitiate this effect.

A territorial system would also tend to eliminate one of the principal distortions caused by deferral – the disincentive to repatriate foreign earnings – and facilitate repatriation decisions based on business needs, rather than on tax considerations. In practice, the extent to which this objective is achieved would depend upon the specifics of the regime implemented – for example, whether dividends from foreign subsidiaries were wholly or only partly exempt, the level of ownership required for eligibility, and the extent to which foreign earnings were required to have been subject to foreign tax to qualify for the exemption.²⁴⁹ Nonetheless, a territorial system would be more neutral than present law on the decision whether to repatriate foreign earnings.

It is less clear whether a territorial system would increase neutrality for other decisions. Some critics have argued that moving from a system of deferral to a system of permanent exemption for business income earned overseas would cause U.S. investment to flow out of the United States and would encourage U.S. companies to move their manufacturing and service operations abroad.

Permanent exemption for foreign income would reduce the rate of tax imposed on that income. Moreover, regardless of the rate of tax imposed on foreign income, permanent exemption would remove any impediments to deriving income abroad because that income could be repatriated at any time in the form of dividend distributions free of residual U.S. tax. Under present law, by contrast, if non-tax considerations such as financial reporting make it important for a taxpayer to report current U.S. income, the residual U.S. tax on dividend repatriations may

²⁴⁸ Reform Panel, p. 241; see also Graetz and Oosterhuis, p. 781. The Reform Panel Proposal is based on the premise that all royalty income and similar payments associated with the domestic research and experimental expenses would be subject to tax in the United States. See, however, the discussion below regarding transfer pricing issues under a territorial system.

²⁴⁹ Foreign withholding taxes on dividends, and possibly State income taxes, could also affect decisions to repatriate foreign earnings.

cause the taxpayer not to shift income abroad to begin with. Possible consequences of the greater attractiveness of foreign earnings under permanent exemption include increasing use of foreign operations to serve U.S. markets. On the other hand, this ability to serve U.S. markets with manufacturing and service operations abroad at no U.S. tax cost could increase the attractiveness of the United States as a location for headquarters operations.

Commentators also have argued that a territorial system would increase the incentives for U.S. taxpayers to develop their intangible assets offshore because the resulting income could be repatriated as exempt dividends rather than as taxable royalties.²⁵⁰ Although foreign-source royalties derived by U.S. corporations also are subject to U.S. tax under present law, the tax often is offset by excess foreign tax credits for foreign tax imposed on other foreign-source income. Consequently, adoption of a territorial taxing system could increase the U.S. taxation of foreign-source royalties unless taxpayers engage in planning to avoid the U.S. tax, including by moving ownership of intangible property abroad.

A territorial system could encourage taxpayers to design strategies to produce what one commentator has referred to as stateless income (income that is taxed nowhere or taxed at extremely low rates in a country in which the income is not earned).²⁵¹ Strategies include the structure of financial capital within a U.S.-based multinational group (and the creation of deductible interest payments in high-tax jurisdictions), and the use of inter-affiliate payments, disregarded entities, and hybrid instruments to strip income out of high-tax jurisdictions into low- or no-tax foreign jurisdictions.²⁵²

On the other hand, some economists who have studied the projected effects of an exemption system on investment decisions have found no definitive evidence that the underlying incentives would change significantly. In this regard, two studies have examined how the

²⁵⁰ George Yin, “Reforming the Taxation of Foreign Direct Investment by U.S. Taxpayers,” 49 *Tax Notes International* 511, 514 (February 11, 2008) (hereinafter, Yin). This incentive might be mitigated through countervailing domestic research and development incentives, but the effects of taxing foreign royalties while at the same time providing incentives for domestic research and development might be difficult to evaluate because those effects would depend on several factors including tax rates in the United States and the relevant foreign jurisdiction and the level of benefits for U.S. research and development relative to any benefits in the foreign country. Financial statement considerations under present law also must be taken into account: research and experimental expenses may produce the greatest after-tax returns when intangibles are developed in low-tax jurisdictions, but deducting the expenses in a low-tax jurisdiction reduces the financial statement tax benefit of the expenses relative to deducting the expenses at the U.S. rate.

²⁵¹ Edward D. Kleinbard, “Throw Territorial Taxation From the Train,” *Tax Notes International*, vol. 48 (April 2, 2007), p. 63 (hereinafter, Kleinbard), p. 77. For more recent thinking about so-called stateless income under U.S. present law and the implications for international tax reform, see Edward D. Kleinbard, “Stateless Income,” USC Center in Law, Economics and Organization Research Paper No. C11-1, USC Legal Studies Research Paper No. 11-6 (March 2011), Edward D. Kleinbard, “The Lessons of Stateless Income,” USC Center in Law, Economics and Organization Research Paper No. C11-2, USC Legal Studies Research Paper No. 11-7 (March 2011), and Edward D. Kleinbard, “Stateless Income’s Challenge to Tax Policy,” *Tax Analysts*, vol. 132 (Sept. 5 2011), p. 1021.

²⁵² *Ibid.*

incentive to invest in low-tax locations abroad would be affected if the United States were to move to a dividend exemption system similar to the one described here.²⁵³ In both studies, the authors consider dividend exemption systems that impose comprehensive expense allocation rules similar to those of present law, such that some portion of the deductions for interest and overhead expenses incurred by the U.S. parent company and allocated to exempt foreign income are disallowed as deductions from U.S. taxable income. This assumption is critically important to the conclusions they reach.

One study concludes that the effective tax rate on U.S. investment in low-tax locations would increase under a territorial system.²⁵⁴ Although active foreign business income would avoid U.S. residual taxation, the loss of the ability to shield foreign royalties from U.S. tax through cross-crediting and to claim deductions for overhead and interest expense at home (or in other high-tax locations) results in a higher overall tax burden on earnings generated in low-tax locations.

The second study presents hypothetical effective tax rates for incremental investment by a U.S. taxpayer in a low-tax subsidiary abroad under the U.S. tax system in place before AJCA and under dividend exemption with expense allocation rules.²⁵⁵ This study also finds that the tax burden of investing in low-tax countries may increase under dividend exemption. The study uses two other approaches to investigate how location decisions may change under a dividend exemption system: a comparison of foreign direct investment patterns for the United States and for two countries that exempt dividends received from certain foreign affiliates (Germany and Canada) and an empirical analysis of the extent to which residual U.S. taxes on low-tax foreign earnings affect the location decisions of U.S. corporations. Neither approach yields results that would suggest that location decisions would be significantly altered if the United States were to exempt dividends from residence country taxation.²⁵⁶

²⁵³ Harry Grubert and John Mutti, *Taxing International Business Income: Dividend Exemption versus the Current System*, Washington, D.C., American Enterprise Institute (2001) (hereinafter, Grubert and Mutti); Rosanne Altshuler and Harry Grubert, "Where Will They Go if We Go Territorial? Dividend Exemption and the Location Decisions of U.S. Multinational Corporations," 54 *National Tax Journal* 787 (December 2001) (hereinafter, Altshuler and Grubert (2001)).

²⁵⁴ Grubert and Mutti.

²⁵⁵ Altshuler and Grubert (2001).

²⁵⁶ Some research has focused on the effect of home country tax systems on foreign direct investment into the United States. The conclusions from this literature are mixed. Joel Slemrod uses time-series data to compare the responsiveness to U.S. corporate tax rates of foreign direct investment from exemption and worldwide countries. Joel Slemrod, "Tax Effects on Foreign Direct Investment: Evidence from a Cross-Country Comparison," in *Taxation in the Global Economy*, edited by Assaf Razin and Joel Slemrod (Chicago: University of Chicago Press), 1990. The study does not find any difference between the two groups of countries. James R. Hines, Jr. examines whether the sensitivity of manufacturing foreign direct investment to State income tax rates varies across exemption and "worldwide" countries. James R. Hines, Jr., "Altered States: Taxes and the Location of Foreign Direct Investment in America," 86 *American Economic Review*, No. 5 (December 1996). The study finds that foreign direct investment from exemption countries is more responsive to differences in State income tax rates. Although

A further complication arises from the differential treatment of portfolio and direct investments under typical exemption systems. Dividends from foreign direct investments (investments in which a domestic corporation's share of the foreign business is at least 10 percent) are exempt under the JCT Option and most similar exemption systems, while portfolio dividends are taxable. As a result, the effects of an exemption system on a U.S. company's investment location decisions may vary as between foreign direct investments and foreign portfolio investments.²⁵⁷

On balance, therefore, it would appear that a territorial approach could improve economic efficiency with respect to the repatriation of foreign earnings but that further analysis is needed to assess whether efficiency would be improved with regard to investment location decisions.

Competitiveness

One of the main arguments of territorial proponents is that many U.S. trading partners have territorial systems and do not subject their resident corporations to tax on worldwide income. As a result, the U.S. system of worldwide taxation arguably places U.S. firms at a competitive disadvantage.²⁵⁸ Thus, it is argued, a U.S. move to territoriality would enhance the competitiveness of U.S. businesses in the global economy.²⁵⁹

For a number of years, policymakers, business groups, and economists have argued that improving the international competitiveness of the U.S. economy should be a major policy goal. This focus on competitiveness is related to some of the economic trends of the past two decades documented in part I of this pamphlet: (1) large U.S. trade deficits; (2) large inflows of foreign investment in the United States; and (3) low national saving rates. Cross-border mergers of recent years and cases of corporate inversions to re-incorporate outside the United States have heightened interest in the position of the United States in the global economy.

One definition of U.S. competitiveness is the ability of U.S.-based multinational businesses 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

relevant, these papers do not examine the experience of U.S. corporations and how location incentives may change under the dividend exemption proposal described here or the current system.

²⁵⁷ Kleinbard, p. 76. Two commentators have suggested that portfolio dividends could be treated as wholly or partially exempt without creating undue potential for tax planning, provided the PFIC rules are retained. Graetz and Oosterhuis, p. 779.

²⁵⁸ Terrence R. Chorvat, "Ending the Taxation of Business Income," 42 *Arizona Law Review* 835 (2000); National Foreign Trade Council, *NFTC Territorial Tax Study Report*, p. 5 (2002), [http://www.nftc.org/default/tax/Territorial percent20Report.doc](http://www.nftc.org/default/tax/Territorial%20Report.doc) (hereinafter, NFTC Report); Keith Engel, "Tax Neutrality to the Left, International Competitiveness to the Right, Stuck in the Middle with Subpart F," 79 *Texas Law Review* 1525 (May 2001), pp. 1563-64; Reform Panel, p. 134; Treasury Department, p. 54.

²⁵⁹ Reform Panel, pp. 105, 134.

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.

Competitiveness may vary from one industry to another. For example, the United States could dominate world markets in one industry and be seen as competitive, while in another industry U.S. businesses could be losing global market share.

If competitiveness is measured by after-tax returns, a territorial system would improve U.S. business competitiveness in the aggregate only if the total tax burden imposed on U.S.-based multinational operations is reduced. When broken down among taxpayers and industry groups, the effects of a territorial system would depend on the details of the system actually implemented, the nature and mix of the taxpayer's activities, and the corporate structure of the taxpayer's legal entities.

There are other definitions of competitiveness than the ability of multinationals to compete in foreign markets. For example, the World Economic Forum defines competitiveness as "the set of institutions, policies, and factors that determine the level of productivity of a country."²⁶⁰ The Global Forum looks at several factors that contribute to a country's ability to compete, including institutions, infrastructure, health and education, innovation, and market size. The U.S. was ranked number one overall in the World Economic Forum's Global Competitiveness Report in 2007-2008 and 2008-2009 and was ranked second and fourth overall in 2009-2010 and 2010-2011, respectively.

3. Structural issues presented by territoriality

Exempt and non-exempt income

In general

Like the JCT Option and the Reform Panel Proposal, territorial taxing systems of the United States's major trading partners do not exempt all foreign income. Most territorial systems distinguish between foreign business income, which is exempt from home country taxation, and other categories of foreign income, such as investment income, which are taxed by the home country. Some territorial systems exempt foreign business income derived through foreign subsidiaries but tax foreign business income derived by foreign branches or partnerships. Additionally, territorial taxing systems may have special rules for the treatment of a resident company's gain or loss from the sale of stock of a foreign subsidiary. The discussion that follows addresses these three broad issues.

²⁶⁰ World Economic Forum, *The Global Competitiveness Report*, 2010-2011, p. 4. The Global Competitiveness Report is a comprehensive assessment of countries' competitiveness, driving productivity that, in turn, enable sustained economic growth and long-term prosperity. The report is produced in collaboration with leading academics and a global network of research institutes. Besides data from leading international sources, these indicators include the results of the Executive Opinion Survey carried out by the World Economic Forum annually. The purpose of the survey is to identify the perceptions of business leaders across the countries on topics related to national competitiveness.

Foreign-source non-dividend income, including from intangible property

The JCT Option, the Reform Panel Proposal, and existing territorial systems of other countries achieve territorial taxation of active business income by means of an exemption for dividends from foreign subsidiaries. The treatment of foreign-source non-dividend income, such as interest and royalties, received directly by a domestic corporation warrants further consideration. Under the JCT Option and the Reform Panel Proposal, these payments would not be exempt. Thus, the U.S. taxation of foreign source non-dividend income could increase under an exemption system compared to taxation under present law because companies now may avoid U.S. tax on these royalties through cross-crediting. Under a system that exempts foreign dividends but taxes foreign royalties, companies may have an incentive to recharacterize taxable royalties as exempt dividends.

One suggestion is to exempt, in whole or in part, royalties and interest received by domestic corporations.²⁶¹ This proposed exemption for royalties is based on the concern that moving to a territorial system under which foreign source royalties are fully taxed could encourage the transfer of both intangible property ownership and research and development activity outside of the United States, a problem that may exist under present law.²⁶²

An alternative approach could exempt, in whole or in part, foreign source royalties and interest received by U.S. corporations in the active conduct of a trade or business. Such an approach might be criticized on the basis that it exempt from U.S. tax income that is attributable to U.S., not foreign, business activities. An option that addresses that criticism would be to treat foreign-source royalties and interest received by a U.S. corporation from a foreign subsidiary as exempt income to the extent the income is allocable to active business income of the subsidiary. This approach reflects the argument of some that interest and royalty payments are simply alternative mechanisms for repatriating active foreign earnings. This alternative could be further narrowed so that it applies only to royalty income (to the exclusion of interest income) on a look-through basis. Whereas a royalty is a payment for the use of intellectual property and such intellectual property may be used in the foreign subsidiary's trade or business to generate the foreign subsidiary's active foreign earnings, the fungible nature of interest is such that it may be more difficult to prove that the use of the borrowed funds related to the foreign subsidiary's activity that generated the active foreign earnings. Therefore, limiting this alternative to royalties may be more administrable.

Some commentators view the imposition of U.S. tax on royalties as a critical component of a territorial system because, among other arguments, royalty payments generally are deductible in the foreign jurisdiction. Thus, an exemption would result in income related to the licensed property being free from any taxation.²⁶³ Moreover, foreign source royalty income may

²⁶¹ Treasury Department, p. 62.

²⁶² *Ibid.*

²⁶³ Harry Grubert and Rosanne Altshuler, "Corporate Taxes in the World Economy: Reforming the Taxation of Cross-Border Income, prepared for presentation at the James A. Baker III Institute for Public Policy

relate to property, the production of which resulted from deductible U.S. research and experimental expenses.²⁶⁴

Controlled foreign company rules

As discussed above, potential concerns with a territorial system include the manipulation of transfer prices and the use of transactions designed to strip income from high- to low- or no-tax jurisdictions in order to maximize income that would be permanently tax-free or extremely low-taxed. If the U.S. were to adopt a territorial system, anti-avoidance provisions including provisions such as subpart F and the transfer pricing rules of section 482 and 367(d) could be retained.²⁶⁵ Additionally, other provisions might be enacted to limit the ability of companies to structure transactions designed to maximize permanently exempted income.

For example, under the JCT Option, the rules of subpart F would generally be retained to determine what income is available for exemption. With subpart F as the starting point, consideration would need to be given as to whether those rules should be modified. One question would be whether to retain the rules that treat highly mobile income (such as related party sales and services income, and related party royalties not covered by the temporary look-through rules of section 954(c)(6)) as subpart F income or whether to exempt all active income, including highly mobile income. A second question might be whether to retain present law section 954(c)(6), which facilitates the creation of low- or no-tax income by permitting a high-tax CFC to make deductible payments to a low-tax CFC without generating subpart F income for the recipient.

Another option is to adopt a “subject to tax” requirement to mitigate some of the pressure on the transfer pricing rules and possibly limit the number of transactions designed to shift high-tax income to low- or no-tax jurisdictions.²⁶⁶ This approach, which is used by some foreign countries, could be implemented in a number of ways. One alternative would be to require that the foreign income be subject to some threshold level of foreign tax in order to qualify for exemption.²⁶⁷ Another approach would be to limit exemption to income derived from countries

Conference, “Is It Time for Fundamental Tax Reform?: The Known, Unknown, and Unknowable,” held in Houston, Texas on April 27-28, 2006 (draft dated December 12, 2006) (hereinafter, Grubert and Altshuler (2006)), pp. 4-5.

²⁶⁴ *Ibid.*

²⁶⁵ Transfer pricing is discussed below.

²⁶⁶ See, e.g., American Bar Association, “Report of the Task Force on International Tax Reform,” *Tax Lawyer*, vol. 59 (2006), p. 649 (hereinafter, ABA Task Force), pp. 722-723.

²⁶⁷ Several countries with dividend exemption systems have adopted a threshold approach. See, *Comparative Tax Law for the International Practitioner*, BNA Tax Management International Forum, 32-1 (March 2011) (hereinafter “BNA CFC Summary”) for a discussion of various country CFC rules. In some countries, if the threshold level of foreign tax is not satisfied, all of the controlled foreign company’s income is taxed by the residence country of the controlling corporation (i.e., an all or nothing regime).

with which the United States has a comprehensive income tax treaty²⁶⁸ or to deny an exemption for income derived from certain countries identified as having privileged tax regimes (a “black list”).²⁶⁹ A subject to tax requirement could be enacted either as a separate category of subpart F income, or as a threshold for application of the subpart F regime. It has been noted, however, that there might be pressure to allow taxpayers to defer U.S. tax on active foreign income that fails to satisfy the “subject to tax” requirement. Conceivably, this pressure could ultimately lead to a system that is at least as complex as today, because three income categories would result (exempt, deferred, and currently includible).²⁷⁰

Another option employed in some foreign dividend exemption systems is to adopt requirements designed to ensure that exempt income is derived from legitimate active entities. This approach could be implemented by limiting any exemption to income derived from entities which carry on genuine activity, or to entities that are not used to avoid tax.²⁷¹

Gain or loss on sale of CFC stock

The proper treatment of gain from the sale of CFC stock under a territorial system is complicated because the gain may relate both to assets that generate exempt business income and to assets that generate taxable income. One approach, which the JCT Option takes, is that gain is exempt to the extent it reflects exempt, undistributed earnings of the CFC. This approach has the virtue of relative simplicity but may be conceptually flawed because it ignores gain attributable to the present value of the future income expected from appreciated assets that give rise to exempt income. A system that requires taxpayers to look through CFC stock to the underlying CFC assets and to allocate gain from the sale of CFC stock between unrealized appreciation in exempt and taxable assets, would be conceptually correct but also complex and would introduce difficult valuation issues.²⁷² A simple, taxpayer favorable approach would be to provide

²⁶⁸ Limiting beneficial tax treatment to treaty partners is not without precedent in the United States. Section 1(h)(11) extends the 15 percent preferential dividend rate to foreign corporations that are eligible for treaty benefits under a comprehensive income tax treaty with the United States.

²⁶⁹ Countries may provide black lists that are used to limit foreign income exemptions. For example, France uses a list of “non-cooperative States” in the application of its controlled foreign company safe harbor rules, the United Kingdom specifically identifies certain countries that employ what it refers to as “designer rate tax provisions” in applying the “lower level of taxation” condition for companies operating in these jurisdictions, and Argentina applies its controlled foreign company rules only to stock companies located in jurisdictions it lists as low- or zero-rate jurisdictions. See, BNA CFC Summary.

²⁷⁰ Graetz and Oosterhuis, p. 783.

²⁷¹ For example, Germany requires meaningful industrial or commercial activity in the European Union or European Free Trade Association residence country in order to qualify for exemption; in Japan, the controlled foreign company rules will not apply to deem income up to the shareholder if the controlled foreign company is actually doing business (defined by a list of applicable activities). Some countries’ controlled foreign company rules are only applicable when a main purpose of the transaction was to avoid taxes. See, BNA CFC Summary.

²⁷² JCT Options Report, p. 191 n.425; Graetz and Oosterhuis, p. 776.

complete exemption for gain from the sale of CFC stock (or exemption of a percentage of gain that is the same as the percentage for dividend exemption).

The treatment of loss from the sale of CFC stock presents issues similar to those raised by the taxation of gain. A further question is whether, if a deduction for the loss from the sale of CFC stock is allowed, taxpayers might engage in inappropriate loss-generating transactions. The JCT Option disallowed a deduction for loss from the sale of CFC stock. This rule prevents loss-generating transactions but might be criticized for creating asymmetrical taxation of gains and losses.

Foreign branches and partnerships

Under the Exemption Proposals, foreign branches are treated like CFCs under rules that treat businesses conducted directly by a domestic corporation as CFCs for all U.S. Federal tax purposes. This approach is intended to ensure that the form in which business is conducted (a branch or wholly owned subsidiary) does not produce disparate tax results. This approach makes the exemption system available to businesses that must operate in branch form due to regulatory or legal requirements and reduces the opportunities for cross-crediting that exist under present law. However, this approach requires the development of rules to allow taxation consistent with the fiction that a branch is in fact a corporation. For example, rules would be necessary to track earnings and profits and foreign tax credit pools (for non-exempt income) at the branch level, as well as to create and track dividend payments from the branch to the “parent” corporation.

An alternative approach would maintain the present law distinction between branches and subsidiaries, with the consequence that income or loss from a branch would flow directly onto the domestic corporation’s U.S. income tax return, foreign tax credits would be available to the domestic corporation for foreign taxes paid on the foreign branch’s income, and transactions between the domestic corporation and the foreign branch would generally be ignored. Under this approach, companies might have an incentive to conduct operations located in high-tax countries in branch form (so as to be able to claim foreign tax credits that might be used to offset U.S. tax on other relatively low-taxed foreign-source income, such as royalties) and operations located in low-tax countries in corporate form (and thus not have to pay any residual U.S. tax on the income from those operations when it is repatriated). Concerns about cross-crediting opportunities presented by this approach might be addressed by adopting a per-country foreign tax credit limitation for branch income.

The Exemption Proposals do not identify any principles that would govern foreign partnerships, leaving this question open for determination. One approach would continue to treat foreign partnerships as flow-through entities for purposes of determining the treatment of the partners, including each partner’s share of exempt and non-exempt income. An alternative approach, similar to that recommended by the Exemption Proposals for foreign branches, would treat a foreign partnership like a foreign corporation. Under this approach, an investment in a foreign partnership could be treated as an interest in a CFC, an interest in a noncontrolled section 902 corporation, or as a portfolio investment.

Treatment of individuals

Although most commentary on the issues of worldwide and territorial bases of taxing jurisdiction have focused on competitiveness of U.S. companies in comparison to foreign owned companies subject to territorial systems, a shift to a territorial system could also include provisions related to the treatment of individual taxpayers. Such reform would constitute a significant departure from long-standing policies, although it would have the effect of aligning the U.S. basis of taxation more closely with that of its trading partners.

The U.S. has consistently defended its assertion of worldwide jurisdiction with respect to its citizens and residents, both in the structure of the Code and in the terms of various bilateral and multilateral agreements. To the extent the U.S. has ceded such authority in practice, it reflects acceptance of international norms in favor of relief from double taxation and the policy favoring the facilitation of employment of U.S. citizens or residents abroad.

If the broad assertion of taxing jurisdiction is to be conceded in favor of expanding territorial taxation to individuals, the scope of any such expansion should be considered. For example, the exclusion could apply only to earned income by increasing or removing caps on the foreign earned income exclusion and making the exclusion available to Federal employees. The treatment of unearned income may require revisions to the rules for determining source of such income, and create a need for new rules to establish status as a nonresident citizen. Such rules in turn would require anti-abuse provisions, possibly modeled on rules governing tax-motivated expatriation.

Expenses

Under a dividend exemption system, there would be two categories of foreign source income: exempt and non-exempt. For non-exempt income, the allocation of expenses would serve the same function as it serves under present U.S. law: as part of the calculation of foreign-source taxable income, the allocation would affect a taxpayer's foreign tax credit limitation. In contrast, expenses that generate exempt foreign income might not be allowed as a deduction.

As an example of expenses of a U.S. parent corporation that support income derived by a foreign subsidiary, consider headquarter expenses such as stewardship and general and administrative costs. Under present law, those expenses are fully deductible (to the extent ordinary and necessary) and, because they benefit both domestic and foreign operations, are allocable in part to foreign-source gross income.²⁷³ To that extent, they reduce foreign-source taxable income and, thus, the foreign tax credit limitation.²⁷⁴ Under a dividend exemption system, the allocation of headquarter expenses to taxable foreign-source income would have the same effect as under current law. Allocation of these expenses to exempt foreign income, by contrast, might reduce the U.S. tax deduction available to the taxpayer.

²⁷³ Temp. Treas. Reg. sec. 1.861-14T(e)(3) and (4).

²⁷⁴ In practice, however, this allocation affects only those taxpayers with substantial foreign tax credits, for whom a reduction in the limitation may preclude full or current use of those credits.

This symmetrical treatment of income and expenses would be consistent with the Code's general approach of disallowing expenses associated with the earning of exempt income.²⁷⁵ The effect of failing to allocate expenses against foreign-source income that is not subject to current U.S. tax has been described as facilitating negative effective tax rates for overseas investments by permitting taxpayers to earn income in low-tax foreign countries while claiming the related deductions in the United States.²⁷⁶ More specifically, if headquarter expenses were allocated solely between U.S. and taxable foreign-source income rather than between U.S. income and all foreign income, both taxable and exempt, those expenses would disproportionately reduce taxable income in those categories by expenses that were not entirely related to the production of that income. In the case of U.S.-source income, the overallocation would directly reduce U.S. tax liability. In the case of taxable foreign-source income, the effect would be to reduce disproportionately the foreign tax credit limitation. The practical effect of this reduction would be limited, however, because the types of foreign-source income that would remain taxable under a dividend exemption system are those that could be expected to bear relatively little foreign tax (because the income is mobile).

Although consistent with present law in the United States, the symmetrical treatment of income and expenses would differ from the rules of most foreign jurisdictions that have dividend exemption systems. Many foreign jurisdictions allow a deduction for expenses that generate exempt foreign income and instead provide that a small percentage of foreign dividends (five percent, for example) is taxable.

In part because other countries that have territorial taxing regimes permit deductions for foreign-related expenses, some commentators have argued that if the United States adopts a territorial system of taxation, it also should allow deductions for all foreign-related expenses. According to one economist, disallowing a deduction for foreign-related expenses would, after taking into account a firm's particular investment decision and the interactions of that decision with the decisions of competitors, distort patterns of asset ownership and would decrease the productivity of domestic business operations.²⁷⁷ Another commentator has argued that disallowing a deduction for foreign-related expenses would make U.S. companies targets of foreign acquirers; would encourage U.S. multinationals to borrow abroad for investment abroad rather than borrow for investment in the United States because the foreign borrowing for foreign investment would be fully deductible in the foreign jurisdiction whereas the U.S. borrowing

²⁷⁵ See, e.g., sec. 265.

²⁷⁶ Grubert and Altshuler (2006), p. 13.

²⁷⁷ James R. Hines Jr., "Foreign Income and Domestic Deductions," *National Tax Journal* (September 2008), pp. 461-75. A challenge to, and further defense of, Hines's view can be found in Johannes Becker and Clemens Fuest, "Foreign Income and Domestic Deductions: A Comment," *National Tax Journal* (June 2010), pp. 269-77, and James R. Hines, "Reply to Becker and Fuest," *National Tax Journal* (June 2010), pp. 278-80. An earlier exchange on the expensing issue is in Harry Grubert, "Comment on Desai and Hines, 'Old Rules and New Realities: Corporate Tax Policy in a Global Tax Setting,'" *National Tax Journal* (June 2005), pp. 263-74, and Mihir A. Desai and James R. Hines, Jr., "Reply to Grubert," *National Tax Journal* (June 2005), pp. 275-78, and in the underlying article prompting that exchange, Mihir A. Desai and James R. Hines, Jr., "Old Rules and New Realities: Corporate Tax Policy in a Global Tax Setting," *National Tax Journal* (December 2005), pp. 937-60.

would not be deductible abroad and would be deductible in the United States only in part; and would cause some business expenditures to be deductible nowhere.²⁷⁸

The JCT Option and the Reform Panel Proposal generally would retain present law rules for expense allocation.²⁷⁹ Some U.S. commentators on the implementation of a territorial regime consider this approach appropriate.²⁸⁰ Concerns have been expressed, however, that merely applying the allocation rules of present law, without modification, could have inappropriate or potentially punitive results. Thus, as noted earlier, both the JCT Option and the Reform Panel Proposal, and other commentators, have assumed that interest expense would be allocated using a worldwide affiliated group approach, such as that of Code section 864(f) (as amended by AJCA and currently scheduled to take effect in 2021). Alternatively, it has been suggested that interest expense could be allocated first to interest income (whether or not eligible for exemption), with the remaining interest expense allocated to each category of income pro rata based on worldwide assets.²⁸¹ It has also been suggested that the allocation of stewardship expenses to exempt foreign source income be limited, on the grounds that these expenses otherwise would not be deductible in any jurisdiction.²⁸²

Both the JCT Option and the Reform Panel Proposal would also modify the treatment of research and experimental expenses, but in different ways. Most significantly, the Reform Panel Proposal would not allocate any research and experimental expenses to exempt income, and therefore would not disallow a deduction for these expenses, on the theory that foreign-source royalty income attributable to U.S. research and development activity would be taxable at the U.S. rate (by virtue of bearing relatively little foreign tax and therefore generating few foreign tax credits). However, as described above, there is substantial evidence that intercompany royalties may be understated under present law.²⁸³ A territorial system might increase the incentive to understate intercompany royalties, because (assuming these royalties were fully taxable in the United States) companies generally would no longer be able to eliminate U.S. tax

²⁷⁸ Amy S. Elliott, "GE Executive Criticizes Possible U.S. Territorial System," *Tax Notes* (February 28, 2011), pp. 998-99 (quoting John Samuels, General Electric Co. vice president and senior counsel for tax policy and planning).

²⁷⁹ This approach is analogous to the treatment of expenses and foreign tax credits in conjunction with section 965 of the Code, which temporarily allowed an 85 percent dividends received deduction for certain foreign dividends. Under section 965, expenses directly allocable to the exempt portion of a qualified 965 dividend were disallowed, as were the associated foreign tax credits.

²⁸⁰ See, e.g., Graetz and Oosterhuis, pp. 780-82; Task Force, pp. 725-26; Grubert and Altshuler (2006), pp. 12-13; Grubert and Mutti (2001), pp. 9-10.

²⁸¹ Graetz and Oosterhuis, p. 781.

²⁸² Graetz and Oosterhuis, p. 782 (pointing out that stewardship expenses, by definition, cannot be properly charged out to foreign subsidiaries).

²⁸³ One study suggests that royalties represent less than half of the contribution that U.S. parent research and development makes to the income of foreign subsidiaries. Grubert and Altshuler, p. 11 (citing Grubert and Mutti (2006)).

on foreign royalties through cross-crediting and, thus, would have an incentive to convert royalties into exempt dividends. Allocating research and experimental expenses solely to taxable income (rather than partially to exempt foreign income supported by the expenses) would permit taxpayers to reduce taxable royalty income further. On the other hand, a territorial taxing system in which foreign source royalties are fully taxed might encourage taxpayers to develop and own intellectual property outside the United States, and denying a deduction for a portion of foreign-related research and development expenses incurred in the United States might exacerbate this problem.

Transfer pricing

A taxpayer may have greater tax savings from misstating transfer prices under a territorial taxing system than under a worldwide taxing system with deferral because in the former case misstated prices can create permanent exemption from home country tax, while in the latter case misstated prices may result in deferral rather than permanent exemption. However, the fundamental transfer pricing issues in countries with territorial taxing systems are similar to transfer pricing issues in the United States. In particular, without effective transfer pricing rules, U.S. companies, like companies organized in countries with territorial taxing regimes, could increase the after-tax returns to inefficient business structures by misstating transfer prices.

Transition Issues

Several transition issues would arise in connection with a move to a territorial system, including the treatment of untaxed earnings and our obligations under existing income tax treaties. Additionally, the treatment of existing tax attributes such as foreign tax credit and net operating loss carryovers, CFC earnings and profits (including previously taxed income), and tax pools must be determined.

Untaxed earnings

One of the critical transition issues is the treatment of previously untaxed earnings generated before the effective date of the territorial system. One approach is to have the exemption system apply only with respect to CFC earnings generated after the effective date.²⁸⁴ With respect to previously untaxed earnings, the present-law system would continue to apply in all respects. Thus, this approach would require ongoing maintenance of separate pre-and post-effective date earnings and foreign tax pools. Dividends could be treated as coming first from exempt, post-effective-date earnings and then from pre-effective date untaxed earnings. Implementing an ordering rule that treats dividends as paid first out of post-effective date

²⁸⁴ The JCT Option takes this approach.

earnings (rather than using a pro rata approach) may alleviate some of the complexity of this approach, and has legislative precedent.²⁸⁵

A variation of this approach is to provide taxpayers a limited window in which to make an election to repatriate some or all of their pre-effective date earnings at a favorable tax rate (perhaps by providing a dividends received deduction similar to section 965). This election feature may encourage taxpayers to repatriate some, or all, of their pre-effective date earnings to obtain the favorable tax rate; absent the availability of the election, these earnings might remain deferred indefinitely.

An alternative approach would exempt from tax all CFC earnings and profits paid out after the effective date of the new system.²⁸⁶ Accordingly, no such distributions would ever be subject to U.S. tax, irrespective of whether they were paid from pre-effective date untaxed earnings or post-effective date earnings. This approach offers compliance simplicity, as separate tracking of earnings pools would not be required. Ostensibly, the trade off is the revenue that would have been generated on the repatriation of previously untaxed earnings. This trade off may be at least partially an illusion, however, as the other approach discussed above leaves in place the elective deferral system for previously untaxed earnings, thereby decreasing the likelihood that such earnings would ever be repatriated, except in extenuating circumstances.²⁸⁷ Nevertheless, exempting pre-effective date earnings provides a windfall to taxpayers that previously made operating and investing decisions expecting to pay residual U.S. tax on their deferred income at whatever time it is repatriated. In addition, applying the territorial system to pre-effective date earnings likely will not produce the same efficiency gains from neutralizing tax considerations in deciding whether to repatriate foreign earnings (i.e., eliminating the lock-out effect) that are achieved by adopting a territorial system for post-effective date earnings as companies will have already made decisions about how to employ pre-effective date earnings.

Similar compliance simplicity may be obtained without any revenue loss, and likely with large revenue gain, by adopting an approach that would deem all pre-effective date earnings repatriated under present law rules (a variation would tax the deemed repatriation at a reduced tax rate). As many taxpayers may not have cash readily available to pay the residual tax that would be due on the deemed repatriation, taxpayers could be allowed to spread the tax payment

²⁸⁵ Graetz and Oosterhuis, p. 784 (“A precedent for this alternative can be found in both the rules applicable to C corporations that elect S corporation status and in the enactment of the 1986 foreign tax credit limitation rules.”).

²⁸⁶ The Reform Panel Proposal takes this approach.

²⁸⁷ The “permanent reinvestment” concept under U.S. Generally Accepted Accounting Principles (“GAAP”), which is articulated in APB 23, plays a role in a company’s repatriation decision. Without the ability to assert that foreign earnings are permanently reinvested, a company would be required to record currently the U.S. tax expense associated with its foreign earnings for financial reporting purposes. However, it is unclear what incentives would follow if the “permanent reinvestment” concept were eliminated (e.g., by congressional override of GAAP rules). While companies would still incur the U.S. cash tax cost of repatriating accumulated foreign earnings, a spectrum of transition rules are possible that could lead to varying results for financial accounting purposes.

over several years. This approach results in a windfall for the U.S. fisc as taxpayers that previously made decisions expecting to pay residual U.S. tax on their deferred income at whatever time they decided to repatriate it will lose any control over when that repatriation occurs (or is deemed to occur).

Income tax treaties

Implementing a territorial system would require the renegotiation of existing income tax treaties, which are currently premised on the assumption that the United States operates on a worldwide tax system. For example, existing treaties generally require the United States to allow foreign tax credits for foreign corporate income taxes and dividend withholding taxes, subject to applicable limitations. These treaties would have to be revised to reflect the conversion from a credit mechanism to an exemption mechanism. As the United States currently has an extensive network of bilateral income tax treaties in place,²⁸⁸ both the United States and our trading partners would have to devote significant time and resources to completing this task.

²⁸⁸ There are currently 58 income tax treaties in place. Internal Revenue Service, *Pub. 901, U.S. Tax Treaties* (2011), pp. 54-55.

B. Full Inclusion System

In recent years, a number of academics and tax professionals have advocated the adoption of a full inclusion system in the United States.²⁸⁹ Although there is no prevailing view regarding the mechanism that should be used to implement a full inclusion system, there seems to be agreement that a full inclusion system would include two basic features: (1) U.S. shareholders of a foreign corporation (at least those satisfying a certain ownership threshold)²⁹⁰ would be taxed currently on their shares of the foreign corporation's income, and (2) the foreign tax credit would be retained in some form to mitigate double taxation of foreign source income. The discussion below is divided into three parts. The first section describes the three basic mechanisms that could be used to implement a full inclusion system. The second section examines the potential benefits of a full inclusion system from an economic perspective. The third section discusses certain structural issues that would need to be addressed in implementing a full inclusion system.

1. Mechanisms for implementing a full inclusion system

This section discusses the following three options for implementing a full inclusion system: (1) treat CFCs as pass-through entities, such that each U.S. shareholder is required to include in income currently its share of the CFC's items of income, gain, deduction and loss; (2) expand the consolidated group to include foreign subsidiaries; and (3) expand the subpart F regime.

Pass-through regime

One mechanism for implementing a full inclusion system is to move to a regime that treats CFCs as pass-through entities. An article published several years ago, outlined the key features of a pass-through regime.²⁹¹ The approach generally would apply the principles of the current rules for taxing partnerships contained in subchapter K of the Code. Therefore, each U.S. shareholder would be subject to U.S. tax currently on its share of the foreign corporation's items of income, gain, deduction and loss, and the character of such items (for example, capital gain or ordinary income) would flow through to the U.S. shareholder. Basis adjustments similar to those in section 705 of the Code would apply to prevent double taxation of the foreign corporation's earnings when they are distributed to the U.S. shareholder or when the U.S. shareholder sells its stock. Consistent with the limits imposed by section 704(d) of the Code, net losses of the foreign corporation generally would flow through to a U.S. shareholder, but would be limited to the

²⁸⁹ See, e.g., Reuven S. Avi-Yonah, "The Logic of Subpart F: A Comparative Perspective," *79 Tax Notes 1775* (June 29, 1998); Robert J. Peroni, J. Clifton Fleming Jr. and Stephen E. Shay, "Getting Serious About Curtailing Deferral of U.S. Tax on Foreign Source Income," *SMU Law Review*, vol. 52 (1999), p. 455 (hereinafter, Peroni, Fleming and Shay); Robert A. Green, "The Future of Source-Based Taxation of the Income of Multinational Enterprises," *Cornell Law Review*, vol. 79 (November 1993), p. 18; Kleinbard. See also ABA Task Force at 731-35 (describing and evaluating, but not endorsing, a full inclusion regime).

²⁹⁰ As discussed below, a threshold question for a full inclusion regime would be whether to require that a certain ownership threshold be met in order to trigger current taxation.

²⁹¹ Peroni, Fleming and Shay, pp. 509-12.

extent of the U.S. shareholder's basis in the corporation's stock and the U.S. shareholder's basis in any loans to the foreign corporation. Distributions would be tax-free to the extent of a U.S. shareholder's basis in its stock. Distributions in excess of the U.S. shareholder's basis would be treated as gain from the sale of the stock.

The foreign tax credit generally would be retained. However, because foreign income items would flow through directly to the U.S. shareholders under the pass through approach, a U.S. shareholder would be treated as paying directly its share of the foreign corporation's foreign taxes. Accordingly, the indirect credit rules of present law would be eliminated.

Two possible alternatives for determining a U.S. shareholder's share of the foreign corporation's items are suggested. The first option, which appears to be the option favored by the authors, would be to apply the principles of subchapter K, including the complex "substantial economic effect" rules. The second option would be to use a pro rata approach based on each shareholder's economic interest in the foreign corporation. The authors suggest that a U.S. shareholder's economic interest could be determined based on three factors: (1) voting rights, (2) rights to participate in current earnings and accumulated surplus, and (3) rights to the corporation's assets upon liquidation. The authors acknowledge that in cases involving multiple class of stock with differing rights, determining a U.S. shareholder's economic interest could be difficult. The authors also point out that such an approach could create distortions in terms of choice-of-entity since foreign partnerships would remain governed by the subchapter K rules.

In recognition of the fact that U.S. shareholders with a small interest (less than 10 percent) could have difficulty in obtaining necessary financial information, the authors suggest special rules that could be applied with respect to those shareholders. In the case of publicly traded foreign corporations, the authors suggest that a U.S. shareholder could be provided with a mark-to-market election similar to that available under present law for U.S. shareholders of a PFIC. In the case of nonpublicly traded foreign corporations, the authors suggest that U.S. shareholders could either: (1) use generally available financial information, with adjustments to reflect U.S. tax rules for material items that can be readily identified, or (2) apply a modified version of the excess distribution rules for U.S. shareholders of PFICs. The authors also describe a narrower pass-through approach that could be applied in lieu of the approach outlined here.

Worldwide consolidation regime

Under a worldwide consolidation regime, a U.S. affiliated group would be required to consolidate with its foreign subsidiaries. The tax results for the consolidated entities generally would be similar to those under a pass-through approach. The U.S. group would include on its return the foreign corporation's items of income, gain, deduction and loss, the character of such items would be preserved, and the foreign tax credit would be retained.

However, there are some significant differences between the partnership approach described above and a consolidation approach. First, under the consolidation approach, losses of foreign subsidiaries would be included on the U.S. return without regard to any basis limitation. Second, the consolidation regime would apply only to U.S. corporate shareholders of foreign subsidiaries. Third, depending on the details of the regime, including the ownership level

required to trigger consolidation, a consolidation regime may require retention of the indirect foreign tax credit rules, with their inherent complexity.

A critical question that would need to be resolved would be the ownership threshold required to trigger consolidation. Under the existing consolidated return rules, consolidation is available only with respect to 80-percent owned subsidiaries. One option would be to retain this ownership threshold. An alternative would be to reduce the threshold to all foreign subsidiaries that are controlled by the U.S. group (i.e., foreign subsidiaries in which members of the U.S. group own more than 50 percent of the stock). Yet a third option would be to require consolidation with respect to 10 percent owned subsidiaries.²⁹² In general, a lower threshold would expand the scope of full inclusion at the cost of greater complexity. For example, if the ownership threshold is reduced to a controlling interest, it would make sense to limit the controlling U.S. shareholder's inclusion to its share of the foreign subsidiary's income, which could create complexities. In addition, if the ownership threshold were lowered to 10 percent, it could be difficult for a U.S. shareholder to obtain the financial information necessary to determine the amount of its annual inclusion.

A U.S. shareholder to which the consolidation rule did not apply (i.e., individuals and minority corporate shareholders) generally would not be subject to tax until such shareholder received an actual distribution. The PFIC rules could be retained for these shareholders.

Expansion of subpart F

A task force comprised of members of the tax section of the American Bar Association published a report on international tax reform, which included an analysis of an expanded subpart F regime.²⁹³ The key feature of the system they evaluated was that a U.S. shareholder would include as a deemed dividend its share of the current foreign earnings of the foreign corporation. Thus, the distinction under current law between subpart F and non-subpart F income would be eliminated, and all foreign income would be taxed currently. Losses of the CFC would not, however, flow through to U.S. shareholders.

U.S. corporate shareholders owning a 10-percent interest in a CFC would continue to claim indirect credits for their share of the foreign taxes paid by the CFC. Because earnings would be deemed to be distributed annually, the amount of indirect credits associated with a deemed dividend would be based on current year earnings and taxes. Therefore, taxpayers would no longer need to maintain multi-year pools of earnings and taxes for CFCs, as required under present law.

²⁹² See Robert A. Green, "The Future of Source-Based Taxation of the Income of Multinational Enterprises," *Cornell Law Review*, vol. 79 (November 1993), p. 18.

²⁹³ ABA Task Force, p. 735. The first serious call for rolling back deferral came from President Kennedy in 1961. Message from the President of the United States Relative to Our Federal Income Tax System, April 20, 1961, reprinted as H.R. Doc. No. 87-140, pp. 6-7. As originally proposed, the subpart F rules would have applied to all CFC earnings.

Earnings that were effectively connected income (i.e., attributable to a U.S. trade or business and, thus, subject to U.S. net income tax at the corporate level) would not be subject to the current U.S. shareholder-level taxation. As under present law, upon a distribution of those earnings, U.S. shareholders would be entitled to the dividends received deduction.

Ordering rules would treat actual distributions as coming first out of previously-taxed earnings, and then from effectively connected earnings. As under present law, distributions in excess of current earnings would reduce basis to the extent thereof, and then generate capital gain. The task force states that the ordering rules would eliminate the need to track earnings and profits at the CFC level because previously taxed earnings would be measured at the shareholder-level and would not transfer to a new shareholder.

The task force suggests modifying the present law definition of a CFC. Under present law, a foreign corporation is treated as a CFC only if the United States Shareholders of the foreign corporation in the aggregate own stock representing more than 50 percent of the total voting power or total value of the stock. Under the proposal, a foreign corporation would be a CFC if U.S. shareholders owned in the aggregate 25 percent or more of the foreign corporation's stock (by vote or value) and U.S. shareholders exceed non-U.S. shareholders from any other single country. The 25 percent U.S. ownership level is based on the belief that this level of ownership would, in most cases, be adequate to cause the foreign corporation to take into account U.S. tax considerations.

With regard to the amount of stock that a U.S. shareholder would need to own to trigger current inclusion, the task force believes that the 10 percent threshold under present law is appropriate. However, the task force suggests that the issue of whether less than 10 percent shareholders of a CFC should be taxed currently should be explored.²⁹⁴

U.S. shareholders of foreign corporations that did not qualify as CFCs generally would not be subject to tax until they received an actual distribution. However, the PFIC rules would be retained, with certain modifications. Accordingly, U.S. shareholders of foreign corporations with substantial passive income (50 percent under the proposal) would be subject to the PFIC rules. Less than 10 percent shareholders of a CFC would also be subject to the PFIC rules, assuming the expanded subpart F rules did not apply.

In summary, the proposal would require current taxation of 10 percent or greater shareholders of CFCs (as defined under the proposal) on their respective shares of the CFC's foreign income and would retain the indirect credit for 10 percent or greater corporate shareholders. Subject to application of the PFIC rules, less than 10 percent shareholders of a CFC and U.S. shareholders of non-CFCs would not be taxed until receipt of an actual dividend.²⁹⁵

²⁹⁴ *Ibid.*, p. 732 n. 195.

²⁹⁵ The task force did not express a view on whether the indirect credit for 10 percent U.S. corporate shareholders of *non*-CFCs should be retained.

2. Economic analysis

Efficiency considerations

Like a territorial system, a full inclusion regime should eliminate the disincentive to repatriate foreign earnings, at least in the case of earnings to which it applied. In that respect, full inclusion, like a territorial system, is more neutral than present law with regard to repatriation decisions. In addition, as a structural matter, a full inclusion regime may be more neutral with regard to investment location decisions than is present law, and possibly than a territorial system, because (in the absence of the foreign tax credit issues described below) there would be no tax advantage to locating direct investments in a low-tax jurisdiction.

As a practical matter, the effect of a full inclusion system on location decisions may depend, in part, on the degree of excess foreign tax credits. If all foreign earnings are taxed on a current basis, in the same manner as domestic earnings, then U.S. taxation should not affect location decisions. Assuming no excess foreign tax credits, effective tax rates for investment in tangible and intangible assets would not vary across locations. Thus, adopting a full inclusion regime that minimized excess credits could be expected to reduce distortions in location decisions.²⁹⁶ On the other hand, low-tax locations would remain attractive if companies are able to generate excess foreign tax credits.²⁹⁷

More broadly, however, full inclusion could affect corporate residency decisions to a greater extent than present law. Under a full inclusion system, any U.S. tax-resident corporation would be taxed on its worldwide income, including its share of the income of its foreign subsidiaries. As under present law, a foreign tax-resident company would not be subject to the U.S. tax regime, except to the extent it had a nexus with the United States.²⁹⁸ Differing U.S. tax treatment, based solely on tax residence, creates an unambiguous dividing line that can be expected to influence behavior. Specifically, existing companies could be expected to analyze and compare the cost of inverting with the cost of maintaining U.S. tax residency, and the incentive for new companies to incorporate outside the U.S. may be increased.

One possible response would be to implement new tax residency rules in conjunction with a full inclusion system. In its 2005 Options pamphlet, the JCT Staff outlined residency rules that would shift from the current, form-based system (which ties residency solely to the location of incorporation) to a “facts and circumstances” based test.²⁹⁹ Under the JCT proposal, the tax residence of a foreign-incorporated company’s residence would be determined based on the location of its primary place of management and control. The primary place of management

²⁹⁶ See Grubert and Altshuler (2006), p. 34.

²⁹⁷ *Ibid.*, p. 35.

²⁹⁸ The exception to this general rule relates to U.S. companies that have reincorporated in foreign jurisdictions, but which are subject to the anti-inversion provisions of section 7874.

²⁹⁹ JCT Options Report, p. 180.

and control would be where the executive officers and senior management of the corporation exercise day-to-day responsibility for the strategic, financial and operational policy decision making for the company (including direct and indirect subsidiaries). Under the JCT proposal, the management and control rules would only apply to publicly traded companies, thereby mitigating the effect on small business.

Competitiveness

Some argue that the competitiveness of a U.S. business is enhanced under any new tax system only if the total tax burden imposed on U.S.-based multinational operations is reduced. The effect of a full inclusion system on total U.S. tax revenues depends, in part, on the operation of the foreign tax credit rules and the treatment of losses. Nonetheless, although there would inevitably be “winners” and “losers,” the total tax burden on U.S. multinationals in the aggregate could be expected to increase unless adoption of a full inclusion system is accompanied by a reduction of the U.S. tax rate.³⁰⁰ For this reason, proponents of full inclusion often recommend that a reduction in the U.S. tax rate accompany its adoption.³⁰¹

A study by Grubert and Altshuler suggests that a U.S. tax rate of 28 percent could achieve what they term a “burden neutral” result in a full inclusion system if accompanied by certain design elements, including the elimination of expense allocation for U.S. parent overhead expenses.³⁰² However, Grubert and Altshuler acknowledge that due to imperfect information, the estimates are subject to substantial uncertainty.

One argument against adoption of a full inclusion system is that few other countries have adopted such a system, and no major U.S. trading partner has such a system.³⁰³ However, a full inclusion system would be consistent with international norms generally because the foreign tax credit would continue to mitigate double taxation of foreign income. Whether the total tax burden on U.S. companies would be more or less than the tax burdens of companies based in other foreign jurisdictions is a difficult assessment that would depend in part on the design of the system and the manner in which those jurisdictions choose to react to the new U.S. approach.

³⁰⁰ See Grubert and Altshuler (2006), pp. 35-36.

³⁰¹ Grubert and Altshuler (2006), p. 15; Kleinbard, p. 80; *see also* ABA Task Force, p. 735.

³⁰² Grubert and Altshuler (2006), pp. 15, 35-36. Their calculation of the burden neutral rate was determined by leaving the taxation of domestic income unchanged. *Ibid.*, p. 36. Grubert and Altshuler propose elimination of expense allocation rules. Although this may violate the rules of income measurement, allowing expenses that support the generation of foreign income, taxable under the full inclusion regime, is appropriate. In addition, the elimination of expense allocation rules is a major simplification over present law and decreases the frequency of excess foreign tax credits as foreign income is not reduced by expenses incurred in the United States. *Ibid.*, p.14.

³⁰³ U.S. Department of the Treasury, *The Deferral of Income Earned Through U.S. Controlled Foreign Corporations: A Policy Study*, (December 2000).

3. Structural issues presented by full inclusion

Transfer pricing

A significant potential benefit of a full inclusion system is that the incentive to shift profits to a low-tax foreign jurisdiction would be eliminated or greatly reduced for many taxpayers. Accordingly, taxpayers may not have an incentive to develop and implement income-shifting strategies. Taxpayer compliance costs and IRS administration costs related to transfer pricing issues may be reduced significantly under a full inclusion system. IRS resources dedicated to auditing transfer pricing issues and to transfer pricing disputes could be redeployed, and the administration of section 482 might be simplified.

However, the incentive to engage in income-shifting would remain for taxpayers with excess foreign tax credits. Taxpayers with excess credits would have an incentive to earn low-taxed foreign income in order to “cross-credit” the excess credits against such income and thereby reduce their U.S. tax. Accordingly, some commentators recommend mitigating this situation by eliminating the allocation of parent overhead expenses.³⁰⁴ The opposite approach would be to limit the ability of taxpayers to cross-credit by strengthening the foreign tax credit limitation rules. In deciding whether to adopt one of these approaches, one consideration would be the effect of each approach on the competitiveness of U.S. based multinationals.

Transfer pricing disputes could still be expected to arise between taxing jurisdictions. However, assuming a taxpayer could fully credit its foreign taxes, the taxpayer generally would be a disinterested party except in limited cases involving a foreign jurisdiction with a materially greater tax rate.³⁰⁵

The full inclusion system would not affect foreign taxpayers operating in the United States. Accordingly, those taxpayers would continue to have an incentive to engage in transfer pricing strategies. However, the more limited scope of the transfer pricing issues in the outbound context would permit the IRS to devote additional resources to policing inbound transfer pricing activity.

Foreign tax credit

Under present law, the foreign tax credit is limited to a taxpayer’s U.S. tax liability on its foreign-source taxable income. There is general agreement that a full inclusion system should retain this limitation; however, modifications to the limitation could be considered. Commentators argue that under a full inclusion system, there could still be an incentive to shift income to low-tax jurisdictions if a U.S. taxpayer is in an excess credit position. With this in mind, a full inclusion system could be accompanied by more stringent foreign tax credit limitation rules.

³⁰⁴ See Grubert and Altshuler (2006), pp. 14-15, 34-35.

³⁰⁵ Kleinbard, p. 79.

Alternatively, some proponents of a full inclusion system advocate liberalization of certain limitation rules in order to minimize excess foreign tax credits. Grubert and Altshuler, for example, recommend eliminating the allocation of overhead expenses (including interest expense) incurred by a U.S. parent corporation to foreign source income.³⁰⁶ While Grubert and Altshuler acknowledge that failure to allocate such expenses may “violate the rules of correct income measurement,”³⁰⁷ they believe that minimizing excess credits will promote the competitiveness of U.S. companies and is necessary to reduce the incentive to engage in income-shifting transactions.³⁰⁸ In addition, the elimination of U.S. parent expense allocation would result in simplification. Finally, to the extent taxpayers have excess foreign tax credits, foreign withholding taxes on dividends may act as a disincentive to repatriate foreign earnings, undermining one of the principal benefits of moving to a full inclusion system.³⁰⁹

In evaluating the design of the foreign tax credit limitation rules, another consideration is that a taxpayer with excess foreign tax credit limitation (that is, a taxpayer that must pay U.S. income tax on its foreign earnings, because those earnings are subject to foreign tax at a less than 35 percent rate) often would be indifferent as to whether it paid current U.S. tax or paid current foreign tax and claimed a credit for the foreign tax against its U.S. tax. Thus, a U.S. taxpayer with excess foreign tax credit limitation might have little or no incentive to minimize its foreign tax. This raises a concern that the U.S. fisc might bear the cost of unnecessary foreign taxes. The foreign tax credit regulations attempt to address this concern by requiring a taxpayer to use its reasonable efforts to reduce its foreign tax liability (including by invoking the competent authority procedures).³¹⁰ Because the regulations generally do not require a taxpayer to alter the form of its business or the form of any business transaction in order to minimize its foreign tax expense, the regulatory requirement (commonly referred to as the “compulsory payment rule”) is somewhat limited in its scope. Accordingly, under a full inclusion regime, certain taxpayers may reduce their efforts to design transactions and structures in a manner that minimizes their foreign tax burden.

The potential reactions of foreign governments complicate the issue. If a full inclusion system were designed such that U.S. taxpayers generally had excess foreign tax credit limitation,

³⁰⁶ Grubert and Altshuler (2006), p. 14.

³⁰⁷ *Ibid.*

³⁰⁸ *Ibid.* On the other hand, U.S. companies for which liberalization of the expense allocation rules results in additional foreign tax credit limitation could have an incentive to engage in transactions designed to produce additional foreign tax credits.

³⁰⁹ Using 2002 corporate tax files, Altshuler and Grubert calculated the amount of excess credits that could be expected to arise, assuming their estimated burden neutral tax rate of 28 percent rate and no allocation of parent overhead expenses. They determined that approximately 30 percent of foreign income would have excess credits (as compared to 50 percent in 2002). Additionally, they estimated that excess credits would be concentrated in the petroleum industry, and that only about 18 percent of foreign income earned by manufacturing companies would have excess credits. *Ibid.* p. 36.

³¹⁰ Treas. Reg. sec. 1.901-2(e)(5).

foreign governments could have an incentive to raise taxes on U.S. taxpayers, for example by increasing dividend withholding taxes.³¹¹ As long as a U.S. taxpayer could claim foreign tax credits for the additional taxes, an increase in the foreign tax rate would not harm the U.S. taxpayer and, thus, would not discourage U.S. investment in the foreign jurisdiction.³¹² Rather, the increase in the foreign tax rate would be borne by the U.S. fisc.

Treatment of foreign losses

Under present law, losses of a foreign subsidiary do not flow through to U.S. shareholders. However, in order to benefit currently from such losses, some taxpayers structure new investments, or restructure existing investments with accumulated losses, as branch operations of a U.S. corporation.

In designing a full inclusion regime, it would be necessary to determine whether to permit losses to flow through. Some argue that fairness and equity require that losses, as well as earnings, flow through to the U.S. shareholder. Allowing losses would also simplify entity choice issues, as it would remove the tax incentive to structure loss operations in branch or partnership form. On the other hand, domestic utilization of foreign losses would reduce tax revenues.

The three approaches described above differ in their treatment of losses. The consolidation approach would permit full flow-through of losses. The pass-through approach outlined above generally permits flow-through of losses, but would limit the amount of losses by a taxpayer's basis in its stock. The expanded subpart F approach, which would utilize the present-law deemed dividend rules, would not allow losses to flow through to U.S. shareholders. However, if it were determined that losses should flow through without limitation under a full inclusion system, the pass through and subpart F approaches outlined above could be modified to reach this result.

Application of full inclusion to minority shareholders

Adopting a full inclusion system would require a determination of the ownership threshold that triggers full inclusion. A "pure" full inclusion system would tax all U.S. shareholders of foreign corporations on a current basis irrespective of the amount of stock owned. This is the result achieved under the pass-through approach to full inclusion outlined above. However, the imposition of current taxation on minority shareholders creates complexity and disincentives for portfolio investment in foreign corporations. In addition, as the level of U.S. ownership declines below that of control, issues arise regarding the ability of the U.S. shareholders to obtain the information necessary to comply with a full inclusion system. Finally, current taxation of minority shareholders in a foreign corporation who do not have the ability to force a distribution from the foreign corporation could leave some shareholders in the position of owing U.S. tax without having the funds to pay the tax.

³¹¹ Grubert and Altshuler (2006), p. 35.

³¹² *Ibid.*

In part for these reasons, some commentators would limit current taxation to 10 percent shareholders. Others would limit current taxation to controlling shareholders. In addition, in considering some of these difficulties, the ABA task force suggested limiting current taxation to those cases where U.S. shareholders in the aggregate own 25 percent or more of the foreign corporation and the percentage owned by U.S. shareholders exceed ownership by non-U.S. shareholders from any other single country.

One alternative for minority shareholders would be to adopt rules similar to the present law rules for PFICs. Under such rules, the benefits of deferral would be eliminated through the use of an interest-charge system.³¹³

Because the pass-through approach would treat U.S. shareholders as paying directly their share of a foreign corporation's foreign taxes, all U.S. corporate shareholders of a foreign corporation would be eligible to claim foreign tax credits for foreign income taxes paid by the foreign corporation. This would be an expansion of present law, which permits only 10 percent U.S. corporate shareholders of a foreign corporation to claim credits for foreign taxes paid by the foreign corporation.

Treatment of individuals

Another issue is whether full inclusion would apply to individuals as well as corporate shareholders. In making this determination, considerations may include the ownership threshold required to trigger full inclusion. If a move to full inclusion does not include applying the rules to individuals, the PFIC rules could be retained to prevent abuse.

Under present law, individuals generally are not entitled to claim indirect credits for foreign corporations in which they own stock, even if the shareholder meets the requisite 10 percent ownership threshold required for corporate shareholders.³¹⁴ This is consistent with the classical system of income taxation in the United States, which imposes income tax at both the corporate and individual levels. In contrast, an individual who is a partner in a foreign partnership is treated as if the individual paid the tax and is allowed to claim a direct credit for the tax.³¹⁵ Consistent with these principles, the pass-through approach would permit U.S. individuals to claim foreign tax credits for foreign taxes paid by foreign corporations while the consolidation and subpart F approaches outlined above would not. One consideration to take into account in determining whether an individual should be permitted to claim a credit under any full inclusion regime would be whether the individual is subject to the full inclusion rules, although as stated, U.S. individuals who are subject to subpart F under present law generally are not permitted to claim indirect foreign tax credits.

³¹³ See, e.g., Peroni, Fleming and Shay, p. 512.

³¹⁴ There is a limited exception for 10 percent U.S. shareholders of CFCs. Such shareholders may claim indirect credits if they elect to treat their CFC stock as if it were held through a domestic corporation. Sec. 962. Thus, the price for the indirect credit is the imposition of a U.S. corporate level tax.

³¹⁵ Sec. 901(b)(5).

Simplification

A full inclusion system could be significantly simpler than present law. First, the detailed rules contained in subpart F for determining whether income constitutes subpart F income subject to current inclusion could be eliminated in their entirety.³¹⁶ Other provisions related to deferral and subpart F, such as sections 367, 956 and 1248, could also be eliminated or simplified. Second, the foreign tax credit rules could also be simplified. For example, depending on the design of the full inclusion system, the indirect credit rules in section 902 and 960 may be eliminated or simplified. Similarly, depending on the details of the full inclusion system, the expense allocation rules could be simplified. Third, depending on the foreign tax credit limitation rules and the extent to which taxpayers are in excess credit, a full inclusion system would reduce the incentive to engage in transactions (such as inter-affiliate payments) designed to strip income from high tax jurisdictions to low or no tax jurisdictions and, thus, could be expected to reduce the resources dedicated to such activities.

Transition issues

Treatment of untaxed earnings

As with a move to a more territorial system, one of the principal transition issues that would be faced if full inclusion were adopted would be the treatment of previously untaxed earnings attributable to periods prior to the effective date of the full inclusion regime. Options span from mandating a current, full inclusion of all untaxed earnings to permitting continued, elective deferral indefinitely.

A current, full inclusion of untaxed earnings, as a policy matter, may be desirable to remove the repatriation disincentive with respect to previously untaxed earnings. This type of inclusion could take different forms depending on the type of regime adopted. For example, the adoption of a pass-through regime could result in current full inclusion of previously untaxed earnings if the pass-through regime required a deemed change in status from corporate to partnership form (treated as liquidation of the corporation followed by a contribution to the partnership).³¹⁷ Adoption of a consolidation regime or expansion of subpart F could include transition rules requiring inclusion of existing, untaxed, earnings and profits of CFCs.

On the other hand, taxing previously untaxed earnings could be viewed as a penalty for taxpayers that have derived foreign earnings under the present law rules allowing deferral of undistributed earnings. The increased current tax burden from requiring full inclusion of pre-effective date earnings could be mitigated by providing a preferential tax rate on pre-effective date earnings, or by allowing taxpayers to spread the tax payment out over several years.

³¹⁶ Peroni, Fleming, and Shay, p. 512.

³¹⁷ Peroni, Fleming, and Shay, p. 520.

Income Tax Treaties

Depending on the design of the system, including the operation of the foreign tax credit, adopting a full inclusion system may not require renegotiation of our income tax treaties. Current treaties reflect the existing foreign tax credit system, which would continue as the mechanism for mitigating international double taxation.