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TAX TREATMENT OF FOREIGN AND EXPORT INCOME

PREPARED FOR THE USE OF THE

COMMITTEE ON FINANCE

BY THE STAFF OF THE

JOINT COMMITTEE ON INTERNAL REVENUE TAXATION

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INTRODUCTION

This pamphlet presents background information on a number of proposals designed to modify the tax treatment of foreign or export-related income. The proposals described here are those which were in the House-passed bill (H.R. 10612). There are, of course, other proposals relating to foreign or export income which could be considered. Subsequent pamphlets will discuss other proposals as well as alternatives and possible modifications to the proposals presented here.

This pamphlet first presents an overview as to the taxation of foreign income, including a brief discussion of the general principles employed in different countries in taxing foreign income. This is followed by a discussion of tax deferral, possible modifications in the foreign tax credit, three modifications made by the House bill in the tax treatment of individuals with income earned abroad, possible modifications of provisions in present law affecting money or other property moving in or out of the United States, possible modifications of three corporate categories receiving special treatment, and finally a discussion of Domestic International Sales Corporations (DISC).

In each of these cases the pamphlet describes present law and the issues which have been presented. The House provisions, to the extent they bear on the problem discussed, are also described briefly. As indicated above, subsequent pamphlets will discuss alternative proposals for dealing with these problems.

1. U.S. Taxation of Foreign Income—An Overview

General Principles

There are two generally recognized bases for any country's jurisdiction to tax income: (1) jurisdiction over the recipient of the income, and (2) jurisdiction over the activity which produces the income (i.e., the source of the income). Thus, a country may tax the worldwide income of persons subject to its jurisdiction or it may tax income earned within its borders, or it may tax under both standards.

Tax jurisdiction over an individual may be obtained, as in the United States, by the residency or citizenship of an individual. Tax jurisdiction over a corporation is determined by place of residency, which in the United States is the place of corporate organization.

In addition, most countries' tax laws and regulations contain rules (called source rules) for determining whether, and the extent to which, income is considered as earned from activities conducted within that country or within some other country.

Since most sovereign nations apply one or both of the above principles in taxing their residents and in taxing income from sources within their borders, two nations often claim the right to tax the same income. Most nations have developed principles to accommodate these competing claims and thus avoid what could be called a double taxation of income. One principle is that the country of the source of income has the primary jurisdictional right to tax that income. In this case the country of residence retains a residual right to tax that income. Since a double tax on this income would tend to discourage capital and individuals from crossing borders and thus would inhibit international commerce, most countries which exercise the residual right to tax their residents and corporations on a worldwide basis allow a tax credit for income taxes paid to the source country.

U.S. Treatment

Under present law, the United States imposes its income tax upon the worldwide income of any corporation organized under the laws of the United States, whether this income is derived from sources within or from without the United States.[1] A tax credit (subject to limits) is allowed for foreign taxes imposed on foreign source income.

Foreign corporations generally are taxed by the United States only to the extent they are engaged in business in the United States (and to some extent on other income derived here). As a result, the United States generally does not impose a tax on foreign income of a foreign corporation even though it is owned or controlled by a U.S. corporation or group of U.S. corporations (or by U.S. citizens or residents). Such a corporation is subject to tax, if any, by the foreign country or countries in which it operates. Generally, the foreign source income of a foreign corporation only will be subject to U.S. tax when it is remitted to the corporate or individual shareholders as a dividend. The tax in this case is imposed on the U.S. shareholder and not the foreign corporation. The fact that no U.S. tax is imposed in this case until (and unless) the income is distributed to the U.S. shareholders (usually corporations) is what is generally referred to as tax deferral.

There are, however, exceptions to the general rules set out above where income of a controlled foreign corporation is taxed to the U.S. shareholders, usually a corporate shareholder, before they actually receive the income in the form of a dividend. The procedures (subpart F of the code) set forth in present law treat certain income as if it were remitted as a dividend. Under these provisions income from so-called tax haven activities conducted by corporations controlled by U.S. shareholders is deemed to be distributed to the U.S. shareholders and currently taxed to them.

Under present law, a U.S. taxpayer who pays foreign income taxes on his income from foreign sources is allowed a foreign tax credit

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[1] Exceptions to this general rule are provided for corporations which primarily operate in the possessions and for DISCs. Also, a reduced rate of tax (34 percent) is provided for Western Hemisphere trade corporations.

against his U.S. tax on his foreign source income. The credit is provided only for amounts paid as income, war profits or excess profits taxes paid or accrued during the taxable year to a foreign country. This foreign tax credit system is based on the principle that the country in which business activity is conducted has the primary right to tax the income from that activity and the home country of the individual or corporation has a residual right to tax that income, but only so long as double taxation does not result. While some countries, such as France and the Netherlands, avoid international double taxation by exempting all income from foreign operations, most of the other industrial nations—including the United States, Great Britain, Germany, Canada and Japan—use the credit system to avoid double taxation of income.

The foreign tax credit is allowed not only for taxes paid on income derived from operations in a specific country, but it is also allowed with respect to dividends received from foreign corporations operating in foreign countries and paying foreign taxes. This latter credit, called the deemed-paid credit, is provided for dividends paid by foreign corporations to U.S. corporations which own at least 10 percent of the voting stock of the foreign corporation. Dividends to these U.S. corporations are considered as carrying with them a proportionate amount of the foreign taxes paid by the foreign corporation. The computation of the amount of the foreign taxes allowed as a deemed-paid credit in the case of a dividend distribution differs depending upon whether or not the payor of the dividend is a less developed country corporation.

In order to prevent a taxpayer from using foreign tax credits to reduce U.S. tax liability on income from sources within the United States, two alternative limitations on the amount of foreign tax credits which can be claimed are provided by present law. Under the overall limitation, a taxpayer aggregates his income and taxes from all foreign countries. A taxpayer may credit taxes from any foreign country as long as the total amount of foreign taxes applied as credits in each year does not exceed the amount of tax which the United States would impose on the taxpayer's income from all sources outside of the United States.

The alternative to the overall limitation is the per-country limitation. Under this limitation, the same calculation made under the overall limitation is made on a country-by-country basis. A taxpayer's credits from any country are limited to the U.S. tax on the amount of income from that country. Taxpayers are required to use the per-country limitation unless they elect the overall limitation. Once the overall limitation is elected, it cannot be revoked except with the consent of the Secretary or his delegate.

In cases where the applicable limitation on foreign tax credits reduces the number of tax credits which can be used by the taxpayer to offset the U.S. tax liability in any one year, present law provides that the excess credits not used may be carried back for two years or carried forward for five years.

The significance of the present overseas operation of U.S. firms is indicated by the fact that the sales (other than petroleum products) of U.S. multinational foreign affiliates were $254 billion in 1974. The U.S. share of the book value of U.S. overseas affiliates in 1974 stood at $118.6 billion—an increase of $15 billion over 1973—of which one-half represented net capital outlays from the United States and the other one-half represented reinvested earnings of these affiliates. Data on U.S. direct investment since 1966 are shown in table 1.

TABLE 1.—U.S. DIRECT INVESTMENT ABROAD BY SELECTED INDUSTRY GROUP, 1966–74

[In millions of dollars]

	Book value at year end	Net capital outflows	Reinvested earnings [1]	Earnings	Balance-of-payments income [2]
All areas:					
1966	51, 792	3, 625	1, 791	5, 231	3, 467
1967	56, 583	3, 073	1, 757	5, 522	3, 847
1968	61, 955	2, 880	2, 440	6, 486	4, 152
1969	68, 201	3, 190	2, 830	7, 485	4, 819
1970	75, 456	4, 281	3, 176	8, 023	4, 992
1971	83, 033	4, 738	3, 176	9, 002	5, 983
1972	90, 467	3, 530	4, 532	10, 800	6, 416
1973	103, 675	4, 968	8, 153	16, 940	8, 841
1974 [3]	118, 613	7, 455	7, 508	25, 141	17, 678
Petroleum:					
1966	13, 893	787	156	1, 482	1, 339
1967	15, 189	1, 102	206	1, 751	1, 559
1968	16, 622	1, 174	248	1, 963	1, 735
1969	17, 720	924	29	1, 996	1, 997
1970	19, 730	1, 492	575	2, 405	1, 881
1971	22, 067	1, 940	421	2, 835	2, 457
1972	23, 974	1, 613	356	3, 063	2, 739
1973	27, 313	1, 442	1, 925	6, 128	4, 249
1974 [3]	30, 248	1, 158	1, 814	13, 513	11, 699
Manufacturing:					
1966	20, 740	1, 611	918	1, 909	950
1967	22, 803	1, 224	845	1, 860	1, 018
1968	25, 160	946	1, 357	2, 395	1, 055
1969	28, 332	1, 210	1, 987	3, 071	1, 126
1970	31, 049	1, 263	1, 528	3, 141	1, 605
1971	34, 359	1, 564	1, 796	3, 517	1, 696
1972	28, 325	1, 163	2, 830	4, 761	1, 910
1973	44, 370	1, 863	4, 107	6, 674	2, 472
1974 [3]	50, 915	2, 712	3, 786	6, 498	2, 636
Other:					
1966	17, 160	1, 227	717	1, 840	1, 177
1967	18, 591	746	707	1, 912	1, 270
1968	20, 174	760	836	2, 128	1, 362
1969	22, 149	1, 056	814	2, 418	1, 696
1970	24, 677	1, 527	1, 073	2, 477	1, 507
1971	26, 007	1, 234	959	2, 649	1, 830
1972	28, 168	754	1, 346	2, 976	1, 767
1973	31, 992	1, 663	2, 126	4, 137	2, 120
1974	37, 450	3, 585	1, 907	5, 129	3, 343

[1] Represents a U.S. reporter's share in the reinvested earnings of its foreign-incorporated affiliates.
[2] Includes interest, dividends, and branch earnings.
[3] Preliminary.

Source: U.S. Department of Commerce, "Survey of Current Business" October 1975.

The earnings, after foreign income taxes, of these foreign investments were $25.1 billion, $11.1 billion of which represented earnings of U.S. branches. Of the $14.0 billion of earnings of foreign affiliates, $6.5 billion or 46.7 percent was distributed as dividends to the U.S. shareholders. The net amount received by shareholders, after foreign with-

holding taxes, was $5.85 billion. An additional $3.8 billion was received as interest, fees, and royalties. The composition of foreign source earnings is shown in table 2.

TABLE 2.—ADJUSTED EARNINGS AND RELATED ITEMS: DERIVATION AND RELATIONSHIP

[In millions of dollars]

	1974 amount and source
1. Earnings of incorporated affiliates	14,049 reported.
2. Earnings of unincorporated affiliates	11,091 reported.
3. Earnings	25,141 equals 1 plus 2.
4. Gross dividends (on common and preferred stock)	6,541 equals 5 plus 6.
5. Foreign withholding tax on dividends	691 derived.
6. Dividends	5,850 reported.
7. Interest	737 reported.
8. Reinvested earnings	7,508 equals 1 minus 4 or 10 minus 9.
9. Balance-of-payments income	17,678 equals 2 plus 6 plus 7 or 10 minus 8.
10. Adjusted earnings	25,186 equals 3 minus 5 plus 7 or 8 plus 9.
11. Fees and royalties	3,023 reported.
12. Balance of payments receipts	20,701 equals 9 plus 11.
13. Direct investors' ownership benefits	28,209 equals 10 plus 11.

Source: Based on data in "Survey of Current Business", October 1975, pp. 48 and 49.

From the point of view of the U.S. investors, the return on this investment in 1974 was $28.2 billion (including interest, royalties, and fees), an increase of $7.8 billion over 1973. This represents a rate of return of 27.2 percent on the book value of the investment as of the beginning of 1974.

Of the $28.2 billion of earnings in 1974, $20.7 billion represents a balance-of-payments inflow (receipts of income on U.S. direct investment), while $7.5 billion is reinvested earnings. This $20.7 billion inflow represents a rate of return of 19.9 percent on the book value of investment at the end of 1973. Of the $20.7 billion inflow, $11.1 billion is earnings of U.S. branches, dividends account for $5.85 billion, royalties and fees account for $3.0 billion, and interest accounts for $0.7 billion.

Earnings and dividend payouts by type of business activity and area of the world are shown in table 3. As would be expected, this shows that a relatively high proportion of dividends are paid out of earnings from high-tax foreign countries. For example, the petroleum industry pays 75 percent of its earnings from developing countries in dividends. Manufacturing companies in Europe pay out 50 percent of their earnings. This table also shows that the worldwide dividend payout ratio of 46.6 percent is increased substantially by the petroleum industry's practice of repatriating most of its high-tax extraction income. For example, the worldwide dividend payout ratio of manufacturing industries alone is 39.8 percent.

It is estimated that for 1976 corporate pre-tax foreign earnings will be approximately $25 billion (other than the extractive industries), foreign taxes on this income will be about $10 billion (40 percent of earnings) and U.S. taxes will be about $2 billion (8 percent of earnings).

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TABLE 3.—DIVIDEND PAYOUT RATIOS OF INCORPORATED AFFILIATES, 1973-74

[In millions of dollars, or ratio]

Area and Industry	1973		1974		Payout ratio (gross dividends/earnings)	
	Earnings	Gross dividends	Earnings	Gross dividends	1973	1974
All areas	13,020	4,852	14,049	6,541	0.373	0.455
Petroleum	3,260	1,335	4,088	2,274	.410	.556
Manufacturing	6,584	2,477	6,279	2,493	.376	.397
Other	3,175	1,049	3,682	1,774	.330	.482
Developed countries	9,376	3,199	9,630	4,106	.341	.426
Petroleum	1,596	356	1,977	796	.223	.403
Manufacturing	5,638	2,150	5,278	2,195	.381	.415
Other	2,142	692	2,375	1,114	.323	.469
Canada	2,567	700	3,071	869	.273	.233
Petroleum	596	144	675	162	.242	.240
Manufacutring	1,441	432	1,774	484	.300	.273
Other	531	125	623	223	.235	.358
Europe	5,544	2,038	5,441	2,719	.358	.500
Petroleum	750	176	1,078	561	.235	.520
Manufacturing	3,464	1,393	2,887	1,439	.402	.498
Other	1,331	470	1,476	719	.353	.487
Other developed	1,265	461	1,118	518	.364	.453
Petroleum	250	38	224	74	.152	.330
Manufacturing	734	325	618	273	.443	.442
Other	280	98	276	171	.350	.620
Developing countries	3,014	1,446	3,613	2,055	.480	.569
Petroleum	1,334	840	1,701	1,278	.630	.751
Manufacturing	945	327	1,001	297	.346	.297
Other	735	280	912	482	.381	.529
Latin America	1,519	527	1,597	683	.347	.428
Petroleum	221	65	161	76	.294	.472
Manufacturing	730	254	767	232	.348	.303
Other	567	207	659	374	.365	.659
Other developing	1,495	918	2,016	1,373	.614	.681
Petroleum	1,112	773	1,539	1,201	.695	.780
Manufacturing	215	72	234	64	.335	.274
Other	167	73	243	108	.437	.444
International and unallocated	630	217	805	379	.344	.470

Note: Details may not add to totals because of rounding.

Source: U.S. Department of Commerce, "Survey of Current Business", October, 1975.

2. Deferral

Present Law

Generally, the foreign source income of a foreign corporation is subject to U.S. income taxes only when it is actually remitted to the U.S. corporate or individual shareholders as a dividend. The tax in this case is imposed on the U.S. shareholder and not the foreign corporation. The fact that no U.S. tax is imposed until and unless the income

is distributed to the U.S. shareholders (usually corporations) is what is generally referred to as tax deferral.[2]

Present law, however, provides for an exception to the general rule of deferral under the so-called subpart F provisions of the Code. Under these provisions income from so-called tax haven activities conducted by corporations controlled by U.S. shareholders is deemed to be distributed to the U.S. shareholders and currently taxed to them whether or not they actually receive the income in the form of a dividend. The statute refers to these types of income as "foreign base company income."

Prior to the Tax Reduction Act of 1975 the three categories of income subject to current taxation as tax haven income were foreign personal holding company income; sales income from property purchased from, or sold to, a related person if the property is manufactured and sold for use, consumption, or disposition outside the country of the corporation's incorporation; and service income from services also performed outside the country of the corporation's incorporation for or on behalf of any related persons. That Act added a fourth category of tax haven income called foreign-base company shipping income. Under the Act, the deferral of U.S. tax for shipping income received by a foreign subsidiary of a U.S. corporation is continued only to the extent that the profits of the shipping company are reinvested in shipping operations.

In addition, present law provides for the current taxation of the income derived by a controlled foreign corporation from the insurance of U.S. risks. Foreign base company income and income from the insurance of U.S. risks are collectively referred to as subpart F income.

Present law also provides, with certain exceptions, that earnings of controlled foreign corporations are to be taxed currently to U.S. shareholders if they are invested in U.S. property. In general terms, U.S. property is defined as all tangible and intangible property located in the United States.

Prior to the enactment of the Tax Reduction Act of 1975 there were a number of significant exceptions to the rules providing for current taxation of tax haven income. By repealing these exceptions, the Tax Reduction Act of 1975 substantially expanded the extent to which foreign subsidiaries of U.S. corporations are subject to current U.S. taxation on tax haven types of income. The Act repealed the minimum distribution exception which permitted deferral of U.S. taxation on tax haven types of income in cases where the foreign corporations distributed a minimum level of dividends to their U.S. shareholders.

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[2] Where it is not anticipated that the income will be brought back to the United States, for financial accounting purposes (in accounting for the income of a consolidated group consisting of one or more domestic corporations and its foreign subsidiaries) this income is often shown as income exempt from U.S. tax.

This provision was the main device used by multinational corporations for avoiding taxation of their tax haven income, and its repeal (together with other changes referred to below) will result in the current taxation of virtually all tax haven income of foreign subsidiaries of U.S. corporations.

The Act also repealed the exception in present law which permitted deferral of taxation in cases where the tax haven income was reinvested in less developed countries. Finally, the Act modified the provision which permitted corporations having less than 30 percent of their gross income in the form of tax haven income to avoid current taxation. The Act provided that this tax haven income is to be taxed currently in any case where it equals or exceeds 10 percent of gross income.[3]

Issues

The merits of the present system of deferral have been frequently debated in recent years. In 1962 the Administration proposed an almost total elimination of deferral. Congress responded by focusing on the abuses of tax haven activities and eliminating deferral for the types of income which are normally susceptible to tax haven arrangements.

However, the general debate over whether to eliminate deferral completely or to limit its use for all taxpayers has continued. No one disputes the fact that deferral permits foreign corporations controlled by U.S. persons to avoid or postpone paying some U.S. tax by retaining their earnings abroad. But whether this is appropriate in view of their separate organization or whether deferral constitutes a significant incentive for foreign investment and, if so, whether that incentive means more or less investment (and jobs) in the United States are still subjects of debate.

House Bill

The Ways and Means Committee decided at this time not to adopt any basic changes in the deferral provisions of present law. Instead, the committee referred the subject to a task force for further study.

However, a number of more technical provisions relating to deferral and the taxation of foreign subsidiaries of U.S. corporations were included in the bill as it passed the House. They are set out below.

The definition of investments in U.S. property by controlled foreign corporations (which are treated as dividends) would be limited by the House bill to investments in stock or obligations of a related U.S. person (not including a subsidiary) and to tangible property leased to, or used by, such related U.S. person. However, sales between a con-

[3] While the above-described provisions in the 1975 Act all resulted in the elimination or tightening of exceptions to the current taxation of tax haven income, one modification was made in the 1975 Act which resulted in a relaxation of those rules. This amendment provided that base company sales income (i.e., income from selling activities in a tax haven) does not include income from the sale of agricultural commodities which are not grown in the United States in commercially marketable quantities.

trolled foreign corporation and a related U.S. person which are disguised dividends would be considered as investments in U.S. property. The new rules would be prospective except that they would apply as of 1969 with respect to foreign corporations owning U.S. subsidiaries which invest in property situated on the U.S. Outer Continental Shelf. (Sec. 1021)

The House bill eliminates the provision in present law which excepts U.S. shareholders of less-developed country corporations from ordinary income tax on gain from the sale of stock of those corporations (to the extent of their accumulated profits). This provision would apply to sales after December 31, 1975, with respect to earnings accumulated after that date. (Sec. 1022)

An exception to the definition of foreign personal holding company income is added by the House bill for income on earned surplus which must be retained by a foreign casualty insurance subsidiary in order to satisfy State insurance solvency requirements as to earned premiums. This exception would apply to taxable years beginning after December 31, 1975. (Sec. 1023)

The tax haven (or subpart F) provisions are modified by the House bill to exclude from the definition of foreign base company income shipping between two or more points within the country of incorporation and registration of the ships. Also, amounts paid on unsecured loans by companies substantially all of whose assets consist of qualified investments in foreign base shipping operations would be treated as a reinvestment in shipping assets for purposes of subpart F. This provision would apply to taxable years beginning after December 31, 1975. (Sec. 1024)

The definition of foreign base company sales income is amended by the House bill to exclude agricultural commodities which are significantly different in grade or type from, and which the Secretary of the Treasury determines after consultation with the Secretary of Agriculture are not readily substitutable for (taking into account consumer preferences) agricultural products grown in the United States in commercially marketable quantities. This provision would apply generally to taxable years beginning after December 31, 1975. (Sec. 1025)

3. Foreign Tax Credit

Present Law

As discussed above (in the Overview section), present law permits taxpayers subject to U.S. tax on foreign income to take a foreign tax credit for the amount of foreign taxes paid on income from sources outside of the United States. The credit is provided only for amounts paid as income, war profits or excess profits taxes to any foreign country or to a possession the United States.

The foreign tax credit is allowed not only for taxes paid on income derived from operations in a foreign country, but it is also allowed for dividends received from foreign corporations operating in foreign countries and paying foreign taxes. This latter credit, called the deemed-paid credit, is provided for dividends paid by foreign corporations to U.S. corporations which own at least 10 percent of the voting stock of the foreign corporation. Dividends to these U.S. corporations

are considered as carrying with them a proportionate amount of the foreign taxes paid by the foreign corporation.[4]

The computation of the amount of the foreign taxes allowed as a deemed-paid credit in the case of a dividend distribution differs depending upon whether or not the payor of the dividend is a less developed country corporation. For less developed country corporations the foreign taxes paid are allocated between the dividend distribution and the portion of the earnings used to pay the foreign taxes. However, this omits from the U.S. tax base the portion of the earnings used to pay the foreign tax. As a result, where the foreign tax is less than the U.S. tax (but above zero), this gives an advantage to dividend income over income subject to the full United States tax. For developed country corporations the earnings used to pay the foreign tax allowed as a credit are included in the distribution base and the credit for foreign taxes paid is based upon all the earnings, including the amount paid as foreign taxes, and not merely the portion paid as a dividend.

To prevent a taxpayer from using foreign tax credits to reduce U.S. tax liability on income from sources within the United States, two alternative limitations on the amount of foreign tax credits which can be claimed are provided by present law. Under the overall limitation, the amount of foreign tax credits which a taxpayer can apply against his U.S. tax liability on his worldwide income is limited to the ratio of his taxable income from sources outside the United States (after taking all relevant deductions) to his worldwide taxable income. Under this limitation, a taxpayer may credit taxes from any foreign country as long as the total amount of foreign taxes applied as a credit in each year does not exceed the amount of tax which the United States would impose on the taxpayer's income from all sources without the United States.

The alternative to the overall limitation is the per-country limitation. Under this limitation the same calculation made under the overall limitation is made on a country-by-country basis. The allowable credits from any single foreign country cannot exceed the ratio of taxable income from that country to worldwide taxable income. Taxpayers are required to use the per country limitation unless they elect the overall limitation. Once the overall limitation is elected, it cannot be revoked except with the consent of the Secretary or his delegate.

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[4] These rules for the deemed-paid credit apply to distributions to a domestic corporation from a first-tier foreign corporation in which the domestic corporation is a 10-percent shareholder and to distributions from a second-tier or third-tier foreign corporation (through a first-tier foreign corporation), as long as each receiving corporation in the chain of dividend distributions is a 10-percent shareholder in the corporation making the distribution. However, distributions originating from a foreign corporation that is more than three tiers beyond the domestic corporate shareholder do not carry with it any deemed-paid foreign tax credit.

In computing taxable income from any particular country or from all foreign countries for purposes of the tax credit limitations, all types of income are included as well as the deductions which relate to that income and a proportionate part of the deductions unrelated to any specific item of income. Thus, for example, income from capital gains is included in the computation of the credit as well as the deductions allocable to those gains (e.g., the 50-percent exclusion of capital gains for individuals).[5]

In cases where the applicable limitation on foreign tax credits reduces the amount of tax credits which can be used by the taxpayer to offset U.S. tax liability in any one year, present law provides that the excess credits not used may be carried back for two years or carried forward for five years. However, if a person using the per-country limitation in any year elects subsequently to use the overall limitation, no carryovers are permitted from years in which the per-country limitation was used to years in which the overall limitation was elected.

The Tax Reduction Act of 1975 prohibits the limitation on the foreign tax credit on income from oil and oil-related activities from being calculated under the per-country method. Instead, this income (and any losses) are computed under a separate overall limitation which applies only to oil-related income. Any losses from oil-related activities are to be "recaptured" in future years through a reduction in the amount of allowable foreign tax credits which can be used to offset subsequent foreign oil-related income.

In addition, the Tax Reduction Act of 1975 requires that the amount of any taxes paid to foreign governments which will be allowed as tax credits on foreign oil extraction income is limited to 52.8 percent of that income (after deductions) in 1975, 50.4 percent in 1976 and 50 percent in subsequent years.

Issue

(a) *Credit limitations.*—It has been noted that the two alternative limitations on foreign tax credits present different advantages for different taxpayers. Some contend that the use of the per-country limitation permits a U.S. taxpayer who has losses in a foreign country to obtain what is in effect a double tax benefit. They point out that since the limitation is computed separately for each foreign country, branch losses in any foreign country do not have the effect of reducing the amount of credits allowed for foreign taxes paid in other foreign countries on other income. Instead, they note that these losses reduce U.S. taxes on U.S. source income by decreasing the worldwide taxable income on which the U.S. tax is based. In addition, they note when the business operations in the loss country become profitable in a subse-

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[5] However, an exception is provided for interest income if that income is not derived from the conduct of a banking or financing business, or is not otherwise directly related to the active conduct of a trade or business in the foreign country. Such interest income and the taxes paid on it are subject to a separate per-country limitation to be calculated without regard to the other foreign income of the taxpayer.

quent tax year, a credit will be allowed for the taxes paid in that country. Thus, they contend that if the foreign country in which the loss occurs does not have a net operating loss carryforward provision (or some similar method of using prior losses to reduce subsequent taxable income), the taxpayer receives a second tax benefit when income is derived from that foreign country because no U.S. tax is imposed on the income from that country (to the extent of foreign taxes paid on that income) even though earlier losses from that country have reduced U.S. tax liability on U.S. source income. Hard mineral companies, which generally incur substantial losses from new mines, are currently the primary beneficiaries of the per-country computation.

The overall limitation does not allow this same advantage to be gained from foreign losses, because these losses are offset against income from other foreign countries rather than against U.S. income. However, in spite of the fact that in most cases foreign losses do not reduce U.S. tax liability under the overall limitation, most companies that operate in more than one country elect to use this limitation because it is substantially less complex and does offer other advantages for companies which do not incur substantial losses. Under the overall limitation, a company averages together all of its foreign income and taxes from all foreign countries. Thus, it has been noted that an individual or company which annually pays taxes in one foreign country at a rate higher than the U.S. tax rate (and thus would have some tax credits disallowed under the per-country limitation) is able to average those taxes with any taxes which might be paid at lower rates in other foreign countries when applying the overall limitation. The result is that a taxpayer can use more of the taxes paid in high tax countries as credits against U.S. tax on foreign income under the overall limitation if he also has income from relatively low-tax countries against which the highly taxed income can be averaged.[6]

(*b*) *Less developed country corporations*.—Under present law, the amount of dividends from a less developed country corporation included in income by the recipient domestic corporation is not increased (i.e., grossed up) by the amount of taxes which the domestic corporation receiving the dividend is deemed to have paid to the foreign government. Instead the amount of taxes is reduced by the ratio of the foreign taxes paid by the less developed country corporation to its pretax profits.

It is contended that the failure to gross up the dividend by the amount of the foreign taxes attributable to the dividend results, in effect, in a double allowance for foreign taxes. It is argued that the amount paid in foreign taxes not only is allowed as a credit in computing the U.S. tax of the corporation receiving the dividend, but also is allowed as a deduction (since the dividends can only be paid

[6] For example, a company earning $100 each in countries A & B and paying $60 in tax in A on that income and $30 in tax in B could use all $90 in foreign taxes under the overall limitation (the limitation would be 48 percent of $200 or $96). Under the per-country limitation only $48 of the taxes paid to country A would be creditable, thus limiting total credits to $78.

out of income remaining after payment of the foreign tax).[7] The result, it is noted, is that the combined foreign and U.S. tax paid by the domestic corporation is less than 48 percent of the taxpayer's income in cases where the foreign tax rate of the less developed country corporation is lower than the 48-percent U.S. corporate tax rate (but not zero or lower). It is also pointed out that in cases where the foreign tax rate exceeds 48 percent, the dividend does not bring with it all the foreign taxes that were paid and thus the size of foreign tax credit carryover is reduced.

(c) *Treatment of capital gains*—A number of questions have been raised with respect to the present treatment of capital gains income under the foreign tax credit as a result of the fact that capital gains are taxed differently than ordinary income. In many cases the source of income derived from the sale or exchange of an asset is determined, if the asset is personal property, by the place of sale. It is pointed out that in these cases, taxpayers presently can often exercise a choice of the country from which the income from the sale of tangible personal property is to be derived.

Since many foreign countries do not tax any gain from sales of personal property, and most countries that do tax these gains do not apply the tax to sales by foreigners, it is argued that the present system permits taxpayers to plan sales of their assets in such a way so that the income from the sale results in little or no additional foreign taxes and yet the amount of foreign taxes usable as a credit against U.S. tax liability is increased.

Another aspect of present capital gains taxation that is of concern to some is that the credit limitations are not adjusted to reflect the lower tax rate on capital gains income received by corporations.[8] Under

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[7] For example, assume that a foreign country imposes a 30-percent tax on $1,000 of income. If the foreign corporation earns $1,000 as a less developed country corporation in that country, a distribution by that corporation of the remaining $700 to its U.S. parent corporation would result in $700 income to the U.S. parent. The parent's U.S. tax would be $336 before allowance of a foreign tax credit. In calculating the foreign tax credit, the $300 amount of foreign taxes paid would be reduced by 300/1000 to $210. The $210 could then be credited against U.S. tax liability of $336, leaving a net liability of $126. Thus, combined U.S. tax and foreign tax liability on the original $1,000 of income would be $426 ($300 foreign taxes plus $126 U.S. tax), not the $480 which would be paid at a 48-percent rate.

If that same foreign corporation earning $1,000 were not a less developed country corporation, the entire $1,000 would be included in the parent corporation's income if it received a dividend of $700 which would carry with it foreign taxes of $300. In this case, the U.S. tax before credit would be $480. The entire $300 of foreign taxes would be credited, leaving a U.S. tax liability of $180. The combined U.S. tax and foreign tax liabilities would be $480.

[8] A similar problem exists to a much lesser extent for capital gains income of individuals under the alternative tax (secs. 1201 (b) and (c)).

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present law, corporations having a net long-term capital gain in most instances pay only a 30-percent rate of tax on that gain. But for purposes of determining foreign source and worldwide income in the limiting fraction of the foreign tax credit limitation, income from long-term capital gains is treated the same as ordinary income (i.e., as if it were subject to a 48-percent rate of tax).[9] Similarly, a taxpayer who has a capital gain income from U.S. sources and has foreign source income that is not capital gain income does not receive a full credit for the amount of U.S. tax attributable to foreign source income.[10]

House Bill

The Ways and Means Committee decided not to adopt any new limitation on the amount of allowable foreign tax credits. Instead, the committee referred the subject to a task force for further study.

However, a number of important provisions providing for changes in the method of computation of the foreign tax credit were included in the House bill. These are outlined below.

Under the House bill the per country limitation on the foreign tax credit would be repealed in general for taxable years ending after December 31, 1975.

A 3-year postponement of this rule (until taxable years ending after December 31, 1978) would be provided by the House bill for domestic mining corporations engaged in the extraction of minerals outside the United States or its possessions for less than 5 years, that have sustained losses in at least 2 of these years, that have 80 percent of their gross receipts from the sale of such minerals, and that have made commitments for substantial expansion of their foreign mineral extraction activities.

The repeal of the per country limitation provided by the House bill does not apply to income derived from sources within the possessions of the United States. (Sec. 1031)

Foreign losses which arise on an overall basis would under the House bill be required to be offset against U.S. income when, and to the extent, foreign income is earned in future years. This provision would apply to losses incurred in taxable years beginning after December 31,

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[9] For example, if a corporation has worldwide income of $20 million, $10 million of which is ordinary income from sources within the United States and $10 million of which is income from the sale of an asset from sources without the United States, that corporation is allowed a foreign tax credit equal to one-half (10/20) of his U.S. tax liability, even though only $3 million of the $7.8 million in U.S. tax liability is attributable to foreign source income. Present law thus favors the taxpayer with a foreign source capital gain since his U.S. tax on U.S. ordinary income of $10 million is not $4.8 million but is $3.9 million.

[10] For example, if such a taxpayer had $10 million of U.S. source capital gain and $10 million of foreign ordinary income, the foreign tax credit limitation would limit the credit to $3.9 million even though he would be liable for $4.8 million of U.S. tax on his foreign source income.

1975. However, this recapture rule would not apply to losses incurred in a possession of the United States, in taxable years beginning before January 1, 1981. (Sec. 1032)

Dividends received by U.S. shareholders from less-developed country corporations would under this House bill be required to be "grossed up" by the amount of taxes paid to less-developed countries for purposes of computing the foreign tax credit and the related foreign source taxable income. (Sec. 1033)

Any capital gain from property sold outside of the country in which a company does most of its business (or outside the country of residence of the individual) under the House bill would not be treated as foreign source income for purposes of the foreign tax credit limitation, if no substantial foreign tax has been paid on that income. New rules would be provided for netting foreign source capital gains and losses with domestic source capital gains and losses in computing the foreign tax credit limitation. Amounts to be included in the limitation would be adjusted for the lower corporate tax rate on capital gains income. (Sec. 1034)

Finally, under the House bill a carryback would be allowed to any taxable year ending in 1975, 1976, or 1977 for certain extraction taxes which would otherwise be disallowed with respect to foreign oil and gas extraction income. (Sec. 1035)

4. Amendments Primarily Affecting Individuals

A. Exclusions for Income Earned Abroad

Present Law

U.S. citizens are generally taxed by the United States on their worldwide income, with the provision of a foreign tax credit for foreign taxes paid. However, U.S. citizens who work abroad may exclude from their income up to $20,000 of earned income for periods during which they reside outside of the United States for 17 out of 18 months or during the period they are *bona fide* residents of foreign countries (sec. 911). In the case of individuals who have been *bona fide* residents of foreign countries for three years or more, the exclusion is increased to $25,000 of earned income. Currently, approximately 100,000 U.S. citizens file returns excluding income from tax under this provision. These exclusions do not apply to amounts paid by the U.S. Government to its employees who work abroad.

A separate exclusion from gross income (sec. 912) is provided for certain statutory allowances paid to civilian employees of the United States Government who work in foreign countries and, in certain instances, in the States of Hawaii and Alaska and in the territories and possessions of the United States. Some of the allowances would, in the absence of the specific exclusion, nevertheless be excluded from income, in whole or in part, under other provisions of the tax laws. Others are amounts for which the employee may be entitled to a deduction in computing taxable income.

Issues

The present exclusions have been opposed on the grounds that they result in a U.S. income tax savings for an individual involved in

those cases where the excluded income of the U.S. citizen is not taxed at all by any foreign country or is taxed at a lower foreign rate than that otherwise imposed by the United States. Those with this view consider this treatment unfair to others who reside in this country and pay the regular income tax.

It is also argued that additional income tax savings can be obtained if foreign taxes are paid on the excluded income because those taxes can be credited against any U.S. tax on any foreign source income not qualifying for the $20,000 (or $25,000) exclusion. It is noted that the effect of this is to provide a foreign tax credit on income which has not been subjected to double taxation and thus to provide in effect a double benefit.

Questions have also been raised as to the appropriateness of the exclusion for allowances paid to U.S. Government employees serving abroad on much the same grounds as the objections to the exclusions for private employees.

House Bill

The $20,000 exclusion (or in certain instances, $25,000) for income earned abroad by U.S. citizens living or residing abroad would be phased out under the House bill over a 4-year period, by lowering the exclusion by $5,000 (or $6,250) each year. However, the $20,000 exclusion would be retained for employees of U.S. charitable organizations (section 501(c)(3) organizations). In addition, employees working on construction projects (other than oil or gas wells) would continue to receive the $20,000 exclusion for taxable years beginning in 1976, 1977, and 1978. In those cases where the full exclusion is not available, a deduction of up to $1,200 would be provided for elementary and secondary school expenses of dependents of U.S. taxpayers employed outside the United States. An exclusion from gross income would also be provided for amounts paid for municipal-type services furnished in a foreign country by an employer on a nondiscriminatory basis. Present law would also be modified to allow a foreign tax credit to individuals claiming the standard deduction. These provisions would apply to taxable years beginning after December 31, 1975. (Sec. 1011).

The House bill does not deal with the exclusion of allowances paid to governmental employees serving abroad. It was decided to defer any action on this provision until an inter-agency task force of the Executive branch could complete a study on the governmental allowances which they were then preparing.

B. U.S. Taxpayers Married to Nonresident Aliens

Present Law

Under present law, a husband and wife may file a single income tax return even though one of the spouses has no gross income or deductions. However, this joint return may not be made if either the husband or the wife at any time during the taxable year is a nonresident alien.

Issues

It has been pointed out that the inability of a husband and wife to file a joint return where one of them is a nonresident alien has re-

sulted in the possibility of a heavier tax burden being placed upon this group of taxpayers than other married taxpayers. For example, even though a joint return is not allowed, the spouse who files a tax return is required to use the rate brackets of married individuals filing separately. In addition, these married individuals cannot obtain the benefits of the 50-percent maximum tax on earned income because married taxpayers must file a joint return in order to obtain the benefits of that provision.

House Bill

U.S. taxpayers married to nonresident aliens would under the House bill be permitted to file joint returns with their spouse if an election is made by both taxpayers to be taxed on their worldwide income and if the taxpayer makes available the necessary books and records. This provision would apply to taxable years ending on or after December 31, 1975. Community property laws for income tax purposes would not apply to taxpayers married to nonresident aliens whether or not they make this election. This provision would apply to taxable years beginning after December 31, 1975. (Sec. 1012).

C. Treatment of Foreign Trusts and Excise Tax on Transfers of Property to Foreign Persons

Present Law

Under present law, the income of a trust is taxed basically in the same manner as the income of an individual, with limited exceptions (sec. 642). Just as nonresident alien individuals are generally taxed only on their U.S. source income other than capital gains and on their income effectively connected with a U.S. trade or business (and not on their foreign source income), so any trust which can qualify as being comparable to a nonresident alien individual is generally not taxed on its foreign source income. If a trust is taxed in a manner similar to nonresident alien individuals, it is considered (under sec. 7701(a)(31)) to be a foreign trust.[11]

If a U.S. taxpayer is a beneficiary of a foreign trust, distributions to him are generally taxed in the same manner as are distributions to a beneficiary of a domestic trust. Any accumulation distributions are subject to throwback rules, under which the amount of tax to be paid by the beneficiary is determined by the tax bracket of the beneficiary in the year the trust originally earned the income rather than the year the income was distributed. However, in the case of an accumulation distribution by a foreign trust which was created by a

[11] The Internal Revenue Code does not specify what characteristics must exist before a trust is treated as being comparable to a nonresident alien individual. However, Internal Revenue Service rulings and court cases indicate that this status depends on various factors, such as the residence of the trustee, the location of the trust assets, the country under whose laws the trust is created, the nationality of the grantor, and the nationality of the beneficiaries. If an examination of these factors indicates that a trust has sufficient foreign contacts, it is deemed comparable to a nonresident alien individual and thus is a foreign trust.

U.S. person, any capital gains income earned by the trust is treated as distributed pro rata with other income (and taxed at favorable capital gains rates to the beneficiary), while in the case of these distributions by domestic trusts, capital gains income is treated as distributed only after all other income is distributed.

In addition to the above provisions which govern the taxation of foreign trusts, present law imposes (sec. 1491) an excise tax of 27½ percent on certain transfers of property to foreign trusts, as well as to foreign corporations (if the transfer is a contribution of capital) and to foreign partnerships. Under present law, the excise tax is imposed on transfers of stock or securities to such an entity by a U.S. citizen, resident, corporation, partnership or trust. The amount of the excise tax is equal to 27½ percent of the amount of the excess of the value of the stock or securities over its adjusted basis in the hands of the transferor.

Issues

The rules of present law permit U.S. persons to establish foreign trusts in which funds can be accumulated free of U.S. tax. In addition, the funds of these foreign trusts are generally invested in countries which do not tax interest and dividends paid to foreign investors, and the trusts generally are administered through countries which do not tax such entities. Thus, these trusts generally pay no income tax anywhere in the world. Although the beneficiaries are taxed (and the throwback rules are applied) upon any distributions out of these trusts, nevertheless it is contended that it is unfair to permit a grantor by using a foreign trust to provide a tax-free accumulation of income while the income remains in the trust.

Little information is known about the value of assets held in foreign trusts, but some experts have concluded that $5 to $10 billion would not be an unreasonable estimate. Many believe this trend was accelerated by the introduction of legislative proposals to tax the earnings of foreign trusts to the grantor of the trust. This point of view assumes that the acceleration occurred because of the belief that any new rules taxing the grantors of foreign trusts would not apply to trusts established prior to the enactment of the legislation. It has been reported that based upon this expectation, one law firm established over 200 trusts for its clients.

Finally, some believe the excise tax on certain transfers to foreign trusts and other foreign entities may not be effective in preventing U.S. taxpayers from transferring appreciated property to foreign trusts or other entites without payment of a full capital gains tax. It is noted that the excise tax of 27½ percent of the amount of appreciation is less than the maximum capital gains tax on individuals (which can be as high as 35 percent). Furthermore, the excise tax provision has been interpreted to exclude transfers to foreign entities to the extent that the entity provides some consideration to the transferor. It is argued that this enables a U.S. taxpayer to transfer appreciated stock to a trust established by him and receive in return from the trust a private annuity contract or other deferred payment obligation. In

any such case, it is noted that the transferor will pay U.S. tax on the gain only as the deferred payments are received and will have the benefit of the tax-free accumulation of income from the property transferred (or from the proceeds of any sale of the property by the trust).

House Bill

U.S. grantors of foreign trusts with U.S. beneficiaries under the House bill would be taxed currently on the income of these trusts under the grantor trust rules of present law. This provision would apply to trusts created after May 21, 1974 and to transfers of property to foreign trusts after May 21, 1974, in taxable years ending after December 31, 1975. (Sec. 1013)

In all other cases U.S. beneficiaries of foreign trusts would under the House bill pay interest charges on the U.S. taxes on any accumulation distributions which are subject to U.S. tax. The interest charge would apply to distributions made after December 31, 1975. (Sec. 1014)

Finally, under the House bill the excise tax on transfers of stocks and securities to foreign entities would be extended to transfers of all other types of property. This tax would apply only to the unrealized appreciation. The rate of this tax would be increased from 27½ to 35 percent. These changes would apply to transfers made after October 2, 1975. (Sec. 1015)

5. Money or Other Property Moving In or Out of the United States

A. *Investments by Foreigners in the United States*

Present Law

Present law provides, in general, that interest, dividends and other similar types of income of a nonresident alien or a foreign corporation are subject to a 30 percent tax on gross amount paid, if such income or gains are not effectively connected with the conduct of a trade or business within the United States (secs. 871(a) and 881). This tax is generally collected through withholding by the person making the dividend or interest payment to the foreign recipient of the income (secs. 1441 and 1442). For this reason the tax is commonly referred to as a withholding tax. However, in the case of interest, a number of exemptions have been provided from this 30-percent tax on the gross amount. Interest from deposits with persons carrying on the banking business are exempt (secs. 861(a)(1)(A) and 861(c)). Any interest and dividends paid by a domestic corporation which earns less than 20 percent of its gross income from sources within the United States is also not subject to the 30 percent tax (secs. 861(a)(1)(B) and 861(a)(2)(A)).

In addition to the above exemptions provided in the Internal Revenue Code, the United States has a number of tax conventions in effect which provide for either an exemption or a reduced rate of tax for interest and dividends paid to foreign persons if the income is not effectively connected with the conduct of a trade or business within the United States.

Issues

For a number of reasons many believe that interest and dividends paid to nonresident aliens and foreign corporations should be exempt from U.S. tax. First, it is argued that the exemption on bank deposits should be retained since amounts on deposit in bank accounts could be very easily transferred out of the United States in to foreign bank accounts. It is also argued that a U.S. exemption for bond issues of U.S. corporations sold to foreign lenders would lessen the administrative burden and cost to U.S. borrowers without resulting in any significant inroad on the revenues since most of these issues are exempt today. Further it is argued that a broad exemption covering all portfolio interest income would increase the supply of capital available to U.S. borrowers and make U.S. borrowing competitive with foreign borrowing which often is eligible for an exemption from tax.

House Bill

Under the House bill, the present exemption from the 30-percent withholding tax which applies to foreign deposits held in U.S. banks (which under present law would expire on December 31, 1976) is made permanent. (sec. 1041)

B. Treatment of Reorganizations Involving Foreign Corporations

Present Law

Present law provides that certain types of exchanges relating to the organization, reorganization, and liquidation of a corporation can be made without recognition of gain to the corporation involved or to their shareholders. However, when a foreign corporation is involved in certain of these types of exchanges, tax-free treatment is not available unless prior to the transaction the Internal Revenue Service has made a determination that the exchange does not have as one of its principal purposes the avoidance of Federal income taxes. This determination is made by issuing a separate ruling for each transaction. The required determination must be obtained before the transaction in all cases unless the transaction involves only a change in the form of organization of a second (or lower) tier foreign subsidiary with no change in ownership.

In 1968, the Internal Revenue Service issued guidelines [12] as to when favorable rulings "ordinarily" would be issued. As a condition to obtaining a favorable ruling with respect to most transactions, the section 367 guidelines require the taxpayer to agree to include certain items in income (the amount to be included is called the section 367 toll charge). The amount required to be included in income generally reflects untaxed accumulated earnings and profits (in the case of transfers of property into the United States), or the immediate potential earnings from liquid assets or the untaxed appreciation from

[12] Rev. Proc. 68-23, 1968-1 Cum. Bull. 821.

passive investment assets (in the case of transfers of property out of the United States).[13]

In addition to section 367, section 1248 provides for the imposition of a U.S. tax on accumulated profits earned abroad when they are repatriated to the United States in cases where gain is recognized on the sale or exchange (or redemption) of stock of a controlled foreign corporation held by a U.S. person owning 10 percent or more of the voting stock. This provision is designed to terminate deferral on the unrepatriated earnings of a foreign subsidiary when the earnings are indirectly repatriated through the sale or liquidation of the subsidiary.

Issues

Many taxpayers have raised questions as to the operation of section 367 and section 1248. First, it is stated that the advance ruling requirement often results in an undue delay for taxpayers attempting to consummate perfectly proper business transactions. Second, it is indicated that a number of cases have arisen where a foreign corporation was involved in an exchange within the scope of the section 367 guidelines without the knowledge of its U.S. shareholders, and thus no request for prior approval was made. As a result, the shareholders were taxed on the exchange despite the fact that a favorable ruling would clearly have been issued by the Internal Revenue Service had it been requested prior to the transaction.

The third area where questions have been raised in the present administration of section 367 concerns situations where the IRS requires a U.S. shareholder to include certain amounts in income as a toll charge even though there is no present tax avoidance purpose but, rather, only the existence of a potential for future tax avoidance. In certain of these cases the Internal Revenue Service only has the option either of collecting an immediate tax or of collecting no tax at all since the IRS has no authority to defer payment of the tax until the time that the avoidance actually arises, except by entering into a closing agreement with the taxpayer.

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[13] For example, if a domestic corporation transfers property to a foreign subsidiary corporation (a transaction otherwise accorded tax-free treatment under section 351), the transaction will be given a favorable ruling only if the domestic corporation agrees to include in its gross income for its taxable year in which the transfer occurs an appropriate amount to reflect realization of income or gain with respect to certain types of assets (e.g., inventory, accounts receivable, and certain stock or securities) transferred to the foreign corporation as part of the transfer. If the transaction involves the liquidation of a foreign corporation into a domestic parent, a favorable ruling will be issued if the domestic parent agrees to include in its income as a dividend for the taxable year in which the liquidation occurs the portion of the accumulated earnings and profits of the foreign corporation which are properly attributable to the domestic corporation's stock interest in the foreign corporation.

The necessity for obtaining the satisfaction of the IRS that no tax avoidance is involved in a transaction results in a taxpayer having the choice of modifying a transaction as suggested by the IRS or not going through with the transaction. Presently, there is no opportunity for a taxpayer who disagrees with the IRS determination to obtain a court review even if the taxpayer believes that the IRS has acted arbitrarily. Many would like to resolve this problem by affording taxpayers who wish to challenge an IRS determination the right to consummate the transaction and have the issue resolved in the courts.

Finally, the section 1248 provision terminating deferral on the sale of a foreign subsidiary applies only to taxable sales or exchanges. In other situations it is pointed out that, for example, where the stock of a foreign subsidiary is sold pursuant to a liquidation plan, the section does not apply and no ordinary income tax is paid on the untaxed foreign earnings.

House bill

The House bill eliminates the requirement of present law under section 367 that an advance ruling from the IRS be obtained for reorganization-type transactions involving foreign corporations. For transactions which are solely foreign or which involve the transfer of property into the United States, the House bill provides that the IRS is to draft regulations by January 1, 1978, specifying the treatment of these transactions. For transfers of property out of the United States, individual rulings would still be required but these rules could be requested up to 183 days after the beginning of the transaction. In addition, these rulings would be subject to Tax Court review. Finally, the provision of present law which taxes as ordinarily income the sale of stock in a foreign subsidiary (to the extent of accumulated earnings) would be extended to apply to nontaxable transfers of stock (Code sections 311, 336, and 337).

These provisions would apply generally to exchanges beginning after October 9, 1975, and to sales, exchanges and distributions taking place after such date. The provision relative to Tax Court review would apply with respect to pleadings filed with the Tax Court after the date of enactment of this legislation but only with respect to exchanges beginning after October 9, 1975. (Sec. 1042)

C. Contiguous Country Branches of Domestic Insurance Companies

Present law

Under present law, a domestic mutual life insurance company is subject to tax on its worldwide taxable income. If the company pays foreign income taxes on its income from foreign sources it is allowed a foreign tax credit against its otherwise payable U.S. tax on foreign source income.

Issue

Since the beginning of this century, U.S. mutual life insurance companies have been engaged in the life insurance business in Canada. At the present time, the tax imposed by the United States on the operations of Canadian branches of U.S. mutual life insurance com-

panies generally exceeds the tax imposed by the Dominion of Canada and its provinces.

The income of the companies from their Canadian operations is derived generally by the issuance of policies insuring Canadian risks and the investment income from the policyholder reserves on the Canadian risks and any surplus. Quite often the investments of the Canadian branch are in Canadian securities. A separate branch account is maintained by the life insurance companies under which the various income, expense, asset, reserve and other items that relate to Canadian policyholders are segregated on the books of the company. The separate branch accounting system is used for purposes of establishing premiums and policyholder dividend rates based upon the separate mortality and earnings experience of the Canadian branch.

The income earned by the Canadian branch inures solely to the benefit of these Canadian policyholders and is reflected either by dividends paid to them, reductions in the cost of insurance, or increases in the size of the reserves and surplus with respect to Canadian policyholders. Thus, it is argued that the additional cost to the company resulting because U.S. tax liability exceeds Canadian income tax liability on the Canadian branch profits falls primarily upon the Canadian policyholders, since it reduces the reserves and surplus available to the Canadian policyholders. It is contended that this tax treatment makes it more difficult to issue mutual life insurance policies in Canada.

Similar tax problems are faced by U.S. stock life companies who compete in Canada for business under terms that are substantially the same as mutual companies.

House Bill

Mutual life insurance companies maintaining separate operations in countries contiguous to the United States would under the House bill be permitted to treat these operations as if carried on through a foreign subsidiary. A mutual company would be treated as having transferred its assets to such a branch operating in the contiguous country and would be subject to the normal tax requirements (of Code section 367) regarding transfers of property out of the United States for tangible property assets except that losses would be netted in determing the gain from these assets. In addition, stock life insurance companies would be permitted to transfer the assets of their foreign branch operations in contiguous countries to foreign subsidiaries under these same section 367 rules. This provision would apply to taxable years beginning after December 31, 1975. (Sec. 1043)

D. Transitional Rule for Bond, etc., Losses of Foreign Banks

Present Law

The Tax Reform Act of 1969 (P.L. 91–172) eliminated the preferential treatment accorded to certain transactions of financial institutions involving corporate and government bonds and other evidences of indebtedness. Previous to that these financial institutions were allowed to treat net gains from these transactions as capital gains and to deduct the losses as ordinary losses. The 1969 Act provided parallel treatment to gains and losses pertaining to these transactions by treat-

ing net gains as ordinary income and by continuing the treatment of net losses as ordinary losses. The ordinary income and loss treatment provided under the 1969 Act was also applied to corporations which would be considered banks except for the fact that they are foreign corporations. Previous to the 1969 Act, these corporations had treated the above-described transactions as resulting in either capital gains or capital losses.

Issue

Some of the corporations which would be considered banks except for the fact that they are foreign corporations had capital loss carryovers predating the 1969 Act. However, any post-1969 gains realized by these corporations resulting from the sale or exchange of a bond, debenture, note, or other evidence of indebtedness is accorded ordinary income treatment. Thus, these corporations are left with capital loss carryforwards which, under present law, cannot be applied against any gains resulting from the same type of transactions which previously generated such losses.

House Bill

Foreign banks would be provided the same transition rule as applies presently to domestic banks with respect to the sale or exchange of a bond, debenture, note or certificate or other evidence of indebtedness. This provision would apply generally to taxable years beginning after July 11, 1969. (Sec. 1044)

6. Special Categories of Corporate Tax Treatment

A. Western Hemisphere Trade Corporations

Present Law

Under present law, domestic corporations called "Western Hemisphere Trade Corporations" (WHTCs) are entitled to a deduction which may reduce their applicable corporate income tax rate by as much as 14 percentage points below the applicable rate for other domestic corporations.[14]

A domestic corporation must meet three basic requirements to qualify as a WHTC. First, all of its business (other than incidental purchases) must be conducted in countries in North, Central or South America or in the West Indies. Second, the corporation must derive at least 95 percent of its gross income for the 3-year period immediately preceding the close of the taxable year from sources outside the United States. Third, at least 90 percent of the corporation's income for the above period must be derived from the active conduct of a trade or business. The above requirements are intended to insure that the corporation is engaged in an active trade or business outside the United States, but within the Western Hemisphere.

Issues

Questions have been raised as to whether there is any longer any basis for continuing the preferential tax treatment provided WHTCs.

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[14] The deduction (sec. 922 of the Code) is equal to taxable income multiplied by 14 over the corporate tax and surtax rates.

It is noted that in any event the benefit of this treatment is no longer significant in many cases because the taxes which are now imposed by the Western Hemisphere Trade countries approach or equal those imposed in the United States. It is also pointed out that under the broad interpretation given the WHTC provisions by the Service, corporations can often obtain the benefits of the provisions for goods manufactured outside the Western Hemisphere by causing title to the goods to pass within the Western Hemisphere. Chiefly, however, it is argued that this is discriminatory treatment which no longer serves any national purpose.

House Bill

The provision of present law which permits a 14-percent lower tax rate for Western Hemisphere Trade Corporations would under the House bill be phased out over a 5-year period, according to the following table:

For a taxable year beginning in—	*The percentage would be—*
1976	11
1977	8
1978	5
1979	2

Thus, the Western Hemisphere Trade Corporation provisions would be repealed with respect to taxable years beginning after December 31, 1979. (Sec. 1052)

B. Corporations Conducting Business in Possessions

Present Law

Under present law, corporations operating a trade or business in a possession of the United States are entitled to exclude from gross income all income from sources without the United States, including foreign source income earned outside of the possession in which they conduct business operations, if they meet two conditions. First, 80 percent or more of the gross income of the corporation for the 3-year period immediately preceding the close of the taxable year must be derived from sources within a possession of the United States. Second, 50 percent of the gross income of the corporation for the same 3-year period must be derived from the active conduct of a trade or business within a possession of the United States.

Any dividends from a corporation which satisfies these requirements are not eligible for the intercorporate dividends received deduction. This deduction, however, is allowed if the corporation did not satisfy these requirements in the current and preceding taxable year. In addition, since a corporation meeting the requirements of section 931 is a domestic corporation, no gain or loss is recognized to a parent corporation if it liquidates a possessions corporation (under section 332).

The exclusion of possessions income applies to corporations conducting business operations in the Commonwealth of Puerto Rico and all possessions of the United States (Guam, the Canal Zone, and Wake Island) except the Virgin Islands. The exclusion also applies to business operations of individuals in possessions but not to Puerto Rico or to the Virgin Islands and Guam.

Issues

The special exemption provided in conjunction with investment incentive programs established by possessions of the United States, especially the Commonwealth of Puerto Rico, has been used as an inducement to U.S. corporate investment in active trades and businesses in Puerto Rico and the possessions. Under these investment programs, little or no tax is paid to the possessions for a period as long as 10 to 15 years and no tax is paid to the United States as long as no dividends are paid to the parent corporation.

Because no current U.S. tax is imposed on the earnings if they are not repatriated, it is pointed out the amount of income which accumulates over the years from these business activities can be substantial. It is also noted that the amounts which may be allowed to accumulate are often beyond what can be profitably invested within the possession where the business is conducted. As a result, corporations generally invest this income in other possessions or in foreign countries either directly or through possessions banks or other financial institutions. In this way, it is claimed possessions corporations not only avoid U.S. tax on their earnings from businesses conducted in a possession, but also avoid U.S. tax on the income obtained from reinvesting their business earnings abroad.

It is a strongly held view of the Government of Puerto Rico that the possessions investment incentives play a key role in keeping investments in the possessions competitive with investments in neighboring countries. It points out that the U.S. Government imposes upon Puerto Rico, for example, various requirements such as minimum wage requirements and requirements to use U.S. flag ships in transporting goods between the United States and Puerto Rico. These requirements substantially increase the labor, transportation and other costs of establishing business operations in Puerto Rico. Thus, without significant local tax incentives that are not nullified by the U.S. tax law, it is argued that the Commonwealth of Puerto Rico would find it quite difficult to attract investments by U.S. corporations.

However, it is recognized that investing the business profits of these possessions corporations outside of the possession where the business is being conducted does not contribute to the economy of that possession either by creating new jobs or by providing capital to others to build new plants and equipment. Accordingly, it is suggested that while it may be appropriate to provide preferential treatment for investment in the possessions as contrasted to investment in a foreign country, it is not appropriate to provide a preference for income earned from investments outside of the possession. The denial of a dividends received deduction to the U.S. parent corporation tends to cause the possessions corporation to invest earnings abroad until liquidation (usually upon termination of the local tax exemption), at which time the earnings can be returned to the United States tax free. These profits derived outside of the possession could be made subject to U.S. tax if the possessions corporation were given the alternative of returning the profits to the United States prior to liquidation without payment of any U.S. tax.

A second set of difficulties under present law stems from the relationship of the possessions corporation provisions to the provisions

relating to the filing of consolidated tax returns. Domestic corporations which are affiliated usually file a consolidated tax return. Among the benefits of a consolidated tax return is the opportunity to offset the losses of one corporation against the income of other corporations. A corporation which is entitled to the benefits of the possessions corporation exclusion may not participate in the filing of a consolidated return. However, the courts have determined that possessions corporations may join in the filing of consolidated returns in years in which they incur losses. As a result, it is argued these corporations can, in effect, obtain a double benefit. Not only is the possessions and other foreign source income of these corporations excluded from U.S. taxable income, but losses of possessions corporations can, by filing a consolidated return, reduce U.S. tax on the U.S. income of related corporations in the consolidated group.

House Bill

The tax treatment of possessions corporations would be modified by the House bill by providing a new tax credit for such corporations in lieu of the income exclusion provided under present law. The tax credit would equal the U.S. tax attributable to a corporation's income from a possessions trade or business and from qualified possessions investments. Other income of a possessions corporation would be subject to U.S. tax. U.S. corporations receiving dividends from possessions corporations would be eligible for the 85- or 100-percent dividends-received deduction. Corporations would qualify as possessions corporations only if they elect for a period of 10 years to remain in that status. These provisions would apply to taxable years beginning after December 31, 1975. (sec. 1051)

C. China Trade Act Corporations

Present Law

Under present law, a China Trade Act Corporation ("CTA corporation") and its shareholders are entitled to special tax benefits. Under these provisions, a CTA corporation is subject to the same tax rates as a domestic corporation, but, upon meeting certain requirements, is allowed a special deduction which can completely eliminate any income subject to tax (sec. 941).

The special deduction is allowed against taxable income derived from sources within Formosa and Hong Kong in the proportion which the par value of stock held by residents of Formosa, Hong Kong, the United States, or by individual citizens of the United States, wherever resident, bears to the par value of all outstanding stock. Thus, where all the shareholders of the CTA corporation are either U.S. citizens or residents of Hong Kong, Formosa, or the United States, and all of the corporation's income is derived within Hong Kong and Formosa, the special deduction would equal and thereby eliminate the taxable income of the corporation.

The special deduction is limited by a requirement that a dividend must be paid in an amount at least equal to the amount of Federal tax that would be due were it not for the special deduction. The "special dividend" must be paid to stockholders who, on the last day of the taxable year, were resident in Formosa, Hong Kong, or were either resi-

dents or citizens of the United States. For example, if the taxable income before the special deduction were $100,000 in 1974, the special dividend would have to equal at least $41,500 (22 percent of the first $25,000 plus 48 percent of the remaining $75,000). In this example, upon payment of the special dividend of $41,500, the CTA corporation deriving all of its taxable income from sources within Hong Kong and Formosa ($100,000) would be entitled to a special deduction in an amount equal to its taxable income, i.e., $100,000. The special dividend deduction enables the CTA corporation to operate free of tax.[15]

In addition special benefits are accorded to the shareholders of a CTA corporation. Dividends paid by a CTA corporation to shareholders who reside in Hong Kong or Formosa are not includable in the gross income of the shareholder (sec. 943). This applies to all dividends paid to Hong Kong or Formosa resident shareholders, regardless of whether they are regular or special dividends.

Issues

It is contended that the combination of benefits granted to CTA corporations and their shareholders is unprecedented. For example, if in a given year a CTA corporation, whose shareholders are U.S. citizens residing in Hong Kong or Formosa, has $500,000 of taxable income and pays a special dividend of at least $233,500 to its shareholders, neither the corporation nor its shareholders will incur any U.S. tax liability, whereas a domestic corporation and its shareholders in this situation (assuming marginal tax brackets of 50 percent for the shareholders) would incur respective U.S. tax liabilities of $233,500 and $116,750. The tax savings to the CTA corporation and its shareholders in the above example would be $350,250. If the balance of the earnings of the CTA corporation were paid out, the tax savings would be even greater.

It is argued that the original purpose of the China Trade Act, that of expanding trade with China, is no longer being served by the very favorable tax advantages it provides. Moreover, there are innumerable U.S. companies currently trading in Hong Kong and Formosa without the extensive tax benefits provided by the China Trade Act.

House Bill

The provisions of present law permitting special tax treatment for China Trade Act Corporations and their shareholders would be phased out over a 4-year period, according to the following table:

For a taxable year beginning in—	*The percentage reduction would be—*
1976	25
1977	50
1978	75

Thus, the China Trade Act Corporation provisions would be repealed with respect to taxable years beginning after December 31, 1978. (Sec. 1053)

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[15] The CTA corporation is not entitled to the foreign tax credit (sec. 942) but is entitled to the deduction of all foreign taxes paid with respect to taxable income derived from sources within Hong Kong or Formosa (sec. 164).

7. Domestic International Sales Corporations (DISCs)

Present Law

Present law provides for a system of tax deferral for a corporation known as a Domestic International Sales Corporation, or a "DISC", and its shareholders. Under this tax system, the profits of a DISC are not taxed to the DISC but are taxed to the shareholders of the DISC when distributed to them. However, each year a DISC is deemed to have distributed income representing 50 percent of its profits, thereby subjecting that income to current taxation in the shareholders hands. In this way the tax deferral which is available under the DISC provisions is limited to 50 percent of the export income of the DISC.

To qualify as a DISC, at least 95 percent of the corporation's assets must be export related and at least 95 percent of a corporation's gross income must arise from export sale or lease transactions and other export-related activities (i.e., qualified export receipts). Qualified export receipts include receipts from the sale of export property, which generally means property such as inventory manufactured or produced in the United States and held for sale for direct use, consumption or disposition outside the United States. The President has the authority to exclude from export property any property which he determines (by Executive order) to be in short supply. However, energy resources such as oil and gas and depletable minerals are automatically denied DISC benefits under the Tax Reduction Act of 1975. That Act also eliminated DISC benefits for products the export of which are prohibited or curtailed under the Export Administration Act of 1969 by reason of scarcity.

If a DISC fails to meet the qualifications for any reason, the DISC provisions provide for an automatic recapture of the DISC benefits received in previous years. This recapture is spread out over the number of years for which the corporation was qualified as a DISC but may not exceed 10 years.

Issues

Those who favor the retention of the DISC provisions believe that DISC was enacted to enable U.S. manufacturers to increase their exports and that DISC has accomplished what it set out to do. Since the enactment of DISC in 1971, exports have increased from $43 billion to $107 billion for 1975. This is an increase of 250 percent. Although recognizing that other factors have played a significant role in the increase of U.S. exports, advocates of DISC conclude that a significant role in this increase has also been played by DISC.

It is argued that DISC increases U.S. exports in a number of ways. First, it enables U.S. manufacturers to reduce their prices to meet foreign competition. This assistance is necessary to counter the variety of ways in which foreign competitors receive export assistance from their governments (such as the rebate of value added taxes). Second, to the extent prices are not lowered, DISC provides increased funds to U.S. exporters to finance their export sales. Third, DISC provides funds to U.S. companies to expand their production facilities (which increases U.S. employment) for export sales. Finally, the existence of the DISC program indicates the importance which the Federal Government places upon export sales. Its repeal could be taken as a signal

that the Federal Government no longer considers exports to be important.

Advocates for the retention of DISC argue that increasing export sales is beneficial to the U.S. economy in a number of ways. First, it is argued that export sales create employment in U.S. industry which would be lost but for the export sales. Additionally, it is argued that increased exports helps the U.S. balance of payments by providing the foreign currency which is essential to enable U.S. industry and U.S. consumers to import high-priced foreign oil.

It is also argued that without DISC it would quite often be necessary to manufacture abroad rather than in the United States, since DISC is designed to equalize the treatment with U.S. firms with foreign subsidiaries. Manufacturing abroad would result in incomes taxes paid to foreign governments rather than the United States; employment for foreign individuals rather than for U.S. individuals: and the loss of positive balance of payments inflow from export sales. Thus, it is argued that the repeal of DISC would result in a loss of jobs and revenue.

On the other hand the drastic changes in economic circumstances have prompted some individuals to call for the elimination of DISC. They take the position that DISC has not been particularly successful in stimulating exports and that the international economic setting is substantially different from what it was at the time the DISC was adopted. Consequently, they argue that the usefulness of the DISC provision is substantially less than it was at the time of its adoption.

Opponents of DISC suggest that the tax benefits from this treatment are small relative to the volume of merchandise sold abroad and thus are unlikely to have any major effect on sale. At the same time they note that major decreases have taken place in prices due to flexible exchange rates and suggest that this is the major cause of export increases rather than the DISC provisions.

They also question the economic rational of having an export incentive during a period of flexible exchange rates. During a period of fixed exchange rates (as when DISC was enacted) they suggest the incentive could be used in part as a method for companies to reduce the dollar price of their exports in the face of a fixed value of the dollar, thus making our exports relatively more attractive. During a period of flexible exchange rates, however, any increase in U.S. exports will be reflected in greater demand for dollars and therefore a higher exchange rate price for dollars in terms of other currencies. This higher dollar value would make U.S. exports somewhat more expensive, offsetting in part the initial increase in exports. Furthermore, the higher dollar value means that foreign goods will be relatively cheaper and consequently the United States would tend to import more.

Questions have also been raised as to whether the employment effects of export stimulation are overemphasized. To the extent imports are increased by the higher dollar value resulting from DISC, it is argued U.S. corporations competing with imported goods are worse off and may lose jobs.

House Bill

The House bill eliminated from DISC treatment products sold for use as military equipment and also agricultural products not in surplus in the United States.

For taxable years beginning after December 31, 1975, DISC benefits receipts would be allowed only to the extent that the DISC's income for the year exceeds 75 percent of its base period in receipts. From 1976 through 1980, the base period is to be average DISC receipts of the corporation in the years 1972, 1973, and 1974. Beginning in 1981 this base period is to move one year forward each year. Companies whose total DISC benefits are less than $100,000 per year are not to be subject to the new base period method of computation, but instead may calculate their DISC benefits as provided by present law.

Taxpayers for whom DISC benefits were repealed under the Tax Reduction Act of 1975 are to continue to receive DISC benefits for exports made pursuant to binding contracts written after the company's DISC was established but before March 18, 1975, but only if the contracts have both fixed price and fixed quantity requirements. This binding contract rule is to apply for 5 years from March 18, 1975. The provision in the Tax Reduction Act of 1975 providing that DISC tax treatment is not to be available if the commodity involved is a natural resource subject to the allowance of cost depletion is changed to eliminate DISC benefits for those items subject to the allowance of percentage depletion.

Finally, the House bill contains two provisions relating to qualification and recapture of DISC income in those cases where export products lose their eligibility for DISC treatment. First, a DISC may continue to loan its accumulated DISC earnings as a qualified producer loan if the loan would otherwise qualify under the rules that were applicable before the DISC benefits were eliminated for the goods which the DISC exported if the parent continues to export those goods. Second, the recapture of accumulated DISC earnings (because of DISC disqualification) are to be spread out over a period equal to two years for each year that the DISC was in existence (up to a maximum of 10 years), instead of being one year (up to a maximum of 10 years) provided under present law. (Sec. 1101)

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