[JOINT COMMITTEE PRINT]

EXPLANATION OF H.R. 5270 (FOREIGN INCOME TAX RATIONALIZATION AND SIMPLIFICATION ACT OF 1992)

SCHEDULED FOR HEARINGS

BEFORE THE

COMMITTEE ON WAYS AND MEANS

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PREPARED BY THE STAFF

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INTRODUCTION

This pamphlet,[1] prepared by the staff of the Joint Committee on Taxation, provides an explanation of the provisions of H.R. 5270 ("Foreign Income Tax Rationalization and Simplification Act of 1992"), introduced by Chairman Rostenkowski and Mr. Gradison on May 27, 1992. The House Committee on Ways and Means has scheduled hearings on H.R. 5270 on July 21-22, 1992.

The first part of the pamphlet is a summary of the bill. The second part is a technical explanation of the bill, including a description of relevant provisions of present law. The bill is divided into six titles:

Title I—Treatment of U.S. businesses operating abroad;

Title II—Treatment of controlled foreign corporations;

Title III—Taxation of foreign persons having U.S.-related income;

Title IV—Other reforms;

Title V—Foreign simplification provisions; and

Title VI—Studies.

Issues relating to the provisions included in H.R. 5270 are discussed in four recent Joint Committee on Taxation staff pamphlets:

(1) *Factors Affecting the International Competitiveness of the United States* (JCS-6-91), May 30, 1991;

(2) *Proposal Relating to Current U.S. Taxation of Certain Operations of Controlled Foreign Corporations (H.R. 2889—American Jobs and Manufacturing Preservation Act of 1991) and Related Issues* (JCS-15-91), October 1, 1991;

(3) *Present Law and Certain Issues Relating to Transfer Pricing (Code Section 482)* (JCS-22-90), June 28, 1990; and

(4) *Background and Issues Relating to the Taxation of Foreign Investment in the United States* (JCS-1-90), January 23, 1990.

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[1] This pamphlet may be cited as follows: Joint Committee on Taxation, *Explanation of H.R. 5270 (Foreign Income Tax Rationalization and Simplification Act of 1992)* (JCS-11-92), May 29, 1992.

I. SUMMARY OF THE BILL

The following is a title-by-title summary of the provisions of the bill.

Title I—Treatment of U.S. Businesses Operating Abroad

1. Revise application of interest allocation rules (sec. 101).—The bill provides that taxpayers may take into account the interest expenses and assets of foreign subsidiaries for purposes of allocating and apportioning interest expenses between gross income from U.S. and foreign sources. In addition, the bill expands the types of corporations that are treated as financial institutions for purposes of applying the one-taxpayer rule separately to financial institutions in a related group.

2. Repeal of limitation on alternative minimum tax foreign tax credit (sec. 111).—The bill repeals the 90-percent limitation on the utilization of the alternative minimum tax foreign tax credit.

3. Recharacterization of overall domestic loss (sec. 112).—The bill applies a resourcing rule to U.S. income where the taxpayer has suffered a reduction in the amount of its foreign tax credit limitation due to a domestic loss. Under the bill, in the case of a taxpayer that has incurred an overall domestic loss, that portion of the taxpayer's U.S. source taxable income for each succeeding taxable year which is equal to the lesser of (1) the amount of the unrecaptured overall domestic loss, or (2) 50 percent of the taxpayer's U.S. source taxable income for such succeeding taxable year, is recharacterized as foreign source taxable income. Any U.S. source income that is resourced under the bill is allocated among and increases the various foreign tax credit separate limitation categories in the same proportion that those categories were reduced by the domestic losses which are responsible for the resourcing.

4. Extension of period to which excess foreign taxes may be carried (sec. 113).—The bill extends the excess foreign tax credit carryback period from 2 to 3 years and extends the carryforward period from 5 to 15 years. Similar extensions are provided for excess oil and gas extraction taxes.

5. Election to treat certain companies as controlled foreign corporations (sec. 114).—The bill permits a domestic corporation that normally would treat a foreign company as a noncontrolled section 902 corporation to elect to treat that company, for foreign tax credit limitation and subpart F purposes, as a controlled foreign corporation of which the electing domestic corporation is a U.S. shareholder. In order to make the election, a U.S. corporation is required to treat as controlled foreign corporations all foreign corporations that would, absent the election, be noncontrolled section 902 corporations with respect to it.

6. Regulatory authority to exempt foreign persons from uniform capitalization rules (sec. 121).—The bill provides that to the extent provided in regulations, the uniform capitalization rules shall apply to any taxpayer who is not a U.S. person only to the extent necessary for purposes of determining the amount of tax imposed on subpart F income or on U.S. effectively connected income. Thus, for example, the bill grants the Treasury authority to waive the application of the uniform capitalization rules in the case of a noncontrolled section 902 corporation (the income of which is not subject to current U.S. taxation), for the purpose of measuring the corporation's multiyear earnings "pools" under section 902.

7. Modification of certain look-through rules (sec. 122).—The bill modifies the look-through rules that apply under the passive foreign corporation regime (which replaces the PFIC regime under the bill's simplification provisions), by reducing the ownership thresholds from 25 percent to 20 percent in both the general look-through rule and the special domestic-subsidiary look-through rule.

Title II—Treatment of Controlled Foreign Corporations

1. Repeal of deferral for controlled foreign corporations (sec. 201).—The bill generally repeals deferral on controlled foreign corporations by treating as subpart F income generally all of a controlled foreign corporation's earnings and profits for the taxable year. Under the bill, the Code retains much of present law solely to preserve the tax treatment applicable to earnings and profits (and deficits in earnings and profits) attributable to years beginning prior to the effective date of the bill.

2. Election to treat controlled foreign corporations as domestic corporations (sec. 202).—The bill provides an opportunity to operate businesses through controlled foreign corporations yet have those corporations be treated as domestic for U.S. tax purposes (such as sharing losses with affiliated U.S. companies). In the case of certain commonly controlled foreign corporations, domestic company treatment must be elected on a consistent group-wide basis.

3. Source of income from certain sales of inventory property (sec. 203).—The bill makes two changes to the method by which income from the sale of inventory property is sourced. First, where the property is produced by the taxpayer and sold to a related person, and the income is derived partly within and without the United States, the amount allocated to production activities under the production/marketing split can be no less than the amount that would be so allocated by applying the production/marketing split to the relevant combined income of the taxpayer and any related person. Second, where inventory property sold abroad is sold by a U.S. resident directly or indirectly to another U.S. resident, the property sold is used, consumed, or disposed of in the United States, and the sale is not attributable to an office or other fixed place of business maintained by the first U.S. resident outside the United States, the gross income of the seller from the sale will be sourced domestically.

Title III—Taxation of Foreign Persons Having U.S.-Related Income

1. Taxation of certain stock gains of foreign persons (sec. 301).—The bill provides that, unless a treaty provides otherwise, where a foreign corporation or nonresident alien individual owns or has owned, at any time during the previous 5 years, 10 percent or more of the stock in a U.S. corporation, gain or loss from the disposition of the stock is treated as income effectively connected with the conduct of a U.S. trade or business and attributable to a U.S. permanent establishment.

2. Limitation on treaty benefits (sec. 302).—The bill imposes a qualified resident requirement, similar to that now in the branch tax provisions, as a prerequisite for reducing U.S. tax on any foreign entity under any treaty. In addition, the bill would prevent any person from obtaining U.S. tax benefits under a treaty with respect to any income that bears a significantly lower tax under the laws of the other treaty country than similar income arising from sources within such foreign country derived by residents of such foreign country.

3. Excise tax on certain insurance premiums paid to certain foreign persons (sec. 303).—The bill raises from 1 percent to 4 percent the excise tax on certain premiums paid to foreign persons in low-tax countries for reinsurance covering casualty insurance and indemnity bonds. The bill includes provisions to assist the IRS in collecting tax in connection with reinsurance of a U.S. risk provided by a reinsurer not eligible for relief with respect to the 4 percent tax on reinsurance.

4. Special section 482 rules for certain foreign and foreign-owned corporations (sec. 304).—The bill sets a minimum amount of taxable income to be reported (absent IRS agreement to accept a different amount) by 25-percent foreign-owned domestic corporations that engage in more than a threshold level of transactions with foreign related parties. (A similar rule also applies to U.S. branches of foreign corporations.) Generally the taxpayer's taxable income from any category of business would be no less than 75 percent of the amount determined by applying an industry profit percentage to the taxpayer's gross receipts from that business category.

Title IV—Other Reforms [2]

1. Treatment of certain grants (sec. 403).—The bill provides that income received by an individual in the form of a scholarship or fellowship grant for study, training, or research is treated as derived from sources in the location of the funded activity. The bill also provides that income received as a prize or award made primarily in recognition of religious, charitable, scientific, educational, artistic, literary or civic achievement is treated as derived from sources in the location of the activities that formed the basis of the prize or award. The bill also allows certain deductions, based on

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[2] Sections 401 and 402 of the bill are simplification provisions (relating to simplified foreign tax credit limitations for individuals and personal transactions by individuals in foreign currency, respectively) that were included in the Tax Fairness and Economic Growth Act of 1992 (H.R. 4210) as passed by Congress on March 20, 1992 (and vetoed by the President). (See also Title V.)

the standard deduction and multiple personal exemptions, to offset certain U.S. source gross income of visiting foreign individuals received in the form of scholarships and fellowships granted by certain tax-exempt or governmental entities.

2. Estate tax marital credit for certain employees of international organizations (sec. 404).—Under present law, the marital deduction from the Federal estate tax generally is disallowed for the value of property passing to a noncitizen spouse. The bill provides a limited credit for such property if either the decedent or the spouse is employed full-time in the United States by a public international organization, so long as neither the decedent nor the spouse is a U.S. citizen or lawful permanent resident of the United States. The amount of the credit generally equals an exemption of $600,000, but, in the case of a decedent domiciled outside the United States, is reduced by the amount of the unified credit.

3. Reduction of Puerto Rico and possession tax credit (sec. 411).—The bill reduces the section 936 credit from 100 percent to 85 percent of pre-credit U.S tax on a company's possession-based operations and qualified possession source investment income.

4. Treatment of passive income related to foreign oil and gas extraction income and shipping income (secs. 412 and 201).—The bill treats passive types of income related to oil and gas extraction activities, such as interest income derived from bank deposits or temporary investments of working capital, as passive income under the separate foreign tax credit limitation rules. In addition, the bill provides that income which would meet the definition of both foreign personal holding company income and foreign base company shipping income under present-law rules is considered passive income for foreign tax credit purposes. The bill also eliminates the treatment of any income that qualifies as passive income for foreign tax credit separate limitation purposes (e.g., interest income from bank deposits or temporary investments) as foreign oil and gas extraction income for purposes of computing the special limitation on foreign tax credits related to extraction activities.

Title V—Foreign Simplification Provisions

The bill includes those simplification provisions passed by Congress on March 20, 1992 (and vetoed by the President), in title IV of the Tax Fairness and Economic Growth Act of 1992 (H.R. 4210), that relate to foreign income, including provisions relating to the treatment of passive foreign corporations, the treatment of controlled foreign corporations, the translation of taxes paid in foreign currencies, the alternative minimum tax foreign tax credit limitation, and inbound and outbound property transfers.

Title VI—Studies

The bill requires a Treasury study on tax issues relating to the maintenance and enhancement of the competitivness of the American economy in light of changing economic policies in Europe and the increasing globalization of the world economy. The bill also requires a Treasury study on administrative and compliance issues related to a value added tax. The bill further requires a Treasury study on issues related to transfer pricing rules and the proper tax-

ation of foreign persons conducting business in the United States, including the effectiveness of provisions in the bill, issues relating to the unitary method of taxation, and the advisability of providing additional confidentiality for information provided by domestic corporations for use in formulating third-party comparable information. Treasury is required to report to Congress on all three studies by January 1, 1994.

II. TECHNICAL EXPLANATION OF THE BILL

Title I—Treatment of U.S. Businesses Operating Abroad

Subtitle A. Interest Allocation Rules: Revise Application of Interest Allocation Rules (Sec. 101 of the Bill and 864(e) of the Code)

Present Law

In general

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

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

Affiliated group

The term "affiliated group" in this context generally is defined by reference to the rules for determining whether corporations are eligible to file consolidated returns. However, some groups of corporations are eligible to file consolidated returns yet are not treated as affiliated for interest allocation purposes, and other groups of corporations are treated as affiliated for interest allocation purposes even though they are not eligible to file consolidated returns. Thus, under the one-taxpayer rule, the factors affecting the allocation of interest expense of one corporation may affect the sourcing of taxable income of another, related corporation even if the two corporations do not elect to file, or are ineligible to file, consolidated returns. (See, e.g., Treas. Reg. sec. 1.861-11T(g).)

Definition of affiliated group—consolidated return rules

For consolidation purposes, the term "affiliated group" means one or more chains of includible corporations connected through stock ownership with a common parent corporation which is an includible corporation, but only if the common parent owns directly

at least 80 percent of the total voting power of all classes of stock and at least 80 percent of the total value of all outstanding stock of at least one other includible corporation. In addition, for each such other includible corporation (except the common parent), stock possessing at least 80 percent of the total voting power of all classes of its stock and at least 80 percent of the total value of all of its outstanding stock must be directly owned by one or more other includible corporations.

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

Definition of affiliated group—special interest allocation rules

Subject to exceptions, the consolidated return and interest allocation definitions of affiliation generally are consistent with each other. For example, both definitions exclude all foreign corporations from the affiliated group. Thus, while debt generally is considered fungible among the assets of a group of domestic affiliated corporations, the same rule does not apply as between the domestic and foreign members of a group with the same degree of common control as the domestic affiliated group. Moreover, Congress in 1986 expressly considered and rejected a rule that would have accomplished a result more consistent with world-wide fungibility by taking foreign members' borrowings into account when allocating the interest expense of the domestic members (H.R. 99-841, 99th Cong., 2d Sess. II-605 (1986)). In practice, the limit in the degree of fungibility recognized by present law can reduce the foreign tax credit limitations that otherwise would apply if the principle of fungibility were extended to foreign and domestic members of a commonly controlled group.

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

Banks, savings institutions and other financial affiliates

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

companies and subsidiaries of banks, bank holding companies, and savings institutions predominantly engaged in the active conduct of a banking, financing, or similar business (sec. 864(e)(5)(D)).

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

Section 936 corporations

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

Regulatory adjustments of the affiliation rules

In addition to the express statutory differences between the consolidated return and interest allocation definitions of affiliation, regulations provide for further differences. Under the statutory rules requiring interest to be allocated on a group-wide basis, and more generally under the statutory rules for determining the foreign tax credit and the limitations applicable to the credit, the Treasury Department has been delegated the authority to resource the income of any member of an affiliated group or modify the consolidated return regulations to the extent such resourcing or modification is necessary to carry out the purposes of the statute. Temporary and proposed Treasury regulations provide that certain corporations not within the general definition of an affiliated group, such as any includible corporation if 80 percent of the vote *or* value of its stock is owned directly or indirectly by an includible corporation or by members of an affiliated group, will be considered to constitute affiliated corporations for purposes of the interest expense allocation rules (Treas. Reg. sec. 1.861-11T(d)(6)(i)).

Example

Assume that a U.S. corporation owns all the stock of a foreign corporation. Neither is a financial corporation within the meaning of present law. Assume that each corporation owns operating assets valued at $1000 for these purposes, each has debt to unrelated parties of $500, and each has interest expense of $50 on that debt. Assume that none of this interest would be directly allocated to any particular stream of gross income under current law. Assume that the stock of the foreign corporation is valued at $500 for purposes of the U.S. parent's allocation of interest. All the operating assets of the U.S. corporation produce U.S. source income, and all the operating assets of the foreign corporation produce foreign source, general limitation income. A foreign country levies tax on the income of the foreign subsidiary at a 34-percent rate.

Assume that in 1993, the U.S. corporation earns $100, before taking into account interest deductions, in taxable income from its U.S. operations, and receives a dividend from its foreign subsidiary. Assume that the amount of the dividend plus the section 78 gross-

up for indirect foreign tax credits equals $50, and that the amount of the foreign tax credit associated with that dividend is $17 (this is consistent with $50 of income at the foreign subsidiary level, burdened by a 34-percent foreign income tax). The entire amount of the foreign source income of the U.S. corporation is subject to the general foreign tax credit limitation. Total taxable income of the U.S. corporation for 1993 is $100—$100 from U.S. operations, plus $50 foreign source, general limitation income, less $50 of interest expense. Assume that U.S. tentative tax on this amount is $34, and that the only income tax credit to which the U.S. corporation is entitled is the foreign tax credit.

The amount of foreign source taxable income, and therefore foreign tax credit limitation, depends on how the $50 of interest expense of the U.S. corporation is apportioned between U.S. and foreign source gross income. On these facts, the U.S. corporation has $1500 worth of assets, one-third of which generate foreign source general limitation income, and two-thirds of which generate U.S. source income. Therefore, one third of its interest expense, or $16.67, would be apportioned to foreign source general limitation income. Foreign source taxable income is $33.33 ($50 minus $16.67). The foreign tax credit limitation is $11.33, computed as $33.33 of foreign source taxable income divided by entire taxable income ($100), multiplied by the tentative U.S. tax of $34. Final U.S. tax for 1993 equals $22.67 ($34 minus $11.33). Total worldwide tax on the $100 of income equals $39.67 ($22.67 plus $17), even though the U.S. corporation and its foreign subsidiary are both subject to local nominal tax rates of 34 percent. It may be argued that the $5.67 excess of tax over the tax which would be computed at the nominal 34-percent rates constitutes double taxation of $16.67 of the U.S. corporation's income.

Explanation of Provision

In general

The bill provides that taxpayers may take into account the interest expense and assets of foreign subsidiaries for purposes of allocating and apportioning interest expense between gross income from U.S. and foreign sources. Thus the bill avoids double-counting the amount of interest expense treated as the cost of holding the assets of the taxpayer's foreign subsidiaries. In addition, the bill expands the types of corporations that are treated as financial institutions for purposes of applying the one-taxpayer rule separately to financial members of an affiliated group.

Foreign affiliate borrowings

Allocation among expanded affiliated group members

Under the bill, a taxpayer performs a hypothetical allocation and apportionment of interest as if an expanded affiliated group were a single taxpayer. In general, the relevant expanded affiliated group includes all members of the affiliated group as defined under present law, plus all the corporations that would be members of the taxpayer's affiliated group but for the fact that they are foreign corporations.

The definition of the expanded affiliated group is adjusted to account for certain foreign financial institutions. Where a foreign corporation that meets the ownership requirements for inclusion in the expanded affiliated group is licensed to do business as a bank in the United States or (to the extent provided in regulations) is not so licensed but is engaged in a banking business, such a foreign corporation will only be treated as a member of the expanded affiliated group (if any) that includes financial institutions to which the one-taxpayer rule would apply separately from a nonfinancial group.

Allocation among foreign affiliates

The amount of interest that would be allocated and apportioned to foreign source gross income on the basis of the expanded affiliated group definition, as described above, is compared to the amount of interest that would be allocated and apportioned to foreign source gross income treating only the foreign members of the expanded affiliated group as a single taxpayer. If the latter amount is equal to or greater than the former, then the interest expense of the affiliated group (as defined under current law) generally will not be apportioned to gross income from foreign sources. On the other hand, if the amount of interest that would be allocated and apportioned to foreign source gross income considering the expanded group as a whole is greater than the amount that would be so allocated and apportioned taking into account only its foreign members, then the interest expense of the affiliated group (as defined under current law) generally will be apportioned to gross income from foreign sources as under current law, but limited by the extent of the difference.[3]

Consistent with the rules governing interest allocation under current law, it is intended that borrowings between members of the relevant group, and stockholdings in members of the group, will be eliminated for purposes of determining the total interest expense of the expanded affiliated group, computing the reduction in foreign-allocated interest expenses to account for foreign affiliate interest expenses, and computing appropriate asset ratios.

Examples

Assume the same facts that were set forth in the example above describing the effect of present law. That is, assume that a U.S. corporation owns all the stock of a foreign corporation. Neither is a financial corporation. Assume that each corporation owns operating assets valued at $1000 for these purposes, each has debt to unrelated parties of $500, and each has interest expense of $50 on that debt. Assume that none of this interest would be directly allocated to any particular stream of gross income under current law. All of the operating assets of the U.S. corporation produce U.S. source income, and all of the operating assets of the foreign corpo-

[3] In either case, allocation and apportionment of interest expense of the affiliated group to gross income from foreign sources may still occur pursuant to the Secretary's existing regulatory authority, including the authority to make direct allocations. The bill is not intended to change the scope of that authority, except insofar as other changes in the law brought about by the bill (e.g., the repeal of deferral) would necessitate adjustments in the interest allocation regulations.

ration produce foreign source, general limitation income. A foreign country levies tax on the income of the foreign subsidiary at a 34-percent rate.

Under the bill, the two corporations form an expanded affiliated group with $100 of interest expense and $2000 worth of assets, half of which generate foreign source general limitation income, and half of which generate U.S. source income. Half of the interest expense of this expanded affiliated group, or $50, would be apportioned to foreign source general limitation income. Since this is the same amount that would be allocated to foreign source income treating the foreign corporation separately, then under the bill none of the interest expense of the U.S. corporation is allocated or apportioned to foreign source gross income.

As another example, assume the same facts as above, except that all the debt, and all interest expense of the group is incurred by the U.S. corporation. As a consequence, the stock of the foreign corporation is valued at $1,000 (rather than $500) for interest allocation purposes. On these facts, the U.S. corporation has $2,000 worth of assets, half of which generate foreign source general limitation income, and half of which generate U.S. source income. Thus, under current law, half ($50) of the U.S. corporation's interest expense would be apportioned to foreign source income. Under the bill, the same amount would be so allocated treating the expanded affiliated group as a single taxpayer. On the other hand, no amount of interest would be allocated to foreign source income treating the foreign corporation separately. Therefore, under the bill, half of the U.S. corporation's interest expense is apportioned to foreign source income, just as under present law.

Financial corporations

The bill modifies the Code's separate treatment for banks and other savings institutions defined in sections 581 and 591, and required by law to be operated separately from other non-banking entities, by extending the same treatment to other corporations predominantly engaged in the conduct of a banking, financing, or similar business (not including an insurance business), the business of which is predominantly with persons other than related persons or their customers, and which are operated, not inconsistently with regulations prescribed by the Secretary, separately from any other entity which is not such an institution.

Under the bill, where assets are made available by such an institution to a nonfinancial affiliate, interest attributable to an equal amount of debt generally is treated as interest of the nonfinancial affiliate. The amount of assets made available for this purpose includes distributions with respect to stock, contributions to capital, loans, and any other direct or indirect use of assets of the corporation to the extent prescribed by regulations.

Effective Date

The provision applies to taxable years beginning after December 31, 1992.

Subtitle B. Foreign Tax Credit Rules

1. Repeal of 90-percent limitation on alternative minimum tax foreign tax credit (sec. 111 of the bill and sec. 59(a)(2) of the Code)

Present Law

Under present law, taxpayers are subject to an alternative minimum tax ("AMT"), which is payable, in addition to all other tax liabilities, to the extent that it exceeds the taxpayer's regular income tax liability. The tax is imposed at a flat rate of 20 percent, in the case of corporate taxpayers, on alternative minimum taxable income ("AMTI") in excess of a phased-out exemption amount. The rate for noncorporate taxpayers is 24 percent. Alternative minimum taxable income is the taxpayer's taxable income increased for certain tax preferences and adjusted by determining the tax treatment of certain items in a manner which negates the exclusion or deferral of income resulting from the regular tax treatment of those items.

Taxpayers are permitted to reduce their AMT liability by an AMT foreign tax credit. The AMT foreign tax credit for a taxable year is determined under principles similar to those used in computing the regular tax foreign tax credit, except that (1) the numerator of the AMT foreign tax credit limitation fraction is foreign source AMTI [4] and (2) the denominator of that fraction is total AMTI.[5]

The AMT foreign tax credit for any taxable year generally may not offset a taxpayer's entire pre-credit AMT. Rather, the AMT foreign tax credit generally is limited to 90 percent of AMT computed without an AMT net operating loss deduction, an AMT energy preference deduction, or an AMT foreign tax credit.[6] For example, assume that a corporation has $10 million of AMTI, has no AMT net operating loss or energy preference deductions, and is subject to the AMT. In the absence of the AMT foreign tax credit, the corporation's tax liability would be $2 million. Accordingly, the AMT foreign tax credit cannot be applied to reduce the taxpayer's tax liability below $200,000. Any unused AMT foreign tax credit may be carried back 2 years and carried forward 5 years for use against AMT in those years under the principles of the foreign tax credit carryback and carryforward set forth in section 904(c).[7]

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[4] This is modified by section 522 of the bill.

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

[6] Certain domestic corporations operating solely in one foreign country with which the United States has an income tax treaty in effect are not subject to the 90-percent limitation on the use of the AMT foreign tax credit if certain other specified criteria are satisfied (sec. 59(a)(2)(C)).

[7] Note that under section 113 of the bill, the carryback and carryforward periods for unused regular tax and AMT foreign tax credits are extended to 3 years for carrybacks and 15 years for carryforwards.

Explanation of Provision

The bill repeals the 90-percent limitation on the utilization of the AMT foreign tax credit.

Effective Date

The provision applies to taxable years beginning after December 31, 1992.

2. Recharacterization of overall domestic loss (sec. 112 of the bill and new sec. 904(g) of the Code)

Present Law

Overview

A premise of the foreign tax credit is that it should not reduce a taxpayer's U.S. tax on its U.S. source income; rather, it should only reduce U.S. tax on foreign source income. The Code contains an overall foreign tax credit limitation which prevents taxpayers from using foreign tax credits to offset U.S. tax on U.S. source income. The overall limitation is calculated by prorating a taxpayer's pre-credit U.S. tax on its worldwide income between its U.S. source and foreign source taxable income. The ratio (not exceeding 100 percent) of the taxpayer's foreign source taxable income to worldwide taxable income is multiplied by its pre-credit U.S. tax to establish the amount of U.S. tax allocable to the taxpayer's foreign source income and, thus, the upper limit on the foreign tax credit for the year. If the taxpayer's foreign source taxable income exceeds worldwide taxable income (because of a domestic source loss), then the full amount of pre-credit U.S. tax may be offset by the foreign tax credit.

If a taxpayer's losses from foreign sources exceed its foreign source income, the excess ("overall foreign loss") may reduce the U.S. tax on the taxpayer's worldwide income. Such a taxpayer's actual U.S. tax liability falls short of the hypothetical tax that would apply to the taxpayer's U.S. source income standing alone. To eliminate a double benefit (that is, the reduction of U.S tax just noted and, later, full allowance of a foreign tax credit with respect to foreign source income), an overall foreign loss recapture rule was enacted in 1976. Under this rule, a portion of foreign source taxable income earned after an overall foreign loss year is recharacterized as U.S source taxable income for foreign tax credit purposes (and for purposes of the possessions tax credit) (sec. 904(f)(1)). Foreign source taxable income up to the amount of the overall foreign loss may be so treated. Unless a taxpayer elects a higher percentage, however, generally no more than 50 percent of the foreign source taxable income earned in any particular taxable year is resourced as U.S. source taxable income.[8] The effect of the recapture

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

is to reduce the foreign tax credit limitation in one or more years following an overall foreign loss year and, therefore, the amount of U.S. tax that can be offset by foreign tax credits in the later year or years.

Domestic losses

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

For example, assume that a taxpayer has domestic and foreign operations. The foreign operations generate $100 of income annually in 1991 and 1992, and bear $34 of foreign income tax each year. The domestic operations generate a loss of $100 in 1991, and income of $100 in 1992. Worldwide income for 1991 is zero; therefore, the foreign tax credit limitation for 1991 is also zero and no net operating loss is generated. For 1992, only $100 of the taxpayer's $200 of income is from foreign sources; therefore, the taxpayer owes $34 of U.S. tax in 1992. For the two years, the total of the taxpayer's foreign tax payments ($68) and domestic tax payments ($34) equals $102.

It may be noted that net U.S. income for the period is zero. Net worldwide and foreign income for the period is $200, and foreign tax for the period is $68. Despite the fact that the taxpayer is subject to income tax at nominal income tax rates of 34 percent both in the United States and abroad, and would normally be entitled both to loss carryovers and to a foreign tax credit on foreign source income, the taxpayer's total tax for the period is 51 percent of taxable income.

Explanation of Provision

In general

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

The bill defines an "overall domestic loss" for this purpose as any domestic loss to the extent it offsets foreign source taxable

income for the current taxable year or for any preceding taxable year by reason of a net operating loss carryback. In the case of a domestic loss that does not offset foreign source income in the current or previous years, it is treated as an overall domestic loss if and to the extent that it offsets foreign source income in a year to which it is carried forward (if any). The term "domestic loss" means the amount by which the U.S. source gross income for the taxable year is exceeded by the sum of the deductions properly apportioned or allocated thereto, except that there shall not be taken into account any net operating loss deduction carried back from a subsequent taxable year. An overall domestic loss does not include any loss for any taxable year unless the taxpayer elected the use of the foreign tax credit for that taxable year.

Examples

Example 1.—Assume that in 1993 a taxpayer has taxable income of $800, consisting of $1,000 of foreign source taxable income and $200 of domestic loss. Also assume that the taxpayer has $340 of foreign income taxes for 1993, and elects the foreign tax credit for 1993. The taxpayer has a $68 foreign tax credit carryover from 1993. Assume that it is carried forward. Under the provision, the taxpayer has a $200 overall domestic loss which is subject to the provision's recharacterization rules. If in 1994 the taxpayer earns $300 of worldwide taxable income, all from domestic sources, and has no net foreign loss, $150 (50 percent) of 1994 income is deemed to be foreign source income. Therefore, up to $51 of the excess foreign taxes carried forward from 1993 may be credited against U.S. tax in 1994. The remaining unrecovered portion of the overall domestic loss ($50) is carried forward to subsequent taxable years.

Example 2.—Assume as above that in 1993 the taxpayer has a $200 overall domestic loss which is subject to the provision's recharacterization rules. Now assume that the taxpayer earns $300 of worldwide taxable income in 1994, which consists of $500 of domestic source income and a $200 foreign source loss. Under the provision, 1994 income is resourced so that net foreign source loss is $50 and domestic source income is $350. Thus, in 1994, the taxpayer has a foreign tax credit limitation of zero, but its overall foreign loss is decreased by $150.

Example 3.—Assume that a taxpayer has a $600 net operating loss for 1993, attributable to a $600 domestic loss. Assume that none of this loss is carried back. Before taking into account net operating loss carryforwards, the taxpayer has $100 of U.S. source income annually for each year after 1993. In 1998, the taxpayer also has $100 of foreign source taxable income. Under the provision, $100 of the net operating loss carryforward to 1998 is an overall domestic loss available for recharacterization starting in 1999. On these facts, the taxpayer is treated as having $50 of foreign source taxable income in each of the years 1999 and 2000. The remainder of the taxpayer's $100 taxable income for those years retains its original characterization as domestic source.

Example 4.—Assume that the taxpayer has $100 of income annually from foreign sources, and the same amount of income from domestic sources, in the years 1993 through 1995. Assume that the taxpayer has a $500 net operating loss in 1996, all from domestic

sources. The entire amount of the loss is carried back and used in the prior three years. Under the provision, it is expected that in general $200 of this loss will be treated as an overall domestic loss: of the $200 carried back to 1993, $100 offsets foreign source income, and of the $200 carried back to 1994, another $100 offsets foreign source income. The remaining $100, which is carried back to 1995, is expected to be treated as reducing the domestic income in that year, because there is sufficient domestic income in 1995 to absorb the entire domestic source carryback in that year.[9]

Separate limitation character of resourced income

Any U.S. source income that is resourced under the bill is allocated among and increases the various foreign tax credit separate limitation categories in the same proportion that those categories were reduced by the domestic losses which are responsible for the resourcing. To illustrate, assume that in example 1 provided above, $160 of the 1993 overall domestic loss reduced foreign source general limitation income and $40 reduced passive income. Of the $150 of 1994 domestic income that is treated as foreign source income under the provision, 80 percent ($120) would be treated as income subject to the general foreign tax credit limitation and 20 percent ($30) would be treated as income subject to the separate foreign tax credit limitation for passive income.

Interaction with foreign loss recapture

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

Effective Date

The provision is effective for losses incurred in taxable years beginning after December 31, 1992. For example, assume that in 1992 a calendar year taxpayer has worldwide taxable income of $200, all of which was from foreign sources. Assume that in 1993 this taxpayer has a net operating loss of $200, all of which is domestic loss. Assume that in 1994 this taxpayer has no net loss from foreign sources and $1000 of worldwide taxable income, all from domestic sources. Assume that the 1993 net operating loss is carried back to 1992. Under the provision, the 1993 loss is an overall domestic loss, because it is a post-1992 loss that has reduced foreign source income of a preceding year by reason of a carryback. Thus, in 1994, the taxpayer resources $200 of domestic income as foreign.

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[9] Cf. Rev. Rul. 71-432, 1971-2 C.B. 270 (in applying the foreign tax credit per-country limitation rules, a net operating loss carryback to a prior year is allocated to income generated in that year from sources within the same country in which the later-year loss was generated).

3. Extension of period to which excess foreign taxes may be carried (sec. 113 of the bill and secs. 904(c) and 907(f) of the Code)

Present Law

As described above, the foreign tax credit is subject to an overall limitation. That is, the total amount of the credit may not exceed the same proportion of the taxpayer's U.S. tax which the taxpayer's foreign source taxable income bears to the taxpayer's worldwide taxable income for the taxable year. In addition, the foreign tax credit limitation is calculated separately for various categories of income, generally referred to as "separate limitation categories." The total amount of the credit for foreign taxes on income in each separate limitation category may not exceed the same proportion of the taxpayer's U.S. tax which the taxpayer's foreign source taxable income in that category bears to its worldwide taxable income.

The amount of creditable taxes paid or accrued (or deemed paid) in any taxable year which exceeds the foreign tax credit limitation is permitted to be carried back to the two immediately preceding taxable years and carried forward to the first five succeeding taxable years and credited (not deducted) to the extent that the taxpayer otherwise has excess foreign tax credit limitation for those years. For purposes of determining excess foreign tax credit amounts, the foreign tax credit separate limitation rules apply. Thus, if a taxpayer has excess foreign tax credits in one separate limitation category for a taxable year, those excess credits are carried back and forward only as taxes allocable to that category notwithstanding the fact that the taxpayer may have excess foreign tax credit limitation in another category for that year.

Explanation of Provision

The provision extends the excess foreign tax credit carryback period from 2 to 3 years and extends the carryforward period from 5 to 15 years. Excess credits, under the provision, are to be utilized in the earliest year to which they may be carried. Similar extensions are provided for excess oil and gas extraction taxes.

Effective Date

The provision is effective for taxable years beginning after December 31, 1992. It applies only with respect to taxes actually paid or accrued (or deemed paid) in such taxable years. The present-law carryback and carryforward periods continue to apply with respect to taxes actually paid or accrued (or deemed paid) in taxable years beginning before January 1, 1993.

The provision allows excess taxes to be carried back to years prior to the provision's effective date. Thus, for example, excess foreign taxes incurred in a taxable year beginning January 1, 1993 are permitted to be carried back three years to the taxable year that began January 1, 1990.

4. Election to treat certain companies as controlled foreign corporations (sec. 114 of the bill and sec. 904(d) of the Code)

Present Law

For purposes of determining a taxpayer's foreign tax credit, a foreign tax credit limitation is computed separately for certain specified categories of income. As a general rule, dividends from foreign corporations may be subject to three different sets of rules, depending on the ownership of the corporation paying the dividend. If the corporation that pays the dividend is a controlled foreign corporation of which the recipient is a "U.S. shareholder" (as that term is defined below), then the dividend generally is treated as a "look-through" payment for purposes of determining in which foreign tax credit separate limitation category the dividend is to be classified (sec. 904(d)(3)). In the case of a foreign corporation the dividends from which do not qualify for look-through treatment, but with respect to which the shareholder is permitted to claim an indirect foreign tax credit (generally referred to as a "noncontrolled section 902 corporation"), the shareholder is required to compute a separate foreign tax credit limitation with respect to dividends from *each* such corporation (sec. 904(d)(1)(E)). Thus, if a taxpayer owns stock in 10 different noncontrolled section 902 corporations, current law requires 10 separate foreign tax credit limitations. Dividends received from foreign corporations other than those specified above generally are classified as passive income, subject to recharacterization as general limitation income if the dividends are subject to high rates of foreign tax (sec. 904(d)(2)(A)).

A controlled foreign corporation generally is defined as a foreign corporation more than 50 percent of the total voting power or value of which is owned directly or indirectly by U.S. shareholders (sec. 957(a)). For this purpose, a U.S. shareholder generally is a U.S. person who owns directly, indirectly, or constructively 10 percent or more of the total combined voting power of all classes of the corporation's voting stock. A U.S. shareholder of a controlled foreign corporation generally is required to include in gross income its pro rata share of the corporation's subpart F income.[10]

Explanation of Provision

The bill permits a domestic corporation that normally would treat a foreign company as a noncontrolled section 902 corporation to elect to treat that company as a controlled foreign corporation (of which the electing domestic corporation is a U.S. shareholder) for foreign tax credit limitation and subpart F purposes. Thus, for example, where such an election is exercised, dividends received from the foreign corporation are entitled to look-through treatment under the foreign tax credit rules, gain on the sale of the stock of the foreign corporation is subject to recharacterization as a dividend under section 1248, and income earned by the foreign corporation is subject to inclusion by the domestic corporation under the

[10] Subpart F income includes, for example, insurance income, foreign personal holding company income, foreign base company sales income, foreign base company services income, foreign base company shipping income, and foreign base company oil related income.

rules of subpart F (secs. 951-964).[11] The election is to be made at the U.S. shareholder level, and once made generally may not be revoked. In order to make the election, a U.S. corporation is required to treat as controlled foreign corporations all foreign corporations that would, absent the election, be noncontrolled section 902 corporations with respect to it.[12]

A taxpayer may make the election for any taxable year beginning after December 31, 1992. Unless revoked with the consent of the Secretary, an election applies to the taxable year for which made and all subsequent years of the electing taxpayer, and to all taxable years of its noncontrolled section 902 corporations that end with or within any such taxable year of the taxpayer. The election may be made for any taxable year at any time on or before the due date, including extensions, for filing the electing corporation's income tax return for that year.

Effective Date

The provision is effective for taxable years beginning after December 31, 1992.

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[11] Note that under section 201 of the bill, subpart F income of a controlled foreign corporation includes all of the corporation's earnings and profits for the taxable year computed with certain adjustments.

[12] Under section 514 of the bill, application of the indirect foreign tax credit is extended to certain taxes incurred by fourth-, fifth-, and sixth-tier controlled foreign corporations. Fourth-, fifth-, and sixth-tier foreign subsidiaries other than controlled foreign corporations do not meet the ownership requirements necessary to be considered noncontrolled section 902 corporations, and are therefore not covered by the election.

Subtitle C. Other Provisions

1. Regulatory authority to exempt foreign persons from uniform capitalization rules (sec. 121 of the bill and sec. 263A of the Code)

Present Law

In general

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

In the case of interest expense, the uniform capitalization rules apply only to interest paid or incurred during the property's production period [13] and that is allocable to property produced by the taxpayer or acquired for resale which (1) is either real property or property with a class life of at least 20 years, (2) has an estimated production period exceeding 2 years, or (3) has an estimated production period exceeding 1 year and a cost exceeding $1,000,000 (sec. 263A(f)).

Application to foreign persons

In general

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

When a foreign corporation is not engaged in business in the United States, its taxable income and earnings and profits may nonetheless be relevant under the Code. For example, the subpart F income of a controlled foreign corporation is currently includible on the return of a U.S. shareholder of the controlled foreign corporation. And whether or not a foreign corporation is U.S.-controlled,

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

its accumulated earnings and profits must be computed in order to determine the indirect foreign tax credit carried by distributions from the foreign corporation to any domestic corporation that owns at least 10 percent of its voting stock.

The Code provides that the earnings and profits or deficit in earnings and profits of any foreign corporation, for any taxable year, shall be determined according to rules substantially similar to those applicable to domestic corporations, under regulations prescribed by the Secretary of Treasury (sec. 964(a)). The regulations under section 964 do not provide for any exception to the application of the uniform capitalization rules in the case of foreign corporations. Moreover, the preamble to the temporary regulations under the uniform capitalization rules included the following statement:

> The provisions of section 263A (including the effective dates thereof) are applicable to all persons engaging in the production of property, or the acquisition of property for resale, including, for example, certain foreign persons which may be organized and operated exclusively outside the United States.[13a]

Thus, foreign persons generally are required to capitalize costs in accordance with the uniform capitalization rules.

U.S. ratio election

In 1988, the IRS issued Notice 88-104 [14] to inform taxpayers of forthcoming guidance designed to provide an elective simplified method of accounting for the costs required to be capitalized in connection with foreign businesses of foreign or U.S. persons under the uniform capitalization rules. The notice stated that the guidance will provide a simplified "U.S. ratio" method of accounting for costs other than interest that are required to be capitalized.

To apply the U.S. ratio method, there must be a U.S. trade or business carried on by the person carrying on the foreign business, or by a related party. The U.S. business so carried on that is the same or most similar to the foreign business must distinguish between costs capitalized in the basis of its relevant property before application of the uniform capitalization rules, and costs capitalized only as a result of those rules, and compute the ratio of the latter to the former ("the U.S. ratio"). The foreign business multiplies this U.S. ratio by the amount of its costs capitalized (without regard to the uniform capitalization rules) in the basis of its relevant property. The product of this multiplication yields the amount of additional costs (other than interest) required to be capitalized by a foreign person under the uniform capitalization rules.[15]

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

[13a] 52 Fed. Reg. 10059 (March 30, 1987).
[14] 1988-2 C.B. 443.
[15] "Additional section 263A costs" as defined in Temp. Treas. Reg. sec. 1.263A-1T(b)(5)(iii).

each taxable year. A separate ratio is required to be computed for each taxable year for properties related to each separate trade or business.

An election to use the U.S ratio method was originally limited by Notice 88-104 to taxable years beginning before January 1, 1988. However, the IRS subsequently extended the provisions of that Notice to taxable years beginning after 1987 and acknowledged that those provisions would remain in effect until further guidance under the uniform capitalization rules is issued.[16] The IRS further provided in Notice 89-67 that if a taxpayer failed to elect the use of the U.S ratio method for its first taxable year for which the uniform capitalization rules applied, it could so elect (1) on an amended tax return for such first taxable year, or (2) on its tax return for the second taxable year for which the uniform capitalization rules were effective, if and only if the method used by the taxpayer for the prior taxable year was a correct method of accounting under the uniform capitalization guidelines. In addition, the Notice provided that it is anticipated that forthcoming regulations will permit a taxpayer to elect the U.S ratio method regardless of whether it had made the election for previous taxable years.

Capitalization of interest expense

The IRS has also provided advance guidance on the application of the interest capitalization rules of section 263A(f).[17] Under the interest capitalization rules, taxpayers must first capitalize debt which is *directly attributable* to the production expenditures of a property specified in section 263A(f)(1)(B) (i.e., "traced debt"). Debt generally is allocated to a particular expenditure by tracing disbursements of the debt proceeds to that expenditure. Traced debt includes only amounts of the taxpayer's eligible debt that do not exceed the property's accumulated production expenditures.

After determining the amount of traced debt directly attributable to the property's production expenditures, taxpayers then must assign any other eligible debt to any remaining production expenditures and interest on such debt must be capitalized, to the extent that the taxpayer's interest costs could have been reduced if such production expenditures had not been incurred (i.e., "avoided cost debt").[18] The determination of whether the taxpayer's interest costs could have been reduced if such production expenditures had not been incurred is made by assuming that the amounts expended for production had instead been used to repay the taxpayer's debt, thus reducing the principal balance of such debt and the interest costs thereon. The operation of the avoided cost concept does not depend on whether, in fact, the taxpayer actually would have used the amounts otherwise expended for production to repay debt.

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

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

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

Capitalization of the interest of parties related to producers of property

The interest costs of parties (including foreign corporations) related to the taxpayer producing qualified property can also be subjected to capitalization requirements (and avoided cost rules).[19] In the case of related parties to which the avoided cost rules apply, a deferred asset method generally is used to comply with the interest capitalization requirements. Under this method, the related party is required to capitalize interest equal to an amount that the producing taxpayer would have capitalized, using the avoided cost principles, had the producing taxpayer itself incurred the interest on the eligible debt of the related party.[20]

Under the deferred asset method, the related party accounts for capitalized interest as an asset in the same manner (and at the same time) as the producing taxpayer would have accounted for such interest had the interest been capitalized into the basis of the qualified property on the taxpayer's books and records. The interest capitalized by the related party is then recovered at the same time and in the same manner as it would have been recovered had it been capitalized into the basis of the property produced by the taxpayer.[21]

A producing taxpayer may elect to use a substitute cost method instead of subjecting the related party to the deferred asset method. Under the substitute cost method, the producing taxpayer capitalizes, during each year of the production period, certain "substitute" costs in lieu of the taxpayer's related parties being required to capitalize interest on their related party avoided cost debt.

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

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

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

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

incurred by every related party organized within the United States must be capitalized before the interest of any other related party is capitalized.

Explanation of Provision

The bill provides that to the extent provided in regulations, the uniform capitalization rules shall apply to any taxpayer who is not a U.S. person only to the extent necessary for purposes of applying the subpart F provisions (secs. 951-964, as amended by the bill) or determining the amount of tax imposed on U.S. effectively connected income. Thus, the bill grants the Secretary of the Treasury the authority to provide a regulatory exemption from the application of the uniform capitalization rules for income of foreign persons (other than controlled foreign corporations) that is not effectively connected (or treated as effectively connected) with the conduct of a trade or business in the United States.

The bill does not mandate that the Secretary issue regulations waiving the uniform capitalization rules in any case. Nor, if any such regulations are issued, does the bill mandate that regulations provide a blanket exemption from the uniform capitalization rules for all noneffectively connected income of all noncontrolled foreign persons. It is intended by this grant of regulatory authority to allow the Secretary to waive application of the uniform capitalization rules to non-controlled foreign corporations on their foreign income where doing so generally does not substantially affect the computation of net U.S. tax. For example, in the case of a noncontrolled section 902 corporation (the income of which is not subject to current U.S. taxation), obtaining a precise annual measure of its taxable income or earnings and profits is less important than ensuring an accurate measurement of the denominator of the corporation's multiyear earnings "pools" under section 902. It is believed that if the earnings in the pools can be measured sufficiently accurately without application of the uniform capitalization rules, waiving the rules in that case would be appropriate.

On the other hand, the bill does not waive the application of the uniform capitalization rules in computing the foreign income earned directly by U.S. persons. To the extent that foreign income of foreign persons is treated similarly to foreign income of U.S. persons under other provisions of the Code, as amended by the bill, it is intended that no such waivers would apply. It is recognized that the "U.S. ratio" method can already be applied to the foreign income of U.S. persons as an alternative to direct application of the uniform capitalization rules to costs of their foreign businesses. It is expected that this method, or any future variation thereof, would apply similarly to the costs of foreign operations of U.S. and foreign persons.

Effective Date

The provision applies on the date of enactment.

2. Modification of certain look-through rules (sec. 122 of the bill and secs. 1296-1297 of the Code)

Present Law

Under present law, the income of foreign corporations, including foreign corporations the stock of which is owned by U.S. taxpayers, generally is subject to U.S. taxation only to the extent that it is income earned in the United States. The Code sets forth several regimes providing exceptions to the general rule deferring U.S. tax on income earned indirectly through a foreign corporation, including the passive foreign investment company (PFIC) rules (secs. 1291-1297). A passive foreign investment company is any foreign corporation if (1) 75 percent or more of its gross income for the taxable year consists of passive income, or (2) 50 percent or more of the average fair market value of its assets consists of assets that produce, or are held for the production of, passive income (sec. 1296(a)).

In determining whether a foreign corporation that owns stock in another corporation is a PFIC, that stock generally is treated as a passive asset. However, the foreign corporation may "look through" to the active or passive assets and income of the issuer of the stock in certain cases (sec. 1296(c)). Under this look-through rule, a foreign corporation that owns, directly or indirectly, at least 25 percent of the value of the stock of another corporation is treated as owning a proportionate part of the other corporation's assets and income. Thus, amounts such as interest and dividends received from foreign or domestic subsidiaries are eliminated from the foreign corporation's income in applying the income test, and the stock or debt investment is eliminated from the foreign corporation's assets in applying the asset test.

In addition, stock in certain types of U.S. corporations, when owned by another U.S. corporation which is at least 25-percent owned by a foreign corporation, is treated as a nonpassive asset (sec. 1297(b)(8)). Under this rule, in determining whether a foreign corporation is a PFIC, stock of a regular domestic C corporation owned by the 25-percent-owned domestic corporation is treated as an asset which does not produce passive income (and is not held for the production of passive income). Similarly, income derived from that stock is treated as income which is not passive income. Thus a foreign corporation, in applying the look-through rule to its investment in a 25-percent owned U.S. corporation, is treated as owning a proportionate share of nonpassive assets consisting of the latter's investments in regular domestic C corporation stock.

The special domestic stock look-through rule does not apply if, under a treaty obligation of the United States, the foreign corporation is not subject to the accumulated earnings tax, unless the corporation agrees to waive the benefit under the treaty.

Explanation of Provision

The provision modifies the passive foreign corporation rules, which replace the PFIC rules under title V of the bill, by reducing the ownership thresholds from 25 percent to 20 percent in both the

general look-through rule of section 1296 and the special domestic-subsidiary look-through rule of section 1297.

Effective Date

The provisions are effective for taxable years of U.S. persons beginning after December 31, 1992, and for taxable years of foreign corporations ending with or within those taxable years.

Title II—Treatment of Controlled Foreign Corporations

1. Repeal of deferral for controlled foreign corporations (sec. 201 of the bill and secs. 552, 861, 864, 881, 884, 898, 904, 952-959, 964, 970-971, 988, 999, 1296, and 6046 of the Code)

Present Law

Under present law, U.S. citizens, residents, and corporations are subject to U.S. taxation on their worldwide incomes. Foreign corporations, including foreign corporations controlled by U.S. taxpayers, generally are subject to U.S. taxation only on income earned in the United States.

Although the income of a foreign corporation controlled by a U.S. shareholder usually is consolidated with the income of the U.S. shareholder for purposes of financial reporting, this is not the case for tax purposes. The shareholder's income subject to U.S. tax generally includes only dividends received from the foreign corporation and not the earnings that the foreign corporation retains. The U.S. tax on dividends from the foreign corporation may be offset by a credit allowed for the foreign taxes paid on the distributed earnings, including foreign taxes paid by the foreign corporation.

"Deferral" refers to the practice of not taxing the income of a U.S.-controlled foreign corporation until that income is distributed to the controlling U.S. shareholders. The term "deferral" is employed because the net U.S. tax liability—equal to the difference between the U.S. tax and the credit for foreign taxes—is "deferred" until such income is distributed as a dividend.

The controlled foreign corporation (subpart F) rules of the Code provide a major exception to the general rule of deferral (secs. 951-964). Certain U.S. shareholders of a controlled foreign corporation are subject to current U.S. taxation on their pro rata portions of the foreign corporation's "subpart F" income. Subpart F income typically is income that is relatively movable from one taxing jurisdiction to another and that is subject to low rates of foreign tax.

Explanation of Provision

Permanent rules

The bill repeals deferral on controlled foreign corporations generally by treating as subpart F income all of a controlled foreign corporation's earnings and profits for the taxable year. As under present law, subpart F income does not include earnings and profits attributable to income from sources within the United States which is effectively connected with the conduct of a U.S. trade or business (except to the extent that the income is exempt from tax or subject to a reduced rate of taxation pursuant to a U.S. treaty obligation). Nor does subpart F income include any foreign trade income of a foreign sales corporation (FSC). Such income remains taxable to the FSC to the extent provided under current law. Subpart F income is not reduced on account of certain illegal payments, as provided under current law.

As under present law, amounts of subpart F income included in the gross incomes of U.S. shareholders are reduced on account of

deficits of certain related foreign corporations (so-called "chain deficits"), and on account of certain prior-year deficits in earnings and profits. For deficits in years beginning after the effective date of the bill, reductions in subpart F income can result from earnings deficits in any category of activity (taking into account the same adjustments to earnings and profits that apply for purposes of determining subpart F income under the bill) for taxable years in which the corporation was a controlled foreign corporation.

Under the bill, as under present law, certain amounts of earnings and profits are not included in subpart F income if it is established to the satisfaction of the Treasury Secretary that those amounts of earnings could not have been distributed to the U.S. shareholders because of currency or other restrictions or limitations imposed under the laws of any foreign country. It is intended that such legal restrictions or limitations be taken into account only if they are publicly promulgated, generally applicable to all similarly situated persons (whether controlled or uncontrolled), and not actually avoided by the foreign corporation or other persons, and if the process prescribed by local law for obtaining a waiver of such restrictions, if any, has been exhausted. No inference is intended regarding the meaning of the corresponding provision of current law.

Also as under present law, reduced ownership thresholds apply to the definition of a controlled foreign corporation and the definition of a U.S. shareholder solely for purposes of determining the tax treatment under subpart F of related person insurance income, as defined in section 953.

In eliminating deferral with respect to all of a controlled foreign corporation's income, rather than only with respect to specified types of income, the bill eliminates the high-tax exception to the definition of subpart F income.

Transition rules

Under the bill, the Code retains much of present law solely in order to preserve the tax treatment applicable to earnings and profits (and deficits in earnings and profits) attributable to years beginning prior to the effective date of the bill. Accordingly, the rules applicable to previously taxed income under section 959 will continue to distinguish between subpart F income and non-subpart F income for pre-enactment years, and non-subpart F income for pre-enactment years will continue to be subject to sections 956 and 1248.

In addition, deficits in earnings and profits (taking into account the same adjustments to earnings and profits that apply for purposes of determining subpart F income under the bill) for years beginning prior to the effective date of the bill will reduce amounts of subpart F income included in the gross incomes of U.S. shareholders only to the extent that those deficits would have reduced subpart F inclusions under the qualified deficit rules of present law.

In eliminating deferral for all controlled foreign corporations, the bill repeals the export trade corporation rules (subpart G). Inasmuch as the export trade corporation rules were replaced by the domestic international sales corporation rules in 1971, which were replaced, in turn, by the foreign sales corporation rules in 1984,

very few export trade corporations remain active. The bill would allow an export trade corporation to avail itself of the FSC rules for future years, assuming that it meets the requirements that any other FSC must meet in order to obtain those benefits.

Effective Date

The provisions are effective for taxable years of controlled foreign corporations beginning after December 31, 1992, and for taxable years of U.S. shareholders during which or with which those taxable years end.

2. Election to treat controlled foreign corporations as domestic corporations (sec. 202 of the bill and new sec. 963 of the Code)

Present Law

A corporation is considered to be a domestic (or U.S.) corporation if it is created or organized in the United States, or under the laws of the United States or the laws of a State or the District of Columbia. Domestic corporations are taxed currently by the United States on their worldwide income, subject to a credit for foreign income taxes against the U.S. tax on foreign income. A U.S. corporation (or other U.S. person) that conducts foreign operations through a foreign corporation generally pays no U.S. tax on the income from those operations until the foreign corporation repatriates its earnings to the United States. However, a U.S. person may pay tax currently on some income of a foreign subsidiary corporation (such as a controlled foreign corporation), for example, under one or more of the Code's anti-deferral regimes, described in connection with subtitle A of title V, below, and item 1 of this title, above.

In some cases, a U.S. corporation or other U.S. person finds it practical to conduct its foreign operations through a U.S. corporation. In other cases, the Code permits a business that may be carried on through a foreign corporation for non-tax reasons to be treated for tax purposes as though carried on through a U.S. corporation. For example, certain foreign corporations engaged in an insurance business are permitted to elect to be treated as domestic for most U.S. tax purposes (sec. 953(d)). In addition, certain corporations organized under the laws of Canada or Mexico and maintained solely for the purpose of complying with the laws of those countries as to title and operation of property may, at the option of a domestic parent corporation, be treated as domestic companies. In other cases, practical difficulties may have prevented foreign operations from being conducted in U.S. corporate form, but no such election is available.

Explanation of Provision

In general

The bill provides an opportunity to operate a business through a controlled foreign corporation but have that corporation be treated as domestic for all U.S. tax purposes, including noneligibility for

tax treaty benefits that the corporation would otherwise be entitled to elect as a resident of a foreign treaty country. In the case of certain commonly controlled foreign corporations, domestic company treatment must be elected, if at all, only on a consistent group-wide basis. In the case of other controlled foreign corporations, domestic company treatment may be elected on a company-by-company basis.

Members of a qualified electing group

Domestic treatment under the bill applies to controlled foreign corporations (other than foreign sales corporations) that are members of a qualified electing group. The term "qualified electing group" refers to any expanded affiliated group for which an election is made and for which the common parent meets such requirements as the Secretary prescribes to ensure payment of the U.S. income tax liabilities of the foreign members of the group. The election is made by the common parent of the expanded controlled group, with the required consent of each foreign corporation which is a member of that group on the day on which the election is made.

Membership in an expanded affiliated group is determined by applying the affiliated group definitions of section 1504, substituting a greater-than-50-percent stock ownership threshold for the 80-percent ownership threshold. For this purpose the bill treats foreign corporations as includible corporations, except that for a common parent to be an includible corporation, it must not actually be foreign. Under the bill, membership in the expanded affiliated group is determined by treating stock owned by attribution under the rules of section 1563 as owned directly. Under the bill, a corporation is considered to be controlled if *either* the 50-percent vote *or* the 50-percent value test is met. Finally, under the bill stock is disregarded for purposes of determining expanded affiliated group membership if it is limited and preferred as to dividends and does not participate in corporate growth to any significant extent.

The bill provides an exception to domestic treatment for foreign members of the qualified electing group that are foreign sales corporations (FSCs). In the case of a FSC that is a member of a qualified electing group, present law continues to apply to the FSC's foreign trade income, interest, dividends, royalties, other investment income, and carrying charges. Any other income of the FSC is treated as effectively connected with a trade or business conducted through a permanent establishment in the United States.

When made, the election of the qualified electing group applies to all foreign corporations in the expanded affiliated group, and all foreign corporations belonging to another expanded affiliated group with the same common parent or with a common parent which is a successor to the common parent. The bill provides that the Treasury will prescribe regulations under which expanded affiliated groups under common control of a single foreign corporation will be required to make consistent elections.

Electing nonaffiliated corporations

The bill further permits a controlled foreign corporation that is not a member of an expanded affiliated group to elect individually

to be treated as domestic, so long as it meets such requirements as the Secretary prescribes to ensure that its U.S. income tax liability is paid. As in the case of an election by a qualified electing group, the election for nonaffiliated corporations under the bill is not available to a FSC.

Scope and effect of election

When made, an election takes effect on the date specified in the election and applies to all subsequent periods unless revoked with the consent of the Secretary. However, an election terminates if the common parent (in the case of a qualified electing group) or the foreign corporation (in the case of an electing nonaffiliated corporation) fails to meet the requirements necessary to ensure payment of a foreign corporation's U.S. tax liabilities. In addition, an electing nonaffiliated corporation's election terminates if it becomes a member of an expanded affiliated group. Were that to happen, the corporation would be subject to the same treatment as the other foreign members of the group. Where domestic treatment ceases to apply to an expanded affiliated group, the common parent (or a successor) may not make a subsequent domestic election for 5 years. The Secretary may, however, waive this restriction on a subsequent election. Similar rules apply to a nonaffiliated corporation to which an election has ceased to apply.

A foreign corporation to which domestic treatment applies generally is treated as transferring all of its assets to a domestic corporation in an exchange to which section 354 applies (cf. Treas. Reg. sec. 7.367(b)-7(c)(2)).[22] The resulting inclusion in U.S. income of pre-1993 earnings is, however, spread over four years. Moreover, in the case of a foreign corporation which, if domestic, would qualify for treatment under the insurance company tax rules of part I or II of subchapter L, the tax consequences of this deemed transfer would continue to be governed by the existing provisions of section 953(d). Under those provisions, special rules apply to pre-1988 earnings and profits, and an additional tax (up to $1,500,000) is imposed based on capital and accumulated surplus as of December 31, 1987. A foreign corporation that ceases to be subject to the election is treated as a domestic corporation transferring all of its property to a foreign corporation in an exchange to which section 354 applies.

As stated above, a foreign corporation subject to an election under the bill generally is treated as a domestic corporation for all purposes of the Code. Thus, for example, such a corporation would not be a foreign corporation for purposes of section 1503(d)(2)(B), which provides that to the extent provided under regulations, the term "dual consolidated loss" will not include any loss which, under foreign income tax law, does not offset the income of any foreign corporation. Current regulations implementing this authority are found in Treas. Reg. sec. 1.1503-2T(c).

For example, assume that under the bill an election applies for a taxable year to one or more foreign corporations that, by reason of the election, are members of an affiliated group of actual and

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[22] It is not intended that net operating losses or built-in losses of the corporation deemed to be making the transfer would be usable by the corporation deemed to be acquiring the transferred assets (cf. Rev. Rul. 72-421, 1972-2 C.B. 166).

deemed domestic corporations filing a consolidated U.S. tax return. Assume that the only members of the affiliated group that generate positive taxable income for the taxable year are among these foreign corporations. Also assume that a dual resident corporation belonging to that group incurs a loss for the taxable year. For purposes of this example, the dual resident corporation could be either a foreign corporation subject to the election or a corporation organized under U.S. law but resident in a foreign country for foreign tax purposes. Assume that under foreign law every other foreign corporation whose income could be offset by the loss is, by virtue of the bill's consistency rule, also subject to the election under the bill. In that case, it generally is intended that the loss be treated as one that offsets the income of only other "domestic corporations." Therefore, the Secretary would be authorized under the bill to permit such a loss to offset the income of any corporation in the affiliated group, assuming such treatment was otherwise appropriate taking into account all other relevant factors.

Effective Date

The provision is effective on January 1, 1993.

3. Source of income from certain sales of inventory property (sec. 203 of the bill and 865 of the Code)

Present Law

The foreign tax credit may eliminate the U.S. tax on foreign source income. That credit cannot reduce U.S. tax on U.S. source income. To calculate the foreign tax credit, every item of gross income is either assigned a domestic or foreign source or is divided into domestic and foreign source portions.

Title passage source rule

In general, gross income derived from the sale of personal property by U.S. residents is U.S. source (sec. 865). Income attributable to the marketing of inventory property by U.S. residents, however, has its source at the place of sale, generally being the place where the seller's right, title, and interest in the property passes to the purchaser (the "title passage" rule). This title passage rule applies both to all income from the purchase and resale of inventory and to the marketing portion of income from the production of inventory property in the United States and marketing of that property abroad. Moreover, this rule applies regardless of whether the sale is to an unrelated purchaser or to a related person (for example, a foreign corporate subsidiary) that resells the property to an unrelated purchaser.

Production/marketing split

Income derived from the manufacture of products in the United States and their sale elsewhere is treated as having a divided source, which may be viewed as a division of the income between production and marketing activities. Under Treasury regulations, 50 percent of such income generally is apportioned on the basis of the location of assets held or used to produce income from the sale

(in this case, typically the United States), and 50 percent of the income is sourced on the basis of the place of sale (determined under the title passage rule).[23] Under certain circumstances, the division of the income between production and marketing activities must be made on the basis of an independent factory or production price, rather than on a 50-50 basis, where a taxpayer sells part of its output to wholly independent distributors or other selling concerns in such a way as to establish fairly the independent factory or production price unaffected by considerations of tax liability (Treas. Reg. sec. 1.863-3(b)(2), *Example (1)*; Notice 89-10, 1989-1 C.B. 631).

Example 1.—As an illustration, assume that a U.S. corporation manufactures in the United States a product that can be sold to an unrelated foreign buyer at a price that generates $100 of gross income. Assume that the U.S. corporation makes such a sale. (Such a "direct" sale could result from marketing by a branch of the corporation located in the foreign country. Or it could result from marketing by a broker or other unrelated intermediary or agent operating abroad, or simply from marketing activities performed wholly within the United States.) The corporation arranges its affairs so that under Treasury regulations, the product is treated as sold in a foreign country. No independent factory or production price is applicable.

Under these assumptions, the corporation generally would be permitted under current regulations to treat approximately $50 of the gross income from the sale as foreign source gross income, and the remainder as U.S. source gross income. Assume that the corporation's deductions allocable to this foreign source gross income are much less than $50 and that no foreign income tax is imposed on the corporation's income from the sale. Using excess foreign tax credits generated by its other foreign income, the corporation may be entitled to exemption from U.S. tax on up to $50 of the taxable income from this sale.

Example 2.—Assume the above facts except that there is an applicable independent factory or production price that applies to the product pursuant to Notice 89-10. Assume that this price is $75. Under this assumption, the U.S. corporation would be entitled to exemption from U.S. tax on up to, at most, $25 of the taxable income from this sale.

Example 3.—Now assume that instead of selling directly to the foreign purchaser, the U.S. corporation has a foreign corporate sales subsidiary. The U.S. corporation sells the product to the sales subsidiary, and the subsidiary sells the product to the purchaser for $100. Assume that the arm's length price of the product between the parent and subsidiary is $75. If no independent factory or production price is applicable, then $37.50 of the parent's gross income from the sale is sourced domestically. The other $37.50 of the parent's gross income is sourced foreign and may be exempt from tax by the use of excess foreign tax credits from other income.

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[23] Treas. Reg. secs. 1.863-3(b)(1) and 1.863-3T(b)(2), *Example (2)*. Under this example, the one-half of the taxpayer's gross income not sourced according to the place of sale is apportioned between U.S. and foreign sources on the basis of the fraction of the taxpayer's property in the United States and the fraction of its property in the foreign country held or used to produce income from the sale.

The remaining $25 of income from the sale belongs to the foreign subsidiary. Depending on the circumstances, this income may bear no current U.S. tax, or may be subject to current U.S. tax under subpart F as an amount of foreign source income of the parent deemed distributed from the subsidiary. In either case, the $25 may be eligible for permanent exemption from U.S. tax due to foreign tax credits. Thus, a total of up to $62.50 of income from the manufacture and sale of the product is eligible for potential U.S. tax exemption.

Example 4.—If in the above example there was also an applicable independent factory price of $75, then all of the parent's income from its sale to the subsidiary would be U.S. source, and (as in the case of the direct sale of the product using an independent factory price of $75) only $25 of income from the manufacture and sale of the product to an unrelated party would be eligible for partial or total U.S. tax exemption through foreign tax credits.

Sales through a Foreign Sales Corporation

As an alternative, in part, to the use of foreign tax credits to reduce or eliminate U.S. tax on income from export sales, U.S. tax on such income may be reduced by selling to a foreign sales corporation (FSC) that sells to unrelated buyers, or having a FSC act as commission agent with respect to export sales. In this case, a portion of the income from exports will be free of U.S. tax as "exempt foreign trade income" of the FSC. Another portion will be subject to tax at the FSC level with no foreign tax credit. The remaining portion is subject to tax in the hands of the manufacturer or other supplier, with sourcing and foreign tax credit rules as described above. However, the amount of the export income that may be sourced foreign in the hands of a supplier related to the FSC is limited to the amount that would have been foreign source had the sale been made to or by a domestic international sales corporation (DISC) (sec. 927(e)(1)). Under current rules, the IRS does not consider an independent factory or production price to be established, and hence requires use of the 50-50 divided sourcing rule, in the case of a manufacturer or producer that uses a FSC to sell inventory (Notice 89-11, 1989-1 C.B. 632; Treas. Reg. sec. 1.861-8(g), *Example (23)*).

Example 5.—Assume a U.S. corporate manufacturer exports through a wholly owned FSC and uses the combined taxable income method to determine the income of the FSC. Assume combined taxable income from exports is $100. Generally, $15 of the combined taxable income is exempt from U.S. tax, and $8 is taxable to the FSC with no foreign tax credit. The remaining $77 is potentially taxable in the hands of the U.S. corporation. Of this amount, approximately $25 may be sourced foreign and the rest (approximately $52) would be domestic source. (The $25 figure is arrived at by applying the 50-50 divided source rule to the amount (approximately $50) that would have been income of the manufacturer were the sale made to or by a DISC, using the DISC combined taxable income pricing rule of section 994(a)(2).) As this example demonstrates, up to approximately 40 percent of the income from exports may be exempted from U.S. tax through a combina-

tion of the FSC-level exemption and the use of foreign tax credits at the related supplier level.

Explanation of Provision

The provision makes two changes to the method by which income from the sale of inventory property is sourced. First, where the income is derived partly within and without the United States, the amount apportioned to production activities under the production/marketing split can be no less than the amount that would be so allocated by applying the production/marketing split to the relevant combined income of the taxpayer and any related person. Second, the bill generally sources domestically gross income of a U.S. resident from the direct or indirect sale of inventory property to another U.S. resident for use, consumption, or disposition in the United States.

Apportionment of income between production and marketing

Under the bill, if a taxpayer produces property and sells it to a related person (within the meaning of section 482), the portion of the taxpayer's income that is allocated and apportioned to production activities is sourced according to the place where the production activities occur. Moreover, that portion must equal at least so much of its income as does not exceed the amount that would be so apportioned under the 50-50 divided source rule if the apportionment were based on the relevant combined income of the taxpayer and any related person. If greater, the amount of the taxpayer's income that is allocated and apportioned to production activities is the amount so allocated and apportioned on a separate company basis.

For example, assume that a U.S. company manufactures a product in the United States and sells the product to its own controlled foreign corporation which markets the product to unrelated persons. Under the bill, a portion of the U.S. company's income possibly may be sourced on the basis of the place of sale. However, a portion of the U.S. company's income must be sourced domestically on the basis of its production activities in the United States. Moreover, if that portion is determined by applying a fraction to gross income from production and marketing, then that fraction must be applied to the combined income of the two entities from production and marketing, as well as to the U.S. taxpayer's income. The portion of the income of the U.S. company from that sale apportioned to production activities is determined on the basis of the computation (combined or separate) that yields the greater apportionment of income to production activities. In determining the source of the income apportioned to production activities, it is intended that foreign assets or other attributes of the U.S. taxpayer or the controlled foreign corporation will not be taken into account unless they are used for production activities by the U.S. taxpayer.

Sales to U.S. persons for U.S. use

The bill expands the general residence-based sourcing rule for sourcing sales of personal property. Under the bill, generally the place of sale abroad remains determinative of the source of income

when inventory property sold abroad is also used, consumed, or disposed of abroad. However, where inventory property sold abroad is sold by a U.S. resident directly or indirectly to another U.S. resident, the property sold is used, consumed, or disposed of in the United States, and the sale is not attributable to an office or other fixed place of business maintained by the first U.S. resident outside the United States, the gross income of the first U.S. resident (or any related person) from the sale will be sourced domestically.

Thus, for example, under the bill a U.S. resident wholesaler derives U.S. source income from the sale of inventory goods to a retailer for resale in the United States, without regard to where the title to the goods passes from the wholesaler to the retailer.[24] In addition, if such a sale is routed by the wholesaler through its controlled foreign corporation, then the subpart F income of the wholesaler from the sale by the controlled foreign corporation will also be U.S. source income. The same source rule will apply under the bill if the wholesaler routes it through any other related person (e.g., a domestic sister corporation of the wholesaler, or a controlled foreign corporation the voting stock of which is owned by such a domestic sister corporation). In that case the related person's income will be treated as U.S. source as well.

Effective Date

The provision is effective for sales after December 31, 1992.

[24] Cf. *Liggett Group, Inc. v. Commissioner,* 58 T.C.M. (CCH) 1167 (1990).

Title III—Taxation of Foreign Persons Having U.S.-Related Income

1. Taxation of certain stock gains of foreign persons (sec. 301 of the bill and new secs. 899 and 1447 of the Code)

Present Law

Foreign persons are subject to U.S. tax on dividends they receive from U.S. corporations. By contrast, under the Code, foreign persons generally are not subject to U.S. tax on gain realized on the disposition of stock in a U.S. corporation (other than a U.S. real property holding corporation), unless the gain is effectively connected with the conduct of a trade or business in the United States. In addition, many U.S. income tax treaties contain provisions to preclude the imposition of U.S. tax on such gains realized by treaty-country residents.

Explanation of Provision

In general

The bill provides in general that where a foreign corporation or nonresident alien individual owns or has owned, at any time during the previous 5 years, 10 percent or more of the stock in a U.S. corporation, gain or loss from the disposition of the stock is treated as income effectively connected with the conduct of a U.S. trade or business and attributable to a U.S. permanent establishment. However, where the period beginning January 1, 1993 and ending on the date of disposition is shorter than five years, the relevant testing period is that shorter period only.

The bill contemplates that because it imposes shareholder-level tax on a disposition by a foreign corporation of stock of a wholly-owned U.S. subsidiary, regulations would be amended to provide that branch tax would be imposed upon termination of a U.S. branch.

A person that meets the ownership criteria for imposition of the tax is termed a "10-percent shareholder" in the corporation under the bill. For purposes of determining whether a person is a 10-percent shareholder, the attribution rules of section 318(a) generally apply, with certain modifications. In addition, if a partnership is a 10-percent shareholder in a U.S. corporation, its partners would generally be treated as 10-percent shareholders in the corporation as well. An exception is provided under which the determination whether a partner is a 10-percent shareholder in the corporation is determined on a "look-through" basis. The exception applies in the case of a disposition where at all times during the 5-year period ending when the disposition occurred, the partnership owned less than 50 percent of the stock of the corporation, and the basis of the stock of the corporation held by the partnership was less than 25 percent of the partnership's costs of its total non-cash assets, less its liabilities.

The bill suspends certain nonrecognition provisions that would otherwise apply to dispositions of stock in a U.S. corporation, and allows the Treasury to prescribe regulations providing the extent

to which nonrecognition provisions shall, and shall not, apply for purposes of the provision.

Withholding

Under the bill the tax would be collected, in the first instance, by withholding, generally at the rate of 10 percent of the gross proceeds of the disposition giving rise to the tax liability. The withholding agent for this purpose is the last U.S. person to have the control, receipt, custody, disposal, or payment of the amount realized on the disposition. If there is no such U.S. person, the withholding agent is the person prescribed in regulations.

The bill provides language to ensure that no undue disruption of the market is caused by the withholding requirement where stock is regularly traded on an established securities market. In that case, brokers, dealers, and others who deal with third parties disposing of stock in U.S. companies may typically carry on business without withholding, without penalty for failure to withhold, and without requiring assurance from the seller that no withholding is necessary. The exceptions to this rule involve cases where the broker or dealer (or other potential withholding agent) knows (or has reason to know) that the transaction is one subject to income tax under the provision, and cases where the amount of stock involved in the disposition constitutes at least 1 percent of the stock in the U.S. company.

Amounts withheld in excess of the tax imposed on the foreign person would be refundable. The bill also gives the Treasury the authority to prescribe reduced rates of withholding in particular circumstances where collection of the tax imposed on the foreign person would not be jeopardized thereby.

Coordination with treaties

The bill does not override any treaty obligation in effect on the date the bill is enacted, to the extent that the treaty obligation would prevent imposition of the tax on a person that is entitled to treaty benefits under the Code as amended by the bill.[25] For example, in order to invoke a treaty to override this provision of the bill, the taxpayer must be a qualified resident of the treaty country.

In cases where a treaty prevents imposition of U.S. tax on stock gains of a qualified resident of a treaty country, the bill applies a special characterization rule to certain amounts received by that person in any distribution in liquidation or redemption, but only if doing so would not violate the treaty. In such a case, the bill treats as dividends for all purposes amounts that would (but for the treaty) be gain subject to U.S. tax. Dividend treatment would only apply to the gain, however, to the extent of the earnings and profits of the distributing corporation which are attributable to the stock with respect to which the distribution is made.

It is believed that the treatment of liquidating gains and redemption gains as dividends to the extent of earnings will be permitted under U.S. treaties in general. Typically, treaties do not define gains or dividends (or define dividends broadly as including income

[25] The requirements for entitlement to treaty benefits are discussed below in connection with bill section 302.

from shares), and provide that for purposes of applying the treaty, each party generally may treat any term not defined therein as having the meaning which it has under the laws of that country. Thus, if a U.S. treaty prohibits each party from taxing stock gains realized by residents of the other, and the other treaty country treats a liquidating distribution as a dividend under its internal tax laws, typically that country may tax, as a dividend, some portion of a liquidating distribution received by a U.S. resident from a company resident in the treaty country. It is understood that such treatment is often accorded by treaty countries to amounts received by U.S. persons, consistent with U.S. treaty language prohibiting tax on gains. It is believed that providing for similar treatment under internal U.S. law, even though the law is enacted after the treaty enters into force, is also consistent with existing treaty language prohibiting tax on gains.

Some have argued, however, that a statutory income tax term referred to in an income tax treaty can only be interpreted, for treaty purposes, by disregarding statutory amendments in the definition of the term (if any) that may have been enacted since the time that the treaty was ratified. It is believed that this so-called "static interpretation" argument does not accurately reflect U.S. law. However, the bill is not intended to override an existing treaty in the event that the courts decide that the bill's change in the definition of "dividend" goes so far as to be inconsistent with that treaty.

It is further understood that application of the bill's dividend definition rule only to liquidating and redemption gains realized by certain foreign persons does not violate a typical treaty nondiscrimination provision. Among other things, it is believed that a U.S. shareholder and a foreign shareholder are not similarly situated for this purpose. A liquidating distribution or redemption distribution by a foreign-owned corporation may permanently remove U.S. corporate earnings from U.S. shareholder-level taxing jurisdiction (which all U.S. treaties retain to some extent), while in the liquidation of (or redemption of shares in) the U.S.-owned corporation the earnings will remain in U.S. taxing jurisdiction, assuring U.S. shareholder-level taxation.

Again, some may argue that such different treatment does violate a treaty nondiscrimination clause. The bill is not intended to override an existing treaty in the event that the courts decide that the bill's change in the definition of "dividend" goes so far as to be inconsistent with such a clause.

Effective Date

The provision generally is effective for dispositions after December 31, 1992. The withholding requirements are applicable only to dispositions occurring 6 months or more after the date the bill is enacted.

2. Limitation on treaty benefits (sec. 302 of the bill and new sec. 894(c) of the Code)

Present Law

In general

The United States has entered into bilateral income tax treaties with approximately 40 foreign countries. One function served by these treaties is to reduce the statutory U.S. tax on U.S. source income earned by a resident of a treaty country. For example, the gross amount of certain items of interest, royalty, and dividend income paid by a U.S. corporation to a related foreign corporation may be subject to U.S. tax of 30 percent under the Internal Revenue Code. However, under some treaties the statutory U.S. tax on interest and/or royalties is completely waived and the tax on dividends is limited to as little as 5 percent. Treaties generally do not operate to increase the amount of taxes that would otherwise be due under internal law.

Treaty benefits generally are limited to tax with respect to payments to a "resident" of the treaty country.[26] If the United States unilaterally wished to reduce taxes on inbound investment to the rates in the treaty, the residency of the recipient probably would not be an issue (indeed, the reduced rates could be enacted into the Code). However, the treaty negotiation process is a means for obtaining concessions of foreign tax rules otherwise applicable to U.S. persons with income abroad. In addition, for other reasons the treaty provisions appropriate to the U.S. tax treatment of residents of one country may be viewed as inappropriate to the treatment of residents of some others. From the taxpayer's point of view, treaties are justified on the basis that they limit double taxation caused by the interaction of the tax systems of the treaty partners as they apply to residents of the treaty partners. However, a taxpayer might attempt to use a U.S. tax treaty in order to avoid all tax on U.S. income, or attempt to use a U.S. tax treaty to avoid U.S. tax on U.S. income even though the taxpayer is not a resident of the United States's treaty partner.

Tax treaty abuse

Tax treaty abuse sometimes takes the form known as "treaty shopping," which refers to the situation where a person who is not a resident of either country seeks certain benefits under the income tax treaty between the two countries. Under certain circumstances, and without appropriate safeguards, the nonresident is able indirectly to secure these benefits by establishing in one of the treaty countries a corporation (or other entity) which, as a resident of that country, is entitled to the benefits of the treaty.

Additionally, it may be possible for a treaty-country resident to reduce or eliminate its income base by making deductible payments to a third-country resident. For example, the former could

[26] Treaties may treat as a resident of a treaty country any person who, under the laws of that country, is liable to tax therein by reason of his domicile, residence, citizenship, place of management, place of incorporation, or any other criterion of a similar nature.
Under the Code, any taxpayer that claims eligibility for treaty relief from U.S. statutory law is required (absent regulatory waiver) to disclose such claim or position to the IRS (sec. 6114).

pay out interest, royalties, or other amounts under favorable conditions (i.e., it may be possible to reduce or eliminate taxes of the resident company by distributing its earnings through deductible payments or by avoiding withholding taxes on the distributions) either through relaxed tax provisions in the distributing country or by passing the funds through other treaty countries (essentially, continuing to treaty shop), until the funds can be repatriated to the third country under favorable terms.

Or, the treaty country resident may be exempt from treaty country tax on foreign income. (Under the internal laws of certain countries with which the United States has entered into treaties, a resident of such a country is exempt from tax on certain foreign income. The tax laws of such countries are sometimes said to apply an "exemption system" with respect to foreign income.) Assume that a corporation is resident in a foreign country that has both (1) an income tax treaty with the United States, and (2) and exemption system for taxing foreign income. The corporation establishes a branch outside the treaty country such that neither that country nor the place where the branch is located taxes its income. The branch earns U.S. source income of a type that may be entitled to treaty relief from U.S. tax under the income tax treaty between the United States and the corporation's residence country.

For U.S. tax purposes, the branch is not a "person" subject to tax. The corporation of which the branch is a part is treated as earning the income earned by the branch. Since the corporation is a treaty country resident, it may be that the treaty requires the United States to reduce or eliminate its tax on the income of the branch, even though the branch's income is not subject to tax by the treaty country.

Existing remedies for treaty abuse

Treaty provisions

Newer treaties negotiated by the United States usually contain "Limitation on Benefit" or "Investment or Holding Companies" articles that may deny treaty benefits, for example, to income earned by treaty-country residents which are simply legal entities set up for the convenience of third country residents who bear little or no treaty-country taxes and simply wish to "treaty-shop" the U.S. treaty network. Of the U.S. income tax treaties now in force, however, over 10 have no such article. In addition, the type of article negotiated over the years has evolved as the Government has become more sensitive to the issue, with the result that some existing articles may be more effective than others in preventing tax treaty abuse.

An example of one of the most recently negotiated provisions is the anti-treaty shopping article in the U.S.-Germany treaty, signed in 1989. This treaty provides that a person other than an individual (for example, a corporation, partnership, trust, or other business organization) generally is not entitled to the benefits of the treaty unless it satisfies an ownership/"base erosion" test, a public company test, or an active business test, or unless it is itself one of the treaty countries or a political subdivision or local authority

thereof, or else is a not-for-profit, tax exempt organization that also satisfies an ownership test.

Under the ownership/base erosion test, more than 50 percent of the beneficial interest (in the case of a company, more than 50 percent of the number of shares of each class of shares) in that entity must be owned directly or indirectly by any combination of one or more individual residents of Germany or the United States, citizens of the United States, certain publicly traded companies (as described in the discussion of the public company test below), the countries themselves, political subdivisions or local authorities of the countries, or certain tax-exempt organizations (as described in the discussion of qualifying organizations below).

In addition, the ownership/base erosion test is met only if no more than 50 percent of the gross income of the entity is used, directly or indirectly, to meet liabilities (including liabilities for interest or royalties) to persons or entities other than those just named. This rule is commonly referred to as the "base erosion" rule.

Under the public company test, a company that is a resident of Germany or the United States and that has substantial and regular trading in its principal class of stock on a recognized stock exchange is entitled to the benefits of the treaty regardless of where its actual owners reside or the amount or destination of payments it makes.

Under the active business test, treaty benefits are available to an entity that is a resident of the United States or Germany, the ownership/base erosion and public company tests notwithstanding, if it is engaged in the active conduct of a trade or business in its residence country, and the income derived from the other country is derived in connection with, or is incidental to, that trade or business.

Finally, the treaty provides a "safety valve" for a treaty country resident that has not established that it meets one of the other more objective tests, but for which the allowance of treaty benefits would not give rise to abuse or otherwise be contrary to the purposes of the treaty.

"Anti-treaty-shopping" articles in U.S. treaties may not deny treaty benefits in *all* cases where foreign persons operate through a treaty-country corporation but pay little or no foreign tax. The model limitation on benefits article in the Treasury Department's draft model income tax treaty of June 16, 1981, for example, provides that any relief from tax provided by the United States to a resident of the other country under the treaty shall be inapplicable to the extent that, under the law in force in that other country, the income to which the relief relates bears significantly lower tax than similar income arising within that other country derived by residents of that other country. There is no similar provision in the U.S.-Germany treaty, nor, generally, does such a provision appear in other tax treaties now in force.

Other rules

In addition to treaty provisions to prevent abuse, the Code contains a provision under which treaty reduction of the branch taxes on a foreign corporation (Code sec. 884) generally is not available

unless the foreign corporation is a "qualified resident" of the treaty country. In order to be a qualified resident, a corporation must meet an ownership/base erosion test or a publicly traded test, or must satisfy the Secretary that it meets such tests as the Secretary may prescribe to ensure that third-country residents do not use the treaty in a manner inconsistent with the purposes of the branch tax provisions (sec. 884(e)(4)). The IRS has provided by regulation that a corporation may be treated as a qualified resident if it meets an active business test (Treas. Reg. sec. 1.884-5T(e)). The two statutory tests and the regulatory active business test under the branch tax rules are similar to the corresponding tests under the U.S.-Germany treaty. The regulations further provide that in the sole discretion of the Commissioner, the IRS may rule that a corporation is a qualified resident for branch tax purposes on the basis that obtaining treaty benefits is not one of the principal purposes for establishing or maintaining the foreign corporation in its country of residence, and the foreign corporation has substantial business reasons for residing in its country of residence (Treas. Reg. sec. 1.884-5T(f)).

Finally, some authority also exists outside the branch tax rules denying treaty benefits under more general anti-abuse principles that inform the application of the tax laws.[27]

Explanation of Provision

In general

Generally, the provision imposes a qualified resident requirement, similar to that now in the branch tax provisions, as a prerequisite for reducing U.S. tax on any foreign entity under any treaty. In addition, the bill prevents any person from obtaining U.S. tax benefits under a treaty with respect to any income that bears a significantly lower tax under the laws of the other treaty country than similar income arising from sources within such foreign country derived by residents of such foreign country.

Qualified resident definition

The bill provides that a foreign entity is a qualified resident of a treaty country if both an ownership and a base erosion test are met. The ownership test is met unless 50 percent or more (by value) of the stock or beneficial interests in the entity are owned (directly or indirectly) by individuals who are not residents of the treaty country, U.S. citizens, or U.S. residents. The base erosion test is met unless 50 percent or more of the entity's income is used to meet liabilities to persons who are not residents of the treaty country, U.S. citizens, or U.S. residents.

The bill provides that if interests in a foreign entity are primarily and regularly traded on an established securities market in the country under whose treaty it claims benefits as a resident, then the entity is considered a qualified resident of that country. The

[27] *See Aiken Industries, Inc. v. Commissioner,* 56 T.C. 925 (1971), acq. on another issue, 1972-1 C.B. 1; Rev. Rul. 84-152, 1984-2 C.B. 381; Rev. Rul. 84-153, 1984-2 C.B. 383, modified by Rev. Rul. 85-163, 1985-2 C.B. 349; Rev. Rul. 87-89, 1987-2 C.B. 195; Tech. Advice Mem. 9133004 (May 1, 1991).

bill also provides that if a foreign entity resident in a treaty country is wholly owned by another foreign entity that is organized in the residence country of the first entity, and interests in the parent entity are primarily and regularly traded on an established securities market in that country, then the first entity is considered a qualified resident of the treaty country, so long as it also meets the anti-base erosion rule described above. Further, the bill provides that a foreign entity wholly owned by a publicly traded domestic corporation (i.e., one whose stock is primarily and regularly traded on an established securities market in the United States) is to be treated as a qualified resident of its country of residence if it also meets the anti-base erosion rule.

Under the bill, the Secretary may specify other circumstances in which a foreign entity is not considered to be treaty shopping. For example, the Secretary may provide that a corporation is not treaty shopping where the foreign corporation operates an active trade or business in its residence country and that country does not provide special tax benefits with respect to the corporation's U.S. income that are not provided with respect to income derived within that country. As another example, the Secretary may find that a corporation is not treaty shopping despite the base erosion rule when more than half of a foreign corporation's income is used to satisfy liabilities outside the corporation's country of residence where the liabilities are bona-fide debt obligations to unrelated parties and are not back-to-back loans from nonresidents of the treaty country.

It is intended that in determining whether a foreign corporation is a qualified resident of a treaty country, the taxpayer has the burden of proof.

Effective Date

The provision takes effect on January 1, 1993, and applies to any treaty whether entered into before, on, or after such date.

3. Excise tax on certain insurance premiums paid to certain foreign persons (sec. 303 of the bill and sec. 4371 of the Code)

Present Law

Under present law, an excise tax generally is imposed on each policy of insurance, indemnity bond, annuity contract, or policy of reinsurance issued by any foreign insurer or reinsurer to or for or in the name of a domestic corporation or partnership, or a U.S. resident individual with respect to risks wholly or partly within the United States, or to or for or in the name of any foreign person engaged in business within the United States with respect to risks within the United States (sec. 4371). The tax does not apply, however, to any amount effectively connected with the conduct of a trade or business within the United States (unless such amount is exempt from the net-basis U.S. tax under a treaty) (sec. 4373(1)).

The tax is imposed at the following rates: (1) 4 percent of the premium paid on a casualty insurance policy or indemnity bond; (2) 1 percent of the premium paid on a policy of life, sickness, or accident insurance, or annuity contracts on the lives or hazards to the

person of a U.S. citizen or resident; and (3) 1 percent of the premium paid on a policy of reinsurance covering any of the contracts taxable under (1) or (2).

The tax is waived in United States tax treaties with the United Kingdom, France, Germany, Spain, Italy, Cyprus, India, and certain other countries. These treaty waivers generally include an anti-conduit rule denying the benefit of the exemption to premiums covering risks that are reinsured with a person not entitled to a similar treaty exemption. Notably, however, the U.K. treaty has no anti-conduit rule. However, the code presently imposes a tax not only on any direct insurance transaction with a foreign insurer (not subject to U.S. income tax), but also on any reinsurance transaction with a foreign insurer, if the transaction involved the insurance or reinsurance of a U.S. risk. A policy of reinsurance issued by a foreign insurer covering U.S. risks is subject to the tax imposed on reinsurance policies, whether the direct insurer is a domestic or foreign insurer.[28]

The Code itself (sec. 4373) provides exemptions from the tax in the case of (1) any amount effectively connected with the conduct of a trade or business within the United States (unless such amount is exempt from the net-basis U.S. tax under a treaty), or (2) any indemnity bond required to be filed by any person to secure payment of any pension, allowance, allotment, relief, or insurance by the United States, or to secure a duplicate for, or the payment of, any bond, note, certificate of indebtedness, war-saving certificate, warrant, or check issued by the United States.

Section 4374 provides that the excise tax imposed by section 4371 shall be paid, on the basis of a return, by any person who makes, signs, issues, or sells any of the documents and instruments subject to the taxes, or for whose use or benefit the same are made, signed, issued, or sold. Thus, the liability for the tax falls jointly on all the parties to the insurance or reinsurance transaction.

Under regulations, the tax must be remitted by the resident person who actually pays the premium to a foreign insurer, reinsurer, or nonresident agent, solicitor or broker (Treas. Reg. sec. 46.4374-1(a)). The Treasury has stated that where a treaty permits an exemption from tax to the extent that the foreign insurer or reinsurer does not reinsure the risks covered by the policy with a person that would not be entitled to an exemption from the tax on such policy, the person otherwise required to remit the tax may consider the policy exempt only if, prior to filing the return for the taxable period, such person has knowledge that there was in effect for such taxable period a certain type of closing agreement between the insurer or reinsurer and the IRS (Rev. Proc. 84-82, 1984-2 C.B. 779). Under the required closing agreement, the foreign insurer or reinsurer makes a secured promise to pay to the IRS any excise tax liability arising due to reinsurance of the risk with a non-treaty-protected reinsurer.

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[28] See Rev. Rul. 58-612, 1958-2 C.B. 850; see also *American Bankers Insurance Co. of Florida v. United States, 265 F. Supp. 67 (S.D. Fla. 1967), aff'd (per curiam),* 388 F.2d 304 (5th Cir. 1968).

Explanation of Provision

The bill raises to 4 percent the excise tax on certain premiums paid to foreign persons for reinsurance covering casualty insurance and indemnity bonds. Such reinsurance premiums are subject to only the existing 1 percent rate, however, if (1) the premiums are paid to a foreign insurer or reinsurer that is a resident of a foreign country, (2) the insurance income (including investment income) relating to the policy of reinsurance is subject to tax by a foreign country or countries at an effective rate that is substantial in relation to the tax imposed under the Code on similar premiums received by U.S. reinsurers, and (3) the insured risk is not reinsured (whether directly or through a series of transactions, which is intended to include for these purposes business relationships or practices having the same effect) by a resident of another foreign country who is not subject to a substantial tax (as defined in condition (2)) on the income. It is intended that an effective rate of taxation equal to at least 50 percent of the applicable U.S. effective tax rate generally will be necessary for foreign taxation to be considered to be substantial in relation to U.S. taxation.

The bill authorizes the Treasury to issue regulations providing for such procedures as it deems appropriate to ensure that only those premiums actually entitled to the reduced 1-percent rate under the above rules are excused from the bill's 4-percent rate of tax. It is anticipated, for example, that the availability of the reduced (1-percent) excise tax rate will be made subject to compliance requirements analogous to those that apply to waivers of the excise tax under U.S. tax treaties. Thus, it is anticipated that the bill's anti-conduit condition for obtaining the 1-percent rate could be enforced by entering into closing agreements similar to those under present law. It is intended that persons liable for the tax will bear the burden of proving that foreign taxes imposed on insurance income are such that premiums are entitled to be taxed at the reduced 1-percent rate.

In addition, the Treasury would be entitled under the bill to waive the above anti-conduit rule in such circumstances and subject to such conditions as it deems to be appropriate. This authority is intended to apply in a situation where a foreign person establishes that it is subject to a substantial tax, but it is later determined that a risk reinsured by that person has been further reinsured by another person not subject to a substantial tax, and the Secretary is satified that, in light of all the facts and circumstances, reinsurance by the latter person was not contemplated or anticipated by the first person.

The bill specifies that, in applying rules for the statutory reduced excise tax rate or any treaty excise tax waiver, no person shall be relieved of the requirement to remit the excise tax to the IRS unless the parties to the transaction satisfy such requirements as the Secretary may prescribe to ensure collection of tax due on any reinsurance of the risk with respect to which the premium was paid. For example, this provision requires the Secretary to ensure that, when a premium on U.S.-risk insurance is paid by a U.S. person to a foreign insurer (including a foreign insurer entitled to treaty benefits under a treaty waiving the excise tax, with or with-

out a treaty anti-conduit clause), and that risk is covered by a policy of reinsurance issued by a foreign reinsurer not entitled to treaty benefits, or not entitled to the 1-percent reduced statutory rate, the U.S. person will satisfy such requirements as will enable the Treasury to collect the U.S. tax imposed on the reinsurance policy. It is anticipated that the Secretary will apply the same or similar requirements as are currently applied under Rev. Proc. 84-82 to ensure compliance with anti-conduit clauses of waivers of the excise tax under U.S. tax treaties.

It is understood that the obligation to remit tax is not affected by treaty provisions that may waive the foreign recipient's ultimate *liability* for the excise tax. This provision of the bill only collects a tax that the United States has the power to impose and collect under any U.S. income tax treaty and, thus, it is believed that the bill is consistent with all existing U.S. treaty obligations, whether or not the treaty provides an explicit anti-conduit rule.

Taking into account the collection procedures described above, the bill is intended to yield to any existing tax treaties to which the United States is a party. The bill is intended to raise the excise tax rate on certain policies covered by the statute and not protected by treaty. Changing the excise tax rate is not intended to override prior treaties that preclude imposition of the tax.

Effective Date

The provision applies to premiums paid after the date of the bill's enactment, but only to the extent that they are allocable to reinsurance coverage for periods after December 31, 1992.

4. Special section 482 rules for certain foreign and foreign-owned corporations (sec. 304 of the bill and new sec. 482(b) of the Code)

Present Law

In general

The United States generally taxes all income of U.S. citizens, residents, and U.S. corporations, whether or not the income is derived in the United States. By contrast, the United States taxes nonresident alien individuals and foreign corporations only on income with a sufficient nexus to the United States. In the case of a multinational enterprise that includes both a U.S. and a foreign corporation under common control, the United States thus may tax all of the income of the U.S. corporation, but only so much of the income of the foreign corporation as satisfies the relevant rules for determining a U.S. nexus.[29] The determination of the amount of income that properly is the income of the U.S. member of a multinational enterprise, and the amount that properly is the income of

[29] In different circumstances, the relevant nexus rules may depend on whether the income has its source in the United States, whether the income is effectively connected with a U.S. trade or business, or whether the income is connected with a business that operates through a permanent establishment located in the United States. In certain situations (as described in connection with subtitle A of Title V, below, and Title II, above), special rules treat undistributed income of a foreign corporation owned by U.S. shareholders (e.g., a controlled foreign corporation) as the current income of the U.S. shareholders.

a foreign member of the same multinational enterprise thus is critical to determining the amount the United States may tax.

Transfer pricing

Due to the variance in tax rates (and tax systems) among countries, a multinational enterprise may have a strong incentive to shift income, or expenditures giving rise to deductions or tax credits, among commonly controlled entities in order to arrive at a reduced overall tax burden. Such a shifting of items between commonly controlled entities might be accomplished by setting artificial transfer prices for transactions between group members.

Code section 482 authorizes the IRS to redetermine the tax of an entity subject to U.S. taxing jurisdiction when it appears that an improper shifting of items between that entity and a commonly controlled entity outside U.S. taxing jurisdiction has occurred. Section 482 does not limit the IRS to reallocations of items among entities in different taxing jurisdictions; it permits reallocations among any commonly controlled entities. It has special significance with respect to multinational enterprises, however, due to their opportunities for tax-motivated cross-border shifting of items affecting the determination of tax liability.

Under regulations, the Service attempts to apply section 482 by application of a so-called "arm's-length" standard. That is, the Service attempts to reallocate income by simulating the transactions that the commonly controlled parties would have entered into had they not been commonly controlled. This may require access to significant amounts of information from each of the related parties to a transaction, or analysis of transactions between other parties that might be considered comparable to the transactions between the related parties. In a multinational context it may be especially difficult for the IRS to obtain the desired information from foreign members of the multinational enterprise. Various statutory and other procedural rules are intended to bolster the ability of the IRS to obtain this information. It may also be difficult to obtain adequate information about comparable or near-comparable transactions involving unrelated persons. Such information may be proprietary to the parties involved (who may not include the taxpayer), and, even if the IRS could use its powers to obtain such information, disclosing it to the taxpayer may constitute a breach of confidentiality laws.

Treaties

"Associated enterprises"

Most income tax treaties to which the United States is a party include an article dealing with "associated enterprises." As an example of such an article, Article 9 of the 1981 proposed U.S. model income tax treaty (the "U.S. model") provides a special rule applicable to cases where either an enterprise of one treaty country participates directly or indirectly in the management, control, or capital of an enterprise of the other treaty country, or the same persons participate, directly or indirectly, in the management, control or capital of enterprises of both treaty countries. In either of these cases, if conditions are made or imposed between the two enter-

prises in their commercial or financial relations which differ from those which would be made between two independent (unrelated) enterprises, then any profits which, but for those conditions, would have accrued to one of the enterprises, but by reason of those conditions have not so accrued, may be included in the profits of that enterprise and taxed accordingly. In addition, the U.S. model expressly permits application of internal law provisions which permit the distribution, apportionment, or allocation by tax authorities of income, deductions, credits, or allowances between persons, whether or not residents of a treaty country, owned or controlled directly or indirectly by the same interests, when necessary in order to prevent evasion of taxes or clearly to reflect the income of any of such persons.

The distribution, apportionment, or allocation by the tax authorities of a treaty country of tax items between related enterprises could, in some cases, give rise to double taxation. For example, if an amount is taxed in the hands of a taxpayer by one treaty country, and is subsequently included in the income of a related enterprise located in the other treaty country (by way of a reallocation allowed under the associated enterprises article of the relevant treaty), and thus is also taxed in that other country, double taxation of the same item of income could be said to occur. In an attempt to avoid this result, treaties often provide that if the first country agrees that the reallocation by the other country was correct then the former shall make an appropriate adjustment (often referred to as a correlative adjustment) to the amount of the tax that it collected from its taxpayer.

Administration of the correlative adjustment provision discussed above generally is handled by the "competent authorities" of the two treaty countries. In the case of the United States, the competent authority function under treaties is the responsibility of the Assistant Commissioner (International) of the Internal Revenue Service, acting in conjunction with the Associate Chief Counsel (International) in the case of interpretive issues.

Carrying on business through a U.S. permanent establishment

Under treaties, there is typically no U.S. taxation of business profits of the enterprise of a qualified treaty country resident unless the enterprise carries on business within the United States through a permanent establishment in the United States: that is, a fixed place of business through which the business of an enterprise is wholly or partly carried on. Treaties often provide that no business profits shall be attributed to a permanent establishment by reason of the mere purchase by that permanent establishment of goods or merchandise for the enterprise. In addition, the 1981 U.S. model income tax treaty provides that the business profits to be attributed to the permanent establishment shall include only the profits derived from the assets or activities of the permanent establishment.

Nondiscrimination

Most U.S. tax treaties provide rules against discrimination relating to residents of the treaty countries. The U.S. model nondiscrim-

ination clause imposes restrictions not only on foreign country taxation and U.S. Federal income taxation, but also on gift and estate tax and on all other nationally imposed taxes "of every kind and description," as well as on all taxes imposed by any state or other political subdivision or local authority thereof.

The U.S. model provides that nationals of a treaty country, wherever they may reside, shall not be subjected in the other country to any taxation (or any requirement connected therewith) which is other or more burdensome than the taxation and connected requirements to which nationals of that other country in the same circumstances are or may be subjected. Similarly, the tax imposed on a permanent establishment which an enterprise of a treaty country resident has in the other country (the source country) generally shall not be less favorably imposed by the source country than the taxation it imposes on enterprises of its own residents carrying on the same activities. Thus, for example, the U.S. branch of a treaty country bank generally would be entitled to U.S. tax parity with a U.S. bank.

Further, an enterprise of a source country resident, the capital of which is wholly or partly owned or controlled by residents of the other country, shall not be subjected in the source country to any taxation (or any requirement connected therewith) which is other or more burdensome than the taxation and connected requirements to which other similar source country enterprises are or may be subjected. Thus, a U.S. corporation wholly owned by a treaty country resident, for example, generally would be entitled to tax parity with similarly situated U.S. corporations wholly owned by U.S. persons. Finally, the U.S. model generally provides (subject to certain arm's length standards) that interest, royalties, and other disbursements paid by a treaty country resident to a resident of the other country shall, for the purposes of determining the taxable profits of the payor, be deductible under the same conditions as if they had been paid to a resident of the source country.

Explanation of Provision

In general

The bill sets a minimum amount of taxable income to be reported (absent IRS agreement to accept a different amount) by 25-percent foreign-owned domestic corporations that engage in more than a threshold level of transactions with foreign related persons. (A similar rule also applies to U.S. branches of foreign corporations.) The minimum is set equal to 75 percent of the product of gross receipts multiplied by an appropriate profit percentage computed in advance by the Secretary on the basis of relevant industry financial data. Although somewhat different from current law, the approach of the bill is in some respects analogous to the process of applying the resale price method or the cost plus method under current Treasury Regulations, in which gross amounts of actual arm's length transactions of the taxpayer are multiplied by an appropriate markup percentage or appropriate gross profit percentage in arriving at a transfer price (Treas. Reg. sec. 1.482-2(e)(3) and (4)). The bill is also in some respects analogous to the approach of the proposed regulations under section 482 insofar as they adopt

comparability of net profit as a check on the reliability of intercompany transfer prices.

Affected companies

In order to be affected by the provision, a corporation must be a 25-percent foreign-owned domestic corporation or a foreign corporation subject to net basis U.S. income tax on its income effectively connected with the conduct of a U.S. trade or business. As under section 6038A, to be 25-percent foreign-owned means that one foreign person owns (directly or by attribution) 25 percent or more of the total combined voting power of all classes of stock of the domestic corporation, or 25 percent of the total value of all classes of its stock.

In addition, in order to be subject to the provision for a taxable year the corporation must have substantial foreign related person transactions during the taxable year. In the case of a domestic corporation, this means that the aggregate amount involved in its transactions with foreign persons to which it is related within the meaning of present-law section 482 exceeds the lesser of $2,000,000 or 10 percent of the corporation's gross income.[30] In the case of a U.S. branch of a foreign corporation, these thresholds apply to the transactions properly attributable to the U.S. branch. Amounts not taken into account in determining taxable income (e.g., a contribution of capital by a foreign parent to a domestic subsidiary corporation, or the principal amount of a loan, but not the purchase of a depreciable asset or inventory property) are disregarded for this purpose.

Minimum taxable income

Under the bill, an affected taxpayer generally will compute its taxable income on the basis of the same rules that currently apply with respect to related party transactions. However (subject to exceptions discussed below), the taxpayer's taxable income from any category of business activities will be subject to a floor equal to 75 percent of the amount determined by applying the applicable profit percentage to the taxpayer's gross receipts from that business activities category.

Category of business activities

The division of taxpayers' receipts by category of business activity is generally based on the 3-digit classification of the Standard Industrial Classification ("SIC") Code. However, where appropriate, the Secretary may provide that two or more 3-digit classifications will be treated in the aggregate for purposes of the provision, or may prescribe a classification system other than the SIC Code. Thus for example, where appropriate, the Secretary may distinguish between two types of businesses that fall into the same 3-digit SIC Code and prescribe separate applicable profit percentages for each.

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[30] The related group for this purpose consists of the group of organizations, trades or businesses (whether or not incorporated, whether or not organized in the United States, and whether or not affiliated) which include the taxpayer and which are owned or controlled, directly or indirectly, by the same interest.

Applicable profit percentage

The applicable profit percentage for each category of business activity will be prescribed by the Secretary for each year. Each such percentage will represent an estimate of an average earnings rate—pre-tax financial book income divided by gross receipts—experienced by domestic companies from activities in that category. It is understood that such data exist in various forms. It is further understood that the classification of such existing data by industry category is inexact. It is not intended to require that the Secretary classify the available data by any means more exact than is currently available. Nor is it intended that the Secretary be required to compute measures of net income finer than those available in publicly available financial statements. Rather, other aspects of the provision are believed to mitigate adequately any imprecision in industry classification or information inherent in the available database.

Exceptions

Under the bill, a taxpayer may compute its taxable income in a business category without regard to the minimum prescribed in the bill if, when it files its return for the taxable year, a qualified section 482 agreement is in effect for that year between the Secretary and the taxpayer with respect to that category. Such an agreement is one that covers the application of section 482 to all related party transactions in a category of business activities of the taxpayer. The Secretary may enter into such an agreement if, in his sole discretion, he determines that such an agreement will result in a clear reflection of the taxable income of the taxpayer from the category of business activities to which the agreement relates.

It is expected that in many cases the process of negotiating and entering into such qualified agreements will not be unlike the existing process for negotiating advance pricing agreements (APAs) based on the particular facts and circumstances that apply to the taxpayer. Just as currently there generally is no obligation on the part of the Secretary to accept a taxpayer's offer to enter into such an agreement, so it is intended that there generally would be no obligation of the Secretary to accept a taxpayer's offer to enter into a qualified section 482 agreement.[31] Further, by requiring such an agreement to be in effect when the return for the year is filed, it is intended that the taxpayer will have disclosed to the Secretary, in advance of the due date of the return for the affected taxable years, what the Secretary views as an adequate factual basis for evaluating the taxpayer's proposed method for setting transfer prices or dividing group-wide income. It is believed that requiring such advance disclosure is desirable in itself, as it will tend to promote efficiency by allowing fuller and more unbiased inquiry into

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[31] See the description of the standard of judicial review of the "sole discretion" rule in section 6038A(e). H. Rep. No. 101-386, 101st Cong., 1st Sess. 594-95 (1989). It is intended that this same standard would apply should any decision committed to the Secretary's sole discretion under the bill be challenged judicially, and that only in an extraordinary circumstance—as, for example, where it is proven that the Secretary or his agents acted on the basis of an illicit motive—would the decision be judicially reversed.

the relevant economic facts in a setting less influenced by legal maneuvering.

Despite the preference embodied in the bill for advance agreements, the bill also gives the Secretary the ability, in his sole discretion, to apply a qualified section 482 agreement to previously filed returns. For example, it is anticipated that not all affected taxpayers will have entered into such agreements before the bill takes effect, and that there may be situations where a method for computing taxable income set forth in a subsequently entered advance agreement satisfies the Secretary that it can also fairly be applied to earlier years. In such a case, it is intended that the Secretary have the flexibility to accept that method as the basis for waiving the minimum taxable income requirement for an earlier year, but only if he so chooses in the exercise of his sole discretion.

Finally, it is understood that when taxable income is set by adjusting the prices paid among related parties for their intercompany transactions, even prices that are adequate to generate appropriate net profits in ordinary circumstances may not do so under certain extraordinary circumstances. An uninsured casualty or disaster loss (e.g., from a fire, theft, flood, earthquake, war, or riot) may have this effect. It is believed that in such circumstances it should be within the Secretary's sole discretion to waive the minimum taxable income requirement even absent a qualified section 482 agreement, if he finds that application of the requirement would be inequitable. This authority is intended to be extremely narrowly drawn. It does not extend, for example, to situations where losses are due to poor business judgment. Nor does it permit waiver of the minimum taxable income requirement of a U.S. corporation on the basis of losses of its related foreign parties. For example, it may be that a multinational, vertically integrated manufacturing enterprise is generating a worldwide consolidated loss. However, under an arm's-length method of determining transfer prices and profits of the component entities of the worldwide organization, such a loss is not inconsistent with the imputation or allocation of a normal profit to a U.S. distributorship subsidiary. To the extent that taxpayers wish to avoid the minimum taxable income requirement in situations outside the narrow scope of this waiver opportunity, it is believed that their sole alternative should be through the process of agreement with the Secretary, as described above.

Relationship with treaties

It is believed that the bill does not violate treaties. For example, although the bill only applies to foreign and foreign-owned corporations (other than controlled foreign corporations), it is believed that in light of the bill's provisions repealing deferral for U.S.-controlled foreign corporations, the effect of the bill is to treat all U.S. operations similarly. Under the bill, shifting profits to a U.S.-controlled foreign corporation would no longer shelter them from current U.S. tax jurisdiction unless a foreign tax credit were available, and likewise under the bill's section 482 provision, shifting what would otherwise be the normal profits of a foreign-controlled U.S. company to a foreign-controlled foreign corporation on the basis of intercompany pricing would no longer shelter that income unless it is estab-

lished to the Secretary's satisfaction that those intercompany prices yield a fair result.

Where a foreign corporation resident in a treaty country and entitled to the benefits of the treaty (taking into account item 2 of Title III of the bill, as described above) is not engaged in business in the United States through a permanent establishment, it is intended that the bill be applied so as not to result in any tax where the corporation is exempt from tax under present law as modified by the treaty. Where a foreign corporation resident in a treaty country and entitled to the benefits of the treaty *is* engaged in business in the United States through a permanent establishment, it is intended that the bill be applied so as to determine a minimum amount of taxable income attributable to the United States permanent establishment.

It is believed that, applied as described above, the minimum taxable income requirement mandated by the bill generally is consistent with the business profits and associated enterprises articles of treaties. It is believed that serious uncertainties often attend the fixing of hypothetical arm's-length transaction terms where the actual transactions of the taxpayer have not occurred at arm's length. Further, of those transactions that *do* occur between unrelated parties in the marketplace, often none are of more than arguable comparability to those of the taxpayer with its related group members. Even if comparable in some respects, these transactions are sometimes beyond the power of the taxpayer to discover at the time the tax return is filed because they represent proprietary information of unrelated parties. Therefore, it is believed that imputation of a minimum profit as is provided in the bill is a prima facie reasonable manner of computing the income attributable to the permanent establishment or enterprise, especially in view of the fact that the amount required is chosen on the basis of a fraction of the domestic industry average. Moreover, if the facts and circumstances of a particular case demonstrate that some method other than the statutory minimum clearly reflects the taxpayer's income, the taxpayer is free to so convince the Secretary and thereby avoid application of the statutory minimum.

If, despite the belief expressed above, it is ultimately determined that this provision of the bill violates a treaty obligation of the United States, it is intended that the provisions of the bill will nevertheless apply.

Effective Date

The provision applies to taxable years beginning after December 31, 1992.

Title IV—Other Reforms

Subtitle A. Individual Provisions

1. Simplified foreign tax credit limitation for individuals (sec. 401 of the bill and sec. 904 of the Code)

Present Law

In order to compute the foreign tax credit, a taxpayer computes foreign source taxable income and foreign taxes paid in each of the applicable separate foreign tax credit limitation categories. In the case of an individual, this requires the filing of IRS Form 1116, designed to elicit sufficient information to perform the necessary calculations.

In many cases, individual taxpayers who are eligible to credit foreign taxes may have only a modest amount of foreign source gross income, all of which is income from investments (e.g., dividends from a foreign corporation subject to foreign withholding taxes or dividends from a domestic mutual fund that can pass through its foreign taxes to the shareholder (see sec. 853)). Taxable income of this type ordinarily is subject to the single foreign tax credit limitation category known as passive income. However, under certain circumstances, the Code treats investment-type income (e.g., dividends and interest) as income in several other separate limitation categories (e.g., high withholding tax interest income, general limitation income) designed to accomplish certain policy objectives or forestall certain abuses. For this reason, any taxpayer with foreign source gross income is required to provide sufficient detail on Form 1116 to ensure that foreign source taxable income from investments, as well as all other foreign source taxable income, is allocated to the correct limitation category.

Explanation of Provision

The bill allows individuals with no more than $200 of creditable foreign taxes, and no foreign source income other than income that is in the passive basket, to elect a simplified foreign tax credit limitation equal to the lesser of 25 percent of the individual's foreign source gross income or the amount of the creditable foreign taxes paid or accrued by the individual during the taxable year. (It is intended that an individual electing this simplified limitation calculation not be required to file Form 1116 in order to obtain the benefit of the credit.) A person who elects the simplified foreign tax credit limitation is not allowed a credit for any foreign tax not shown on a payee statement (as that term is defined in sec. 6724(d)(2)) furnished to him or her. Nor is the person entitled to treat any excess credits for a taxable year to which the election applied as a carryover to another taxable year. Because the limitation for a taxable year to which the election applies can be no more than the creditable foreign taxes actually paid for the taxable year, it is also the case under the provision that no excess credits from another year can be carried over to the taxable year to which the election applies.

For purposes of the simplified limitation, passive income generally is defined to include all types of income that would be foreign personal holding company income under the subpart F rules, plus income inclusions from passive foreign corporations (as defined by the provision), so long as the income is shown on a payee statement furnished to the individual. Thus, for purposes of the simplified limitation, passive income includes all dividends, interest (and income equivalent to interest), royalties, rents, and annuities; net gains from dispositions of property giving rise to such income; net gains from certain commodities transactions; and net gains from foreign currency transactions that give rise to foreign currency gains and losses as defined in section 988. The statutory exceptions to treating these types of income as passive for foreign tax credit limitation purposes, such as the exceptions for high-taxed income and high-withholding-tax interest, are not applicable in determining eligibility to use the simplified limitation.

Although an estate or trust generally computes taxable income and credits in the same manner as in the case of an individual (Code sec. 641(b); Treas. Reg. sec. 1.641(b)-1), the simplified limitation does not apply to an estate or trust.

Effective Date

The provision applies to taxable years beginning after December 31, 1992.

2. Personal transactions by individuals in foreign currency (sec. 402 of the bill and sec. 988 of the Code)

Present Law

When a U.S. taxpayer with a U.S. dollar functional currency makes a payment in a foreign currency, gain or loss (referred to as "exchange gain or loss") arises from any change in the value of the foreign currency relative to the dollar between the time the currency was acquired (or the obligation to pay was incurred) and the time that the payment is made. Gain or loss results because foreign currency, unlike the U.S. dollar, is treated as property for Federal income tax purposes.

Exchange gain or loss can arise in the course of a trade or business or in connection with an investment transaction. Exchange gain or loss can also arise where foreign currency was acquired for personal use. For example, the IRS has ruled that a taxpayer who converts U.S. dollars to a foreign currency for personal use—while traveling abroad—realizes exchange gain or loss on reconversion of appreciated or depreciated foreign currency (Rev. Rul. 74-7, 1974-1 C.B. 198).

Prior to the Tax Reform Act of 1986 ("1986 Act"), most of the rules for determining the Federal income tax consequences of foreign currency transactions were embodied in a series of court cases and revenue rulings issued by the IRS. Additional rules of limited application were provided by Treasury regulations and, in a few instances, statutory provisions. Pre-1986 law was believed to be unclear regarding the character, the timing of recognition, and the source of gain or loss due to fluctuations in the exchange rate of

foreign currency. The result of prior law was uncertainty of tax treatment for many legitimate transactions, as well as opportunities for tax-motivated transactions. Therefore, in 1986 Congress determined that a comprehensive set of rules should be provided for the U.S. tax treatment of transactions involving "nonfunctional currencies;" that is, currencies other than the taxpayer's "functional currency."

However, the 1986 Act provisions designed to clarify the treatment of currency transactions, primarily found in section 988, apply to transactions entered into by an individual only to the extent that expenses attributable to such transactions would be deductible under section 162 (as a trade or business expense) or section 212 (as an expense of producing income, other than expenses incurred in connection with the determination, collection, or refund of taxes). Therefore, the principles of pre-1986 law continue to apply to personal currency transactions.[32]

Explanation of Provision

In a case where an individual acquires nonfunctional currency and then disposes of it in a personal transaction, and where exchange rates have changed in the intervening period, the bill provides for nonrecognition of an individual's resulting exchange gains not exceeding $200. The provision does not change the treatment of resulting exchange losses. It is understood that under other Code provisions, such losses typically are not deductible by individuals (e.g., sec. 165(c)).

Effective Date

The provision applies to taxable years beginning after December 31, 1992.

3. Treatment of certain grants (sec. 403 of the bill and secs. 873 and 1441 of the Code)

Present Law

Generally under the Code, the United States imposes tax, at graduated rates, on the taxable income of a nonresident alien individual that is effectively connected with the conduct of a trade or business in the United States. Generally, deductions are permitted in computing such U.S. taxable income only if and to the extent that they are connected with income which is so effectively connected.

A nonresident alien cannot use the standard deduction (sec. 63(c)(6)(B)). A nonresident alien is permitted a deduction for personal exemptions without regard to whether the deduction is connected with effectively connected income. However, a nonresident alien generally is allowed only one personal exemption unless he or she is a resident of a contiguous country or a national of the United

[32] See, e.g., Rev. Rul. 90-79, 1990-2 C.B. 26 (where the taxpayer purchased a house in a foreign country, financed by a foreign currency loan, and the currency appreciates before the house is sold and the loan is repaid, the taxpayer's exchange loss on repayment of the loan is not deductible under sec. 988 and does not offset taxable gain on the sale of the house).

States (sec. 873(b)). By contrast, a U.S. citizen or resident (hereinafter referred to as a "U.S. person") is entitled to an exemption for him- or herself; an additional exemption for a spouse if a joint return is not made and the spouse, for the year in which the taxable year of taxpayer begins, has no gross income and is not the dependent of another taxpayer; and further additional exemptions for certain dependents (sec. 151). The term "dependent" excludes a spouse and generally also excludes any individual who is not a citizen or national of the United States unless the individual is a U.S. resident or a resident of a contiguous country (sec. 152(a)(9) and (b)(3)). In addition, no joint return may be made by a husband and wife if either is at any time during the year a nonresident alien, unless one spouse is a U.S. person, and the other elects to be taxed as a U.S. resident on all of his or her worldwide income (sec. 6013(a) and (g)). Thus, while a married U.S. person whose spouse is also a U.S. person can either file a joint return claiming personal exemptions for both spouses, or file a separate return claiming personal exemptions for both where the spouse has no gross income (and may claim more exemptions if there are dependents), a married nonresident alien with U.S. effectively connected income generally may take no more than one personal exemption in all cases (unless the spouse is a U.S. person and the nonresident alien subjects his or her worldwide income to U.S. tax jurisdiction).

Under the Code, a nonresident alien generally is subject to a 30-percent tax on gross amounts of fixed or determinable, annual or periodical income from U.S. sources that is not effectively connected with the conduct of a trade or business in the United States. The payor of income subject to this gross-basis tax generally is required to collect the tax by withholding at the full 30-percent rate.

Gross income generally excludes certain amounts received as a qualified scholarship by an individual who is a candidate for a degree at an educational institution (sec. 117(a)). In addition, U.S. source amounts that are received by a nonresident alien individual who is temporarily present in the United States under an F, J or M visa, and that are either (1) incident to a qualified scholarship to which section 117(a) applies (but includible in gross income), or (2) a scholarship or fellowship for study, training, or research in the United States and received from a government, a 501(c)(3) organization, or certain types of international, binational, or multinational organizations, are treated as effectively connected with the conduct of a trade or business within the United States and eligible for withholding at a 14-percent rate. In Revenue Ruling 89-67, 1989-1 C.B. 233, the Service ruled that in certain circumstances, it would determine the source of income received to support or subsidize a recipient's research or study activities by reference to the residence of the payor.

Some U.S. income tax treaties provide for reductions in the U.S. tax that would otherwise be imposed under the Code on certain income of foreign persons, including the income of certain visiting foreign individuals such as scholars.

Source rules are also applicable to income received by U.S. persons. Such persons generally are taxable in the United States on their worldwide income, subject to certain foreign tax credits. For-

eign tax credits, however, can be used only to offset foreign source income.

Explanation of Provision

The bill provides that income received by an individual in the form of a scholarship or fellowship grant for study, training, or research in the United States is treated as derived from sources within the United States, without regard to the residence of the payor. The bill further provides that income received by an individual in the form of any other scholarship or fellowship grant (for example, for study, training, or research outside the United States) is treated as derived from sources outside the United States, without regard to the residence of the payor. Thus, for example, contrary to the position of the IRS announced in Rev. Rul. 89-67, an individual who receives a fellowship grant for study or research abroad from a U.S.-based organization generally is treated as receiving foreign source income.

In addition, the bill provides a special source rule for certain prizes and awards. In the case of amounts received as a prize or award made primarily in recognition of religious, charitable, scientific, educational, artistic, literary or civic achievement, the income is treated as derived from sources within the United States if the activities that formed the basis of the prize or award were carried out within the United States. Similarly, the income is treated as derived from sources outside the United States if the activities that formed the basis of the prize or award were carried out outside the United States. It is intended that substantially all of the relevant activities must be conducted in the specified location (whether within or outside the United States) in order for these specific source rules to apply. In cases where substantial activities that formed the basis of the prize or award were carried out both within and outside the United States, it is intended that the Secretary of the Treasury shall determine the source of the income in accordance with the general regulatory authority applicable to income from sources partly from within and partly from without the United States (sec. 863).

The bill also allows certain deductions, based on the standard deduction and multiple personal exemptions, to offset certain U.S. source gross income of visiting foreign individuals received in the form of certain scholarship and fellowship grants. Further, the bill provides that withholding on such income may be adjusted to take these deductions into account.

In the case of a nonresident alien individual who is temporarily present in the United States under an F, J or M visa who receives or accrues any qualified scholarship or fellowship grant during the taxable year (hereinafter referred to as a "qualified nonresident alien individual"), the bill permits that individual the benefit of certain deductions (regardless of whether those deductions are connected with income which is effectively connected with the conduct of a trade or business in the United States) up to the amount of the qualified scholarship or fellowship grants includible in gross income for the taxable year. Those deductions include the standard deduction and the personal exemptions allowed under the general

personal exemption rules (i.e., the rules without regard to the one-exemption limitation in section 873(b)(3)), subject to two modifications. First, in determining who is a dependent of the nonresident alien, there will be no exclusion of a child or other individual, on the grounds of his or her failure to be a U.S. person or national, if that child or other individual is a member of the taxpayer's household in the United States. Second, no exemption will be allowed for a spouse unless the spouse is a member of the taxpayer's household in the United States.

As described above, the amount of the deductions allowed under the bill is limited by the amount of the nonresident alien's qualified scholarship or fellowship grants for the year. The term "qualified scholarship or fellowship grant" is defined as any amount which is includible in the gross income of the nonresident alien for the taxable year, and which is granted as a scholarship or fellowship for study or research in the United States by an organization described in section 501(c)(3) which is exempt from tax under section 501(a); a foreign government; an international organization, or a binational or multinational educational and cultural foundation or commission created or continued pursuant to the Mutual Education and Cultural Exchange Act of 1961; or the United States, an instrumentality or agency thereof, a State, a possession of the United States, any political subdivision thereof, or the District of Columbia. Thus, for example, the term does not include amounts excluded from gross income under section 117(a) of the Code (e.g., certain scholarships, to the extent not exceeding tuition and fees, received by degree candidates) or under a treaty.

Finally, the bill provides that notwithstanding the 30-percent or 14-percent statutory withholding rates that may be generally applicable to U.S. source income of a nonresident alien under the Code, the Secretary shall have authority to provide for a reduction in the amount of withholding from any qualified scholarship or fellowship grant to take into account the reduction in a grant recipient's tax liability as a result of the bill.

Effective Date

The bill applies to taxable years beginning after December 31, 1992.

4. Estate tax marital credit for certain employees of international organizations (sec. 404 of the bill and new sec. 2210 of the Code)

Present Law

Property subject to tax

For U.S. citizens and residents, the amount subject to Federal estate tax is determined by reference to all the decedent's property, wherever situated. For nonresident noncitizens, the amount subject to that tax is determined only by reference to the decedent's property situated in the United States.

Treasury regulations provide that a "resident" decedent is one who was domiciled in the United States at the time of his or her death, and that residence without an intention to remain indefi-

nitely does not establish domicile. (*See* Treas. Reg. sec. 20-1(b).) Thus, whether a decedent employed in the United States by an international organization was domiciled there depends upon whether the decedent intended to remain in the United States indefinitely. (*See* Rev. Rul. 80-363, 1980-2 C.B. 250.)

Rates and unified credit

The Federal estate and gift taxes are unified, so that a single progressive rate schedule applies to an individual's cumulative lifetime and death-time transfers. The estate and gift tax is first computed without any exemption and then a unified credit is subtracted to determine the amount of estate or gift tax payable before the allowance of other credits.

U.S. citizens and resident noncitizens are allowed a unified credit of $192,800, which effectively exempts the first $600,000 of transfers from estate and gift tax. Nonresident noncitizens are allowed by statute a unified credit of $13,000, which effectively exempts the first $60,000 of transfers from estate tax. Some treaties, however, allow the estate of a nonresident noncitizen the same unified credit allowed a U.S. citizen multiplied by the proportion of the decedent's gross estate situated in the United States.

Marital deduction

For Federal estate tax purposes, a deduction generally is allowed for the value of property passing to a citizen spouse, but not for the value of property passing to a noncitizen spouse. Property passing to a noncitizen spouse, however, may qualify for the deduction if it passes to a qualified domestic trust, or if the spouse becomes a U.S. citizen before the estate tax return is filed.

Explanation of Provision

The bill reduces the Federal estate tax of an eligible estate by the applicable marital transfer credit. The provision is intended to allow a marital deduction to estates subject to U.S. estate tax solely by reason of employment by an international organization.

Eligible estates

An estate is eligible for the credit if, at the date of the decedent's death, neither the decedent nor the surviving spouse is a citizen or a lawful permanent resident of the United States (i.e., a green card holder), and either the decedent or the surviving spouse is a full-time employee of an international organization [33] and has his or her principal place of employment in the United States, and if the executor waives the right to use a qualified domestic trust. An estate is not eligible for the credit if the marital deduction is allowed because the spouse becomes a U.S. citizen before the estate tax return is filed.

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[33] An international organization is a public international organization entitled to enjoy privileges, exemptions, and immunities under the International Organizations Immunities Act.

Amount of credit

The amount of the applicable marital transfer credit depends upon whether the decedent, on the date of death, is a U.S. resident for Federal estate tax purposes.

Residents

In the case of an estate of a resident decedent, the applicable marital transfer credit equals the excess of (1) the estate tax on the sum of the marital transfer amount and the greater of (a) the decedent's adjusted taxable gifts or (b) $600,000, over (2) the estate tax on the greater of (a) the decedent's adjusted taxable gifts or (b) $600,000. The marital transfer amount is the amount that would have qualified for the marital deduction if the spouse were a U.S. citizen, but cannot exceed either (1) $600,000 or (2) the excess of the sum of the taxable estate and the adjusted taxable gifts over $600,000. Thus, for property passing from U.S. residents, the credit effectively exempts a second $600,000, in addition to the amount exempted by the unified credit.

Example 1.—On the date of death, the decedent and spouse are neither citizens nor lawful permanent residents of the United States. Prior to his death, the decedent was domiciled in the United States, where he was employed full-time by an international organization. The decedent made no adjusted taxable gifts, and bequeathed his entire taxable estate, valued at $600,000, to his spouse in a form that would qualify for the marital deduction if the spouse were a U.S. citizen. The executor of the estate waives the right to use a qualified domestic trust. Under the provision, the applicable marital transfer credit equals zero because the taxable estate does not exceed $600,000. After application of the unified credit, however, no estate tax is due.

Example 2.—Same as Example 1, except that the decedent's taxable estate is valued at $1 million, $600,000 of which is bequeathed to the spouse. Under the provision, the applicable marital transfer credit equals the tax on $400,000, imposed at the rates applicable to transfers between $600,000 and $1 million. After application of this credit and the unified credit, no estate tax is due.

Example 3.—Same as Example 1, except that the decedent's taxable estate is valued at $1,600,000, of which $1 million is bequeathed to the spouse. Under the provision, the applicable marital transfer credit equals the tax on $600,000, imposed at the rates applicable to transfers between $600,000 and $1,200,000. After application of this credit and the unified credit, $400,000 is taxed at the rates applicable to transfers between $1,200,000 and $1,600,000.

Example 4.—Same as Example 3, except that the decedent also made adjusted taxable gifts of $800,000. Under the provision, the applicable marital transfer credit equals the tax on $600,000, imposed at the rates applicable to transfers between $800,000 and $1,400,000 million. Because of this credit and the credit for tax previously paid on lifetime gifts, $1 million is taxed at the rates applicable to transfers between $1,400,000 and $2,400,000.

Nonresidents

In the case of an estate of a nonresident decedent, the applicable marital transfer credit equals the excess of (1) the estate tax on the sum of the marital transfer amount and the greater of (a) the decedent's adjusted taxable gifts or (b) the deduction equivalent of the unified credit, over (2) the estate tax on the greater of (a) the decedent's adjusted taxable gifts or (b) the deduction equivalent of the unified credit. For this purpose, the marital transfer amount cannot exceed either (1) $600,000, reduced by the deduction equivalent of the unified credit, or (2) the excess of the sum of the taxable estate and the adjusted taxable gifts over the deduction equivalent of the unified credit. The deduction equivalent of the unified credit is the amount of property the tax on which would equal the unified credit allowed by Code or by treaty. Thus, for property passing from nonresidents, the provision effectively exempts $600,000, but reduces that amount by the amount exempted by the unified credit.

Example 5.—Same as Example 1, except that the decedent was domiciled in a country not having an estate tax treaty with the United States. Under the provision, the deduction equivalent of the unified credit is $60,000 and the applicable marital transfer credit equals the tax on $540,000, imposed at the rates applicable to transfers between $60,000 and $600,000. After application of this credit and the unified credit, no estate tax is due.

Example 6.—Same as Example 5, except that the decedent was domiciled in a country having a treaty with the United States allowing residents of that country a unified credit equal to a pro-rata share of the statutory unified credit allowed U.S. citizens. One-half of the decedent's worldwide estate is located in the United States and there are no estate tax deductions. Under the provision, the deduction equivalent of the marital deduction is $300,000 and the applicable marital transfer credit equals the tax on $300,000, imposed at the rates applicable to transfers between $300,000 and $600,000. After application of this credit and the unified credit, no estate tax is due.

Example 7.—Same as Example 5, except that the decedent's taxable estate is valued at $1,600,000, of which $1 million is bequeathed to the spouse. Under the provision, the applicable marital transfer credit is the tax on $540,000, imposed at the rates applicable to transfers between $60,000 and $600,000. After application of this credit and the unified credit, $1 million is taxed at the rates applicable to transfers between $600,000 and $1,600,000.

Example 8.—Same as Example 7, except that the decedent also made adjusted taxable gifts of $800,000. Under the provision, the applicable marital transfer credit is the tax on $540,000, imposed at the rates applicable to transfers between $860,000 and $1,400,000. Because of this credit and the credit for tax previously paid on lifetime gifts, $1 million is taxed at the rates applicable to transfers between $1,400,000 and $2,400,000.

Effective Date

The provision applies to decedents dying after the date of enactment.

Subtitle B. Other Provisions

1. Reduction of Puerto Rico and possession tax credit (sec. 411 of the bill and sec. 936 of the Code)

Present Law

Domestic corporations with business operations in U.S. possessions (including, for this purpose, Puerto Rico and the U.S. Virgin Islands) may elect under Code section 936 generally to eliminate the U.S. tax on certain income which is related to their possession-based operations. The section 936 credit may offset the U.S. tax on the following types of income: (1) foreign source income arising from the active conduct of a trade or business within a U.S. possession or from the sale or exchange of substantially all of the assets used by the taxpayer in the active conduct of such trade or business, or (2) income from certain investments in the possessions or in certain Caribbean Basin countries ("qualified possession source investment income"). The credit spares the electing corporation U.S. tax whether or not it pays income tax to the possession.

In order to qualify for the section 936 credit, a domestic corporation must derive at least 75 percent of its gross income from the active conduct of a trade or business within a U.S. possession over a three-year period, and at least 80 percent of the corporation's gross income must be derived from sources within a possession during that same period.

Explanation of Provision

The bill limits the amount of U.S tax which a company may reduce with the section 936 credit. Under the bill, the section 936 credit may offset no more than 85 percent of the U.S. tax on the company's possession-based operations. The 85-percent limitation applies not only to possession source active business income, but also to qualified possession source investment income.

Effective Date

The provision is effective for taxable years beginning after December 31, 1992.

2. Treatment of passive income related to foreign oil and gas extraction income and shipping income (secs. 412 and 201(f)(9)(B) of the bill and secs. 904 and 907 of the Code)

Present Law

Foreign tax credit limitations in general

Foreign tax credit limitations are computed separately for certain categories of income, including passive income, high withholding tax interest, financial services income, shipping income, dividends from each noncontrolled section 902 corporation, certain distributions from DISCs, FSCs, and former DISCs and FSCs, certain types of FSC income, and all other (i.e., "overall basket") income. Passive income generally includes interest and dividends, among other things. The existence of these separate limitations generally

prevents the cross-crediting of high foreign taxes on overall basket income against the U.S. tax on passive income.

The separate foreign tax credit limitation for passive income was enacted in 1986 and replaced the prior-law separate foreign tax credit limitation for passive interest income. Prior law excluded from the separate limitation category for passive interest income interest derived from any transaction which is directly related to the active conduct by the taxpayer of a trade or business in a foreign country. Regulations under prior law expressly treated certain types of interest from working capital as interest derived from a transaction which is directly related to the active conduct of a trade or business (Former Treas. Reg. sec. 1.904-4(b)). No such working capital exception generally exists under the passive income definition as established in the 1986 Act. However, that definition excludes foreign oil and gas extraction income ("FOGEI").

Moreover, the present-law rules classify certain types of income which are passive in nature, such as income derived from money, bank deposits, and other temporary investments which are reasonably necessary to meet the working capital requirements of the shipping operations of a corporation, as shipping income rather than as passive income if the income is considered foreign base company shipping income under the Code or regulations.[34]

Special limitation on credits for foreign extraction taxes

In addition to the foreign tax credit limitations that apply to all foreign tax credits, a special limitation is placed on foreign income taxes on income from oil and gas extraction. Under this special limitation, amounts claimed as taxes paid on FOGEI of a U.S. company qualify as creditable taxes (if they otherwise so qualify) only to the extent they do not exceed 34 percent of foreign extraction income. Foreign taxes paid in excess of that amount on FOGEI are, in general, neither creditable nor deductible (unless a carryover provision applies).

Under regulations issued prior to the 1986 Act and still effective, the definition of FOGEI includes certain types of income that are passive in nature. For example, FOGEI includes interest on bank deposits or on any other temporary investment which is not in excess of funds reasonably necessary to meet the working capital requirements and the specifically anticipated business needs of a taxpayer engaged in extraction activities (Treas. Reg. sec. 1.907(c)-1T(f)(3)).

In general, the statutory FOGEI rules are intended to prevent the crediting of high foreign taxes on FOGEI against U.S tax on other types of foreign source income. However, if a taxpayer has both high-taxed FOGEI, and also FOGEI which bears little or no foreign income tax, such as interest income on working capital, the current rules permit high FOGEI taxes to be credited against U.S tax on that interest income.

[34] See Treas. Reg. sec. 1.904-4(f) and 1.954-6(e).

Explanation of Provision

The bill treats passive types of income related to oil and gas extraction activities, such as interest income derived from bank deposits or temporary investments of working capital as passive income under the separate foreign tax credit limitation rules. In addition, the bill provides that income which would meet the definition of both foreign personal holding company income and foreign base company shipping income under present-law rules is considered passive income for foreign tax credit purposes.

The bill also eliminates the treatment of any income that qualifies as passive income for foreign tax credit separate limitation purposes (e.g., interest income from bank deposits or temporary investments) as foreign oil and gas extraction income for purposes of computing the special limitation on foreign tax credits related to extraction activities, regardless of whether the underlying investments or deposits represent working capital.

Effective Date

The provision is effective for taxable years beginning after December 31, 1992.

Title V—Foreign Simplification Provisions

Subtitle A. Consolidation of Statutory Rules Providing Exceptions to Deferral (secs. 501-504 of the bill and secs. 453, 532, 535, 542-543, 551-558, 563, 851, 954, 1246-1247, 1291-1297, and 4982 of the Code)

Present Law

U.S. citizens and residents and U.S. corporations (collectively, "U.S. persons") generally are taxed currently by the United States on their worldwide income. Income earned by a foreign corporation, the stock of which is owned in whole or in part by U.S. persons, generally is not taxed by the United States until the foreign corporation repatriates those earnings by payment to its U.S. stockholders.

The Code sets forth several regimes providing exceptions to the general rule deferring U.S. tax on income earned indirectly through a foreign corporation: the controlled foreign corporation rules (secs. 951-964); the foreign personal holding company rules (secs. 551-558); passive foreign investment company (PFIC) rules (secs. 1291-1297); the personal holding company rules (secs. 541-547); the accumulated earnings tax (secs. 531-537); and rules for foreign investment companies (sec. 1246) and electing foreign investment companies (sec. 1247). These separate regimes have complex and overlapping application to foreign corporations with U.S. stockholders.

Explanation of Provisions

In general

The bill replaces the separate anti-deferral regimes of present law with a unified set of rules providing for the elimination of deferral. The bill preserves the present-law approach under which full current taxation is a function of a type of income or assets of the corporation exceeding some threshold (as currently embodied in subpart F, the PFIC rules, and the foreign personal holding company rules), while reflecting the repeal of deferral for all controlled foreign corporations as provided in section 201 of the bill. The bill eliminates regimes that are redundant or marginally applicable, and ensures that no more than one set of rules generally will apply to a shareholder's interest in any one corporation in any one year.

Generally, the simplification provisions of the bill retain the subpart F rules as the foundation of the unified anti-deferral regime (with certain modifications described below and also in item 2., following, describing secs. 511-513 of the bill). They include a modified version of the PFIC rules while eliminating the other regimes as redundant to one or the other. Where deferral is eliminated by U.S. shareholder inclusions of foreign corporate-level income, the bill applies a single set of rules (the subpart F rules) for basis adjustments, characterization of actual distributions, foreign tax credits, and similar issues. As under present law, the bill in some cases affords U.S. persons owning stock in foreign corporations a choice of technique for recognizing income from the elimination of defer-

ral. However, in a greater number of cases than under present law, the bill provides only one method of eliminating deferral.

Replacement of current law regimes for full elimination of deferral

The bill creates a single definition of a passive foreign corporation (PFC) that will unify and replace the foreign personal holding company and PFIC definitions. The rules applicable to PFCs represent a hybrid of characteristics of the foreign personal holding company rules, the PFIC rules, and the controlled foreign corporation rules (subpart F), plus a new mark-to-market regime, as well as a variety of simplifying or technical changes to rules under the existing systems. The following discussion explains the differences between the PFIC provisions of present law and the PFC provisions applicable under the bill.

A PFC is any foreign corporation if (1) 60 percent or more of its gross income is passive income, (2) 50 percent or more of its assets (on average during the year, measured by value) produce passive income or are held for the production of passive income, or (3) it is registered under the Investment Company Act of 1940 (as amended) either as a management company or as a unit investment trust.[35] As under the PFIC rules, the foreign corporation is permitted to elect to measure its assets based on their adjusted bases rather than their value.

As under present law, passive income for this purpose under the bill generally is any income of a kind which would be foreign personal holding company income as defined in section 954(c) of present law, subject to the current law exceptions for banking and insurance income and the current look-through rules for certain payments from related persons (current sec. 1296(b)(2)).[36]

The bill adds a new exception to the definition of passive income. Under the bill, to the extent that any asset is properly treated as not held for the production of passive income (and therefore is treated as not a passive asset for purposes of the asset test), all income derived from the asset is treated as active income for purposes of the income test. Ordinarily the character of an asset as passive or active depends on the income generated by that asset. However, as explained above, some assets (for example, stocks or securities held for sale to customers in the ordinary course of business by a regular dealer in such property, and properly identified as inventory property) may be treated as active even though those assets generate, among other things, passive income. It is unclear whether this was intended when the PFIC rules were enacted.[37]

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[35] It is understood that a mutual insurance company could be treated under the bill and under present law as a passive foreign corporation, notwithstanding the fact that such a company does not actually issue "stock."

[36] Thus, the bill retains the exception for income derived in the active conduct of an insurance business by a corporation which is predominantly engaged in an insurance business and which would be subject to tax under subchapter L if it were a domestic corporation. It is intended that in determining whether a corporation is "predominantly engaged" for this purpose, the Secretary may require a higher standard or threshold than the definition of an insurance company under Treasury Regulations section 1.801-3(a).

[37] Active asset treatment of certain securities held for sale to the public is confirmed in Notice 88-22, 1988-1 C.B. 489, 490, and S. Rep. No. 100-445, 100th Cong., 2d Sess. 281 (1988). The legislative history of the 1986 Act further suggested a view that all income from such inventory would be treated as active. "[S]ecurities held for sale to the public[] are assets that do not give

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The bill establishes that, to the extent an asset is properly treated as active, all of the income from that asset is treated as active for purposes of the income test. The bill is not intended to change the outcome of the application of the asset test under present law. For example, it is not intended to limit the IRS's authority to prescribe limits, as it did in Notice 88-22, on the cases in which assets generating what could be passive income are treated as active assets.[38] In addition, it is intended that where one item of property is properly viewed as two separate assets, a portion of the property can be treated as a passive asset that generates passive income while another portion of the same property can be treated as a nonpassive asset that generates nonpassive income. For example, assume that a taxpayer owns a six-story office building, and occupies two floors for use in its active business while renting out the other four floors. Assume that the two floors used in the active business are properly viewed as a nonpassive asset, while the four leased floors are properly viewed as a passive asset. It is intended that the rental income from the four leased floors in this example be treated as passive income.

The bill includes in its definition of passive income one type of income that is not treated as foreign personal holding company income under present-law subpart F (sec. 954(c)), but is treated as foreign personal holding company income under the present-law foreign personal holding company rules (sec. 553(a)(5)). The bill treats as passive income for purposes of the PFC definition an amount received under a personal service contract if a person other than the corporation has the right to designate (by name or by description) the individual who is to perform the services, or if the individual who is to perform the services is designated (by name or by description) in the contract. The bill similarly treats as passive income for purposes of the PFC definition any amount received from the sale or distribution or disposition of such a contract. This rule applies only if at some time during the taxable year 25 percent or more of the value of the corporation's stock is owned (directly, indirectly, or constructively) by or for the individual who may be designated to perform the services.[39] Income from such personal service contracts is not, however, treated as passive for foreign tax credit purposes.

In addition, the bill provides two clarifications to present law. First, the bill clarifies that, as indicated in the legislative history of the 1988 Act, the same-country exceptions from the definition of foreign personal holding company income in section 954(c) of present law do not apply in determining passive income for purposes of the PFIC definition.[40] Second, the bill clarifies that any

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rise to subpart F FPHC income by virtue of the dealer exception in sec. 954(c)...." Staff of the Joint Committee on Taxation, 100th Cong., 1st Sess., *General Explanation of the Tax Reform Act of 1986*, at 1025 (1987).

[38] Under the Notice, for example, the IRS conditioned active asset treatment of securities inventories on compliance with an identification requirement and a reasonable needs requirement. 1988-1 C.B. at 490.

[39] This rule was included in the definition of foreign personal holding company income for purposes of subpart F prior to the amendments included in the 1986 Act.

[40] H. Rep. No. 100-795, 100th Cong., 2d Sess. 272 (1988); S. Rep. No. 100-445, 100th Cong., 2d Sess. 285 (1988).

foreign trade income of a foreign sales corporation does not constitute passive income for purposes of the PFIC definition (cf. sec. 951(e)).

The bill modifies the present law application of the asset test by treating certain leased property as assets held by the foreign corporation for purposes of the PFC asset test. This rule applies to tangible personal property with respect to which the foreign corporation is the lessee under a lease with a term of at least 12 months. Under the bill, the value of leased property for purposes of applying the asset test is the lesser of the fair market value of the property or the unamortized portion of the present value of the payments under the lease. Regulations are to provide for determining the unamortized portion of the present value of the payments. Present value is to be determined, under regulations, as of the beginning of the lease term, and, except as provided in regulations, by using a discount rate equal to the applicable Federal rate determined under the rules applicable to original discount instruments (sec. 1274(d)), substituting under those rules the term of the lease for the term of the debt instrument. In applying those rules, options to renew or extend the lease are not to be taken into account. Also, the special rule to be applied under section 1274(d)(2) in the case of a sale or exchange is disregarded. Property leased by a corporation is not taken into account in testing for PFC status under the asset test either if the lessor is a related person (as that term is defined under the foreign base company rules) with respect to the lessee, or if a principal purpose of leasing the property was to avoid the PFC provisions.

The bill also modifies the present law rules that provide an exception from the definition of a PFIC in the case of a company changing businesses. Under the bill, if a foreign corporation holds 25 percent or more of the stock of a second corporation that qualifies for the change-of-business exception (current sec. 1297(b)(3)), then in applying the look-though rules (current sec. 1296(c)), the first corporation may treat otherwise passive assets or income of the second corporation as active.[41]

The bill generally retains those provisions of current law the application of which depends upon whether a foreign corporation was a PFIC for years after 1986 (e.g., current sec. 1291(d)), but modifies these provisions to test whether the foreign corporation was a PFC for years after 1986. As a transitional definition, the bill provides that a foreign corporation that was treated as a PFIC for any taxable year beginning before the introduction of the bill is treated as having been a PFC for each such year.

The bill provides a new election that will allow certain passive foreign corporations to be treated as domestic corporations. A foreign corporation is eligible to make this election if (1) it would qualify for treatment as a regulated investment company (RIC) under the relevant provisions of the Code if it actually were a domestic corporation, (2) it meets such requirements as the Secretary

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[41] The bill retains the present law rules that provide an exception from the definition of a PFIC in the case of a start-up company (current sec. 1297(b)(2)). Under the bill, the start-up company exception is intended to be applied, where necessary to carry out the purposes of the PFC rules, by treating as one corporation all related foreign corporations that transferred assets to the start-up company.

may prescribe to ensure the collection of taxes imposed by the Internal Revenue Code on the passive foreign corporation, and (3) the electing passive foreign corporation waives all benefits which are granted by the United States under any treaty (including treaties other than tax treaties) and to which the corporation is otherwise entitled by reason of being a resident of another country. The rules governing such an election generally will be similar to those applicable to the election by a foreign insurance company to be treated as a domestic corporation under section 953(d). The rules governing the election under the PFC rules, however, will not include rules similar to the special rules applicable under section 953(d) for pre-effective-date earnings and profits (sec. 953(d)(4)(B)).

The bill provides a special rule regarding the application of the PFC rules to tax-exempt organizations that own stock in passive foreign corporations. The PFC rules, under the bill, apply to any stock held by a tax-exempt organization (under section 501) in a passive foreign corporation only to the extent that a dividend on that stock would be taken into account in determining the organization's unrelated business taxable income. To that extent, the PFC rules apply with respect to amounts taken into account in computing unrelated business taxable income in the same manner as if the organization were fully taxable. Even if a dividend on the PFC stock would not be taken into account in determining the organization's unrelated business taxable income, however, it is intended that any U.S. corporation regardless of its tax-exempt status will be treated as a U.S. person for purposes of determining whether or not a PFC is U.S. controlled.

Tax treatment under full elimination of deferral

The benefits of deferral are eliminated with respect to the income of a PFC under three alternative methods: current inclusion, mark-to-market, or interest charge on excess distributions.

Current inclusion method

Mandatory current inclusion.—If a passive foreign corporation is U.S. controlled, the bill will subject every U.S. person owning (directly or indirectly) stock in the PFC to income inclusions under a modified version of the controlled foreign corporation rules. If a PFC is not U.S. controlled, every U.S. person owning (directly or indirectly) 25 percent or more of the vote or value of the stock of the PFC will be subject to the same rules. Under the bill, the entire gross income of the passive foreign corporation (subject to applicable deductions) is treated as subpart F income, and thus is included (net of appropriate deductions) on a pro rata basis in the income of each U.S. person directly or indirectly owning stock in the PFC, under a modified application of the rules of sections 951 and 961.[42] Actual distributions of earnings by such a PFC are treated similarly to distributions of previously taxed income under sections 959 and 961. These rules supersede all application of the present-law rules applicable to foreign personal holding companies,

[42] The treatment of PFC income as subpart F income is not intended to affect the application of look-through treatment of that income for purposes of the foreign tax credit limitation.

under which earnings are deemed distributed and then contributed to the capital of the foreign personal holding company.

In general conformity with present law, the bill permits the character of the PFC's income as either ordinary income or capital gain to be passed through to those shareholders of the PFC who are not treated as "U.S. shareholders" of a controlled foreign corporation under the general rules of subpart F (i.e., those who do not own, whether directly, indirectly, or constructively, at least 10 percent of the voting power of the controlled foreign corporation).

A passive foreign corporation is treated under the bill as U.S. controlled for this purpose either if it would be treated as a controlled foreign corporation under the rules of subpart F, or if, at any time during the taxable year, more than 50 percent of the vote or value of the corporation's stock was owned directly or indirectly by five or fewer U.S. persons (including but not limited to individuals, and including all U.S. citizens regardless of their residence). Indirect stock ownership under the bill generally refers to stock ownership through foreign entities within the meaning of section 958(a)(2). In addition, for the purpose of determining whether a foreign corporation is U.S. controlled by virtue of the ownership of more than 50 percent of its stock by five or fewer U.S. persons, the constructive ownership principles of the present-law foreign personal holding company rules generally apply. In the case of pass-through entities such as partnerships, S corporations, estates, and trusts, the constructive ownership principles of the present-law foreign personal holding company rules apply except as provided in regulations. It is contemplated that regulations may modify the constructive ownership rules, for example, in the case of a trust in which the beneficial interests may be contingent, subject to determination or adjustment within the discretion of the trustee, or otherwise variable or indeterminate.

Elective current inclusion.—A U.S. person not subject to the above mandatory current inclusion rules—that is, a U.S. person owning less than 25 percent of the stock in a PFC that is not U.S. controlled—may elect application of those rules. As under current law, the PFC is characterized as a "qualified electing fund" with respect to such a U.S. person. In the application of the elective current-inclusion rules, the passive foreign corporation is treated as a controlled foreign corporation with respect to the taxpayer, and the taxpayer is treated as a U.S. shareholder of the corporation. For foreign tax credit purposes, amounts included in the taxpayer's gross income under this modified application of the controlled foreign corporation rules are treated as dividends received from a foreign corporation which is not a controlled foreign corporation. Thus, an amount would be treated as a dividend from a noncontrolled section 902 corporation, or as passive income, depending on the shareholder's percentage ownership and status as an individual or a corporation.

The application and operation of the shareholder-level election for treatment as a qualified electing fund generally are the same as under the present-law PFIC rules. It is intended that, in the case of PFC stock owned through a foreign partnership, a partner-level election for treatment as a qualified electing fund will be permitted.

Mark-to-market method

Less-than-25-percent shareholders of passive foreign corporations that are not U.S.-controlled, and who do not elect current inclusion ("nonelecting shareholders"), are subject under the bill to one of two methods for taxing the economic equivalent of the PFC's current income: the mark-to-market method or the interest-charge method. The mark-to-market method does not apply to the stock of a U.S. person in any PFC that is U.S. controlled (as discussed above), to the stock of a person choosing qualified electing fund treatment, or to stock of a U.S. person who is a 25-percent shareholder (as defined above).

Under the bill, nonelecting shareholders of a PFC with marketable stock are required to mark their PFC shares to market annually. Under the mark-to-market method, the U.S. person is required to include in gross income each taxable year an amount equal to the excess (if any) of the fair market value of the PFC stock as of the close of the taxable year over the adjusted basis of the stock. In the event the adjusted basis of the stock exceeds its fair market value, the U.S. person is allowed a deduction for the taxable year equal to the lesser of the amount of the excess or the "unreversed inclusions" with respect to the stock. The bill defines the term "unreversed inclusions" to mean, with respect to any stock in a passive foreign corporation, the excess (if any) of the total amount of mark-to-market gains with respect to the stock included by the taxpayer for prior taxable years, over the amount of mark-to-market losses with respect to such stock that were allowed as deductions for prior taxable years.

The adjusted basis of stock in a passive foreign corporation is increased by the amount of mark-to-market gain included in gross income, and is decreased by the amount of mark-to-market losses allowed as deductions with respect to such stock. In the case of stock owned indirectly by the U.S. person, such as through a foreign partnership, foreign estate or foreign trust (as discussed below), the basis adjustments for mark-to-market gains and losses apply to the basis of the PFC stock in the hands of the intermediary owner, but only for purposes of the subsequent application of the PFC rules to the tax treatment of the indirect U.S. owner. In addition, similar basis adjustments are made to the adjusted basis of the property actually held by the U.S. person by reason of which the U.S. person is treated as owning PFC stock.

All amounts of mark-to-market gain on PFC stock, as well as gain on the actual sale or distribution of PFC stock, are treated as ordinary income. Similarly, ordinary loss treatment applies to the deductible portion of any mark-to-market loss on PFC stock, as well as to any loss realized on the actual sale or other disposition of PFC stock to the extent that the amount of such loss does not exceed the unreversed inclusions with respect to that stock. These loss deductions are treated as deductions allowable in computing adjusted gross income.

The source of any amount of mark-to-market gain on PFC stock is determined in the same manner as if the amount of income were actual gain from the sale of stock in the passive foreign corporation. Similarly, the source of any amount allowed as a deduction

for mark-to-market loss on PFIC stock is determined in the same manner as if that amount were an actual loss incurred on the sale of stock in the passive foreign corporation.

Definition of "marketable stock."—The mark-to-market method under the bill only applies to passive foreign corporations the stock of which is "marketable." PFC stock is treated as marketable if it is regularly traded on a qualified exchange, whether inside or outside the United States. An exchange qualifies for this treatment if it is a national securities exchange which is registered with the Securities and Exchange Commission or the national market system established pursuant to section 11A of the Securities and Exchange Act of 1934, or if the Secretary is satisfied that the requirements for trading on that exchange ensure that the market price on that exchange represents a legitimate and sound fair market value for the stock. It is intended that the Secretary may adopt a definition of the term "regularly traded" that differs from definitions provided for other purposes under the Code. Further, it is intended that the Secretary not be bound by definitions applied for purposes of enforcing other laws, including Federal securities laws. Similarly, in identifying qualified foreign exchanges for these purposes, it is intended that the Secretary not be required to include exchanges that satisfy standards established under Federal securities laws and regulations. PFC stock is also treated as marketable, to the extent provided in Treasury regulations, if the PFC continuously offers for sale or has outstanding any stock (of which it is the issuer) that is redeemable at its net asset value in a manner comparable to a U.S. regulated investment company (RIC).

In addition, the bill treats as marketable any stock in a passive foreign corporation that is owned by a RIC that continuously offers for sale or has outstanding any stock (of which it is the issuer) that is redeemable at its net asset value. It is believed that the RIC's determination of PFC stock value for this non-tax purpose would ensure a sufficiently accurate determination of the fair market value of PFC stock owned by the RIC. The bill also treats as marketable any stock in a passive foreign corporation that is held by any other RIC, except to the extent provided in regulations. It is believed that even for RICs that do not make a market in their own stock, but that do regularly report their net asset values in compliance with the securities laws, inaccurate valuations may bring exposure to legal liabilities, and this exposure may ensure the reliability of the values such RICs assign to the stock they hold in PFCs. However, it is intended that Treasury regulations will disallow mark-to-market treatment for nonmarketable stock held by any RIC that is not required to perform such a net asset valuation at the close of each taxable year, that does not publish such a valuation, or that otherwise does not provide what the Secretary regards as sufficient indicia of the reliability of its valuations under the relevant circumstances.

Coordination with RIC rules.—The bill coordinates the application of the mark-to-market method with the tax rules generally applicable to RICs. The bill treats mark-to-market gain on PFC stock as a dividend for purposes of both the 90-percent investment income test of section 851(b)(2) and the 30-percent short-short limitation of section 851(b)(3). In addition, the bill permits RICs to de-

termine their mark-to-market gain using a fiscal year ending on October 31 of each year, solely for purposes of determining their ordinary income for purposes of the excise tax on the undistributed income of regulated investment companies (sec. 4982). Reductions in value of the PFC stock between October 31 and the end of the RIC's normal taxable year are treated, to the extent provided in regulations, as occurring in the following taxable year for purposes of computing the RIC's investment company taxable income (sec. 852(b)) and the RIC's earnings and profits (sec. 852(c)).[43]

Marketable stock not directly owned by a U.S. person.—In the case of a controlled foreign corporation (including a passive foreign corporation that is treated under the bill as a controlled foreign corporation) that owns or is treated as owning stock in a passive foreign corporation, the mark-to-market method generally is applied as if the controlled foreign corporation were a U.S. person. The source of mark-to-market income or loss is determined by reference to the actual (foreign) residence of the controlled foreign corporation.

For purposes of the mark-to-market method, any stock in a passive foreign corporation that is owned, directly or indirectly, by or for a foreign partnership or foreign trust or foreign estate is treated as if it were owned proportionately by its partners or beneficiaries, except as provided in regulations.[44] Stock in a passive foreign corporation that is thus treated as owned by a person is treated as actually owned by that person for the purpose of applying the constructive ownership rule at another level. In the case of a U.S. person who is treated as owning stock in a passive foreign corporation by application of this constructive ownership rule, any disposition by the U.S. person or by any other person that results in the U.S. person being treated as no longer owning the stock in the passive foreign corporation, as well as any disposition by the person actually owning the stock of the passive foreign corporation, is treated under the bill as a disposition by the U.S. person of stock in the passive foreign corporation.

Transition to mark-to-market.—The bill provides certain transition rules for PFC stock that becomes subject to the mark-to-market method—that is, generally, marketable PFC stock with respect to which current inclusion rules do not apply. One method applies in general, another applies to PFC stock held by regulated investment companies, and a third method applies to PFC stock held by individuals who become subject to U.S. tax jurisdiction as the result of a change in residence or citizenship.

(1) The general rule applies in the case of marketable stock in a PFC that is held by the shareholder on the effective date of the bill, where the PFC was also a PFIC under present law but was not a qualified electing fund with respect to the shareholder for all post-1986 years in the taxpayer's holding period. Under this general rule, tax is imposed under the bill's mark-to-market rule on the amount of mark-to-market gain representing the stock's apprecia-

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[43] Similar rules apply under present law for currency gains of RICs (secs. 4982(e)(5), 852(b)(8), and 852(c)(2)).

[44] For this purpose, it is intended that proportionate ownership will take into account any special or discretionary allocations of the distributions or gains with respect to stock in the passive foreign corporation.

tion (if any) in the first post-effective date year. In addition, if the stock has not depreciated in the first post-effective date year, tax may be imposed on the full amount of mark-to-market gain representing the stock's appreciation prior to the effective date, as if the stock had been sold at the end of the last pre-effective-date year and taxed subject to present law's interest-charge method.

If on the other hand the stock has not appreciated during the first post-effective date year, tax is imposed only on the amount of the net mark-to-market gain representing the stock's appreciation between the beginning of the taxpayer's holding period and the last day of the first post-effective date year. In either case, the difference between the fair market value of the PFC stock at the close of the first taxable year under the bill and the shareholder's adjusted basis in the PFC stock, less the amount of that difference (if any) that represents appreciation during that first taxable year, is treated pursuant to the interest-charge method as having accrued ratably over the shareholder's holding period (ending prior to that first taxable year) in the stock of the PFC.

Both the amount of pre-effective-date appreciation included in gross income (in this case, generally the portion of appreciation treated as having accrued before 1987), and the amount excluded from gross income (but subject to the "deferred tax amount" under the interest-charge method) are treated as an unreversed inclusion for purposes of the application of the mark-to-market method in future years.

In addition, the bill provides an election to defer the payment of tax (similar to the election for qualified electing funds to defer the payment of tax under present law's section 1294) imposed as a result of the recognition of the pre-effective-date gain. Under the bill, this election is treated as terminated to the extent a future mark-to-market loss deduction is allocable to the unreversed inclusion for pre-effective-date appreciation. This election is also terminated to the extent of any distribution received by the shareholder that would be an excess distribution under the interest-charge rules if those rules applied to the stock. In either case, the bill contemplates that regulations will provide rules for determining the appropriate proportion of the deferred tax for which the extension will terminate. As under present law, any direct or indirect loan by the PFC to the shareholder is treated as a distribution for purposes of determining the extent to which the extension remains in effect. Also, the extension generally is terminated upon disposition of the PFC stock. To the extent provided in regulations, however, a disposition of PFC stock in a nonrecognition transaction does not terminate the extension; rather, the person acquiring the PFC stock succeeds to the transferor's treatment of the PFC stock under the mark-to-market rules.

(2) Regulated investment companies are subject to a special transition rule for the PFC stock they hold on the bill's effective date. Instead of applying the interest-charge method to the amount of pre-effective-date appreciation, RICs include the full amount of pre-effective-date appreciation under the mark-to-market method, and pay a separate nondeductible interest charge. No election to defer the payment of tax is available.

(3) In the case of a shareholder of a PFC with marketable stock who becomes subject to the tax jurisdiction of the United States as a result of a change in residence or citizenship, no U.S. tax applies under the mark-to-market method or under the interest-charge method to the appreciation of the stock's value prior to the time that the shareholder becomes subject to the tax jurisdiction of the United States. The bill implements this rule by treating the greater of (i) the fair market value of the PFC stock at the time that the shareholder enters U.S. tax jurisdiction, or (ii) the shareholder's basis in the PFC stock, as the shareholder's basis in the PFC stock solely for purposes of the mark-to-market method.

Interest-charge method

Nonelecting shareholders [45] of a PFC with stock that is not marketable are subject to the interest-charge method, based on the PFIC interest-charge method that is currently provided in Code section 1291, with certain modifications.

First, although allowable foreign tax credits may reduce a U.S. person's net U.S. tax liability on an excess distribution, the interest charge computed on that excess distribution is computed, under the bill, without regard to reductions in net U.S. tax liability on account of direct foreign tax credits.

The PFIC provisions of present law, to the extent provided in regulations, impose recognition of gain in the case of a transfer of interest-charge PFIC stock in a transaction that would otherwise qualify for the nonrecognition provisions of the Code. The bill imposes that result as a general rule, except as otherwise provided in Treasury regulations. It is anticipated that under those regulations, nonrecognition provisions may apply to the gain, but only to the extent that the transferee will be subject to the interest-charge method on a subsequent distribution by the PFC or disposition of the PFC stock.

In addition, the bill requires that proper adjustment be made to the basis of property, held by the U.S. person, through which the U.S. person is treated as owning stock in the passive foreign corporation.

The PFIC provisions of present law apply rules for the attribution of ownership of PFIC stock to U.S. persons, including a rule that attributes PFIC stock owned by a corporation to any person who owns, directly or indirectly, 50 percent or more of the value of the stock of the corporation. Under the bill, the 50-percent threshold applies not only to stock owned directly or indirectly, but also to stock treated as owned by application of the family attribution rules of the personal holding company provisions (sec. 544 (c)(2)).

The PFIC provisions of present law provide special rules for the application of the interest-charge method in the case of PFIC stock held by an U.S. person through an intermediary entity. These rules describe the dispositions that are treated as dispositions of PFIC stock by the U.S. person, and include rules to eliminate the possibility of double taxation (sec. 1297(b)(5)). The bill clarifies that, under regulations, these rules apply to any transaction that results

[45] All citizens (and residents) of the United States are included, irrespective of residence in a U.S. commonwealth or possession.

in the U.S. person being treated as no longer owning the PFC stock, as well as any disposition of the PFC stock by the entity actually owning the PFC stock. These rules apply regardless of whether the transaction involves a disposition of the PFC stock, and regardless of whether the parties to the transaction include the U.S. person, the entity actually owning the PFC stock, or some other entity. For example, these rules apply to the issuance of additional stock by an intermediary corporation to an unrelated party in a case where, by increasing the total outstanding stock of the intermediary corporation, the transaction causes the U.S. person to fall below the ownership threshold for indirect ownership of the PFC stock. The bill also clarifies that an income inclusion under the interest-charge method takes precedence over an income inclusion under subpart F resulting from the same disposition. The second clarification ensures that the interest charge is imposed without regard to the structure of the transaction.

Under the bill, the interest-charge method applies to any stock in a passive foreign corporation unless either the stock is marketable (and therefore the mark-to-market method applies) as of the time of the distribution or disposition involved, or the stock in the passive foreign corporation was subject to the current inclusion method (under the bill or under prior law) for each taxable year beginning after December 31, 1986 which includes any portion of the taxpayer's holding period in the PFC stock. In the event that PFC stock, not subject to the current inclusion method, becomes marketable during the taxpayer's holding period, the interest-charge method applies to any distributions and dispositions during the year in which the stock becomes marketable, as well as to the mark-to-market gain (if any) as of the close of that year. In the event that PFC stock was initially marketable, and later becomes unmarketable and subject to the interest-charge method, the taxpayer's holding period in the PFC stock for purposes of the interest-charge method is treated as beginning on the first day of the first taxable year beginning after the last taxable year for which the mark-to-market method applies to the taxpayer's stock in the PFC.

Under the bill, as under the present-law PFIC rules, stock in a foreign corporation generally is treated as PFC stock if, at any time during the taxpayer's holding period of that stock, the foreign corporation (or any predecessor) is a passive foreign corporation subject to the interest-charge method (current sec. 1297(b)(1)). (This rule is sometimes referred to as the "once-a-PFIC-always-a-PFIC" rule.) Under present law this rule generally does not affect a taxpayer holding stock in a foreign corporation if at all times during the holding period of the taxpayer with respect to the stock when the foreign corporation (or any predecessor) is a PFIC, qualified electing fund treatment applies with respect to the taxpayer. Under the bill, the similar once-a-PFC-always-a-PFC rule does not apply if during the taxpayer's entire holding period with respect to the stock when the foreign corporation (or any predecessor) is a PFC, either (a) mark-to-market treatment applies, (b) mandatory current inclusion of income applies (either because the corporation is U.S. controlled or because the taxpayer is a 25-percent share-

holder), or (c) elective current inclusion of income applies.[46] Thus, for example, the once-a-PFC-always-a-PFC rule is not implicated by any year for which a PFC is also a controlled foreign corporation.

The bill also provides for full basis adjustment for partnerships and S corporations that own stock in a passive foreign corporation subject to the interest-charge method. Although tax is imposed on a distribution or disposition under the interest-charge method without including the distribution or disposition in gross income, thus precluding the natural basis adjustments for amounts included in gross income, the bill grants regulatory authority for appropriate basis adjustments to partnerships and S corporations based on the amount of income subject to tax under the interest-charge method and thereby excluded from gross income.

The bill includes a broad grant of regulatory authority, as does the present-law PFIC statute. In addition, the bill specifies that necessary or appropriate regulations under the PFC rules may include regulations providing that gross income should be determined without regard to the operation of the interest-charge method for such purposes as may be specified in the regulations. Such regulations may relieve pressure on many aspects of the Code that result from the operation of the interest-charge method other than through gross income. In addition, the bill specifies that necessary or appropriate PFC regulations may include regulations dealing with changes in residence status or citizenship by shareholders in passive foreign corporations (e.g., a resident alien becoming a nonresident, or a nonresident U.S. citizen renouncing U.S. citizenship). It is intended that no inference be drawn from this explicit regulatory authority as to the Secretary's authority to issue similar regulations under the authority of the PFIC provisions of present law.

Modification or repeal of other antideferral regimes

The bill repeals the foreign personal holding company provisions, the PFIC provisions (except as modified and preserved as the passive foreign corporation provisions), and the foreign investment company provisions. The bill also excludes all foreign corporations from the application of the accumulated earnings tax and the personal holding company tax. It is understood that the purposes of all the anti-deferral regimes are adequately served by the passive foreign corporation provisions as set forth in the bill, in conjunction with the controlled foreign corporation provisions as modified by the bill.

In addition, the bill denies installment sales treatment for any installment obligation arising out of a sale of stock in a passive foreign corporation that is subject to the interest-charge regime.

As a conforming amendment to the special rules applicable to RICs holding PFC stock, the bill confirms that the income of a RIC

[46] In the case of a PFC that was a PFIC prior to the effective date of the bill, even if the PFC is subject to either mark-to-market treatment or mandatory current inclusion, the once-a-PFC-always-a-PFC rule applies unless the PFIC was subject to elective current inclusion for the entire portion of the taxpayer's holding period prior to the effective date of the bill. In the case of a PFC that was *not* a PFIC prior to the effective date of the bill, the application of the once-a-PFC-always-a-PFC rule is determined without regard to the portion of the taxpayer's holding period prior to the effective date of the bill.

from either a controlled foreign corporation or a PFC, which income is derived from the active conduct of the business of investing in stocks or securities, is a type of income that counts toward meeting the 90-percent investment income test of section 851(b)(2).

In addition, as a conforming amendment to the elimination of the present-law PFIC rules, distributions from a PFC of amounts that previously were included in a shareholder's income under the elective current-inclusion rules of present law are treated, under the bill, as previously taxed income under the subpart F rules (sec. 959).

Effective Date

The bill generally is effective for taxable years of U.S. persons beginning after December 31, 1992, and taxable years of foreign corporations ending with or within such taxable years of U.S. persons.

The denial of installment sales treatment is effective for sales or dispositions after December 31, 1992.

The bill does not affect the determination of the basis of any stock that was acquired from a decedent in a taxable year beginning before January 1, 1993.

Subtitle B. Treatment of Controlled Foreign Corporations (secs. 511-514 of the bill and secs. 902, 951, 952, 959, 960, 961, 964, and 1248 of the Code)

Present Law

Treatment of controlled foreign corporation earnings

In general

A U.S. shareholder generally treats dividends from a controlled foreign corporation as ordinary income from foreign sources that carries both direct and indirect foreign tax credits. Under look-through rules, the income and credits are subject to those foreign tax credit limitations which are consistent with the character of the income of the foreign corporation.

Several Code provisions result in similar tax treatment of a U.S. shareholder if it either disposes of the controlled foreign corporation stock, or the controlled foreign corporation realizes certain types of income (including income with respect to lower-tier controlled foreign corporations). First, under section 1248, gain resulting from the disposition by a U.S. person of stock in a foreign corporation that was a controlled foreign corporation with respect to which the U.S. person was a U.S. shareholder in the previous five years is treated as a dividend to the extent of allocable earnings.

Second, a controlled foreign corporation has subpart F income when it realizes gain on disposition of stock and, ordinarily, when it receives a dividend. Under sections 951 and 960, such subpart F income may result in taxation to the U.S. shareholder similar (but not identical) to that on a dividend from the controlled foreign corporation. In addition to provisions for characterizing income and

credits in these situations, the Code also provides certain rules that adjust basis, or otherwise result in modifying the tax consequences of subsequent income, to account for these and other subpart F income inclusions.

Third, when in exchange for property any corporation (including a controlled foreign corporation) acquires stock in another corporation (including a controlled foreign corporation) controlled by the same persons that control the acquiring corporation, earnings of the acquiring corporation (and possibly the acquired corporation) may be treated under section 304 as having been distributed as a dividend to the seller.

For foreign tax credit separate limitation purposes, a controlled foreign corporation is not treated as a noncontrolled section 902 corporation with respect to any distribution out of its earnings and profits for periods during which it was a controlled foreign corporation and except as provided in regulations, the recipient of the distribution was a U.S. shareholder in such corporation. The consequence of not being treated as a section 902 corporation is application of the so-called "look-through" rule. That is, dividends paid by such controlled foreign corporation to its U.S. shareholder are characterized for separate limitation purposes by reference to the character of the underlying earnings of the controlled foreign corporation.

Lower-tier controlled foreign corporations

For purposes of applying the separate foreign tax credit limitations, receipt of a dividend from a lower-tier controlled foreign corporation by an upper-tier controlled foreign corporation may result in a subpart F income inclusion for the U.S. shareholder that is treated as income in the same limitation category as the income of the lower-tier controlled foreign corporation. The income inclusion of the U.S. shareholder may carry deemed-paid credits for foreign taxes paid by the lower-tier controlled foreign corporation, and the basis of the U.S. shareholder in the stock of the first-tier controlled foreign corporation is increased by the amount of the inclusion. If, on the other hand, the upper-tier controlled foreign corporation sells stock of a lower-tier controlled foreign corporation, then the gain generally is also included in the income of the U.S. shareholder as subpart F income and the U.S. shareholder's basis in the stock of the first-tier controlled foreign corporation is increased to account for the inclusion, but the inclusion is not treated for foreign tax credit limitation purposes by reference to the nature of the income of the lower-tier controlled foreign corporation. Instead it generally is treated as passive income.

If subpart F income of a lower-tier controlled foreign corporation is included in the gross income of a U.S. shareholder, no provision of present law allows adjustment of the basis of the upper-tier controlled foreign corporation's stock in the lower-tier controlled foreign corporation.

Subpart F inclusions in year of disposition

The subpart F income earned by a foreign corporation during its taxable year is taxed to the persons who are U.S. shareholders of the corporation on the last day, in that year, on which the corpora-

tion is a controlled foreign corporation. In the case of a U.S. shareholder who acquired stock in a controlled foreign corporation during the year, such inclusions are reduced by all or a portion of the amount of dividends paid in that year by the foreign corporation to any person other than the acquirer with respect to that stock. The reduction is the lesser of the amount of dividends with respect to such stock received by other persons during the year or the amount determined by multiplying the subpart F income for the year by the proportion of the year during which the acquiring shareholder did not own the stock.

Distributions of previously taxed income

If in a year after the year of a subpart F income inclusion, a U.S. shareholder in the controlled foreign corporation receives a distribution from the corporation, the distribution may be deemed to come first out of the corporation's previously taxed income and, therefore, may be excluded from the U.S. shareholder's income. However, a distribution by a foreign corporation to a domestic corporation of earnings and profits previously taxed under subpart F is treated as an actual dividend, solely for purposes of determining the indirect foreign tax credit available to the domestic corporation (sec. 960(a)(3)).

In addition, the domestic corporation is permitted to increase its foreign tax credit limitation in the year of the distribution of previously taxed earnings and profits in an amount equal to the excess of the amount by which its foreign tax credit limitation for the year of the subpart F inclusion was increased as a result of that inclusion, over the amount of foreign taxes which were allowable as a credit in that year and which would not have been so allowable but for the subpart F inclusion (sec. 960(b)). The increase in the foreign tax credit limitation may not, however, exceed the amount of the foreign taxes taken into account under this provision with respect to the distribution of previously taxed earnings and profits. In order for this rule to apply, the domestic corporation either must have elected to credit foreign taxes in the year of the subpart F inclusion or must not have paid or accrued any foreign taxes in such year, and it must elect the foreign tax credit in the year of the distribution of previously taxed earnings and profits.

Treatment of United States source income earned by a controlled foreign corporation

As a general rule, subpart F income does not include income earned from sources within the United States if the income is effectively connected with the conduct of a U.S. trade or business by the controlled foreign corporation. This general rule does not apply, however, if the income is exempt from, or subject to a reduced rate of, U.S. tax pursuant to a provision of a U.S. treaty.

Indirect foreign tax credits

A U.S. corporation owning at least 10 percent of the voting stock of a foreign corporation is treated as if it had paid a share of the foreign income taxes paid by the foreign corporation in the year in which the foreign corporation's earnings and profits become subject to U.S. tax as dividend income of the U.S. shareholder (sec. 902(a)).

A U.S. corporation may also be deemed to have paid taxes paid by a second- or third-tier foreign corporation. That is, where a first-tier foreign corporation pays a dividend to a 10-percent-or-more U.S. corporate shareholder, then for purposes of deeming the U.S. corporation to have paid foreign tax, the first-tier foreign corporation may be deemed to have paid a share of the foreign taxes paid by a second-tier foreign corporation of which the first-tier foreign corporation owns at least 10 percent of the voting stock, and from which the first-tier foreign corporation received dividends. The same principle applies to dividends from a second-tier or third-tier foreign corporation. No taxes paid by a second- or third-tier foreign corporation are deemed paid by the first- or second-tier foreign corporation, respectively, unless the product of the percentage ownership of voting stock at each level from the U.S. corporation down equals at least 5 percent (sec. 902(b)). Under present law, foreign taxes paid below the third tier of foreign corporations are not eligible for the indirect foreign tax credit.

An indirect foreign tax credit generally is also available to a U.S. corporate shareholder meeting the requisite ownership threshold with respect to inclusions of subpart F income from controlled foreign corporations (sec. 960(a)).[47] Moreover, an indirect foreign tax credit may also be available to U.S. corporate shareholders with respect to inclusions of income from passive foreign investment companies.

Explanation of Provisions

In general

The bill makes a number of modifications in the treatment of income derived from the disposition of stock in a controlled foreign corporation. The bill provides deemed dividend treatment for gains on dispositions of lower-tier controlled foreign corporations. Where the lower-tier controlled foreign corporation previously earned subpart F income, the bill permits the amount of gain taxed to the U.S. shareholder to be adjusted for previous income inclusions. Where proceeds from the sale of stock to a controlled foreign corporation that previously has earned subpart F income would be treated as a dividend under the principles of section 304, the bill expressly permits exclusion of the deemed section 304 dividend from taxation to the extent of the previously taxed earnings and profits of the controlled foreign corporation from which the property was deemed to be distributed. (Appropriate basis adjustments also are permitted to be made.) Where a controlled foreign corporation (whether or not it is a lower-tier controlled foreign corporation) earns subpart F income in a year in which a U.S. shareholder sells its stock in a transaction that does not result in the foreign corporation ceasing to be a controlled foreign corporation, the bill contains statutory language providing for a proportional reduction in the taxation of the subpart F income in that year to the acquiring U.S. shareholder.

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[47] Unlike the indirect foreign tax credit for actual dividend distributions, the indirect credit for subpart F inclusions can be available to individual shareholders in certain circumstances if an election is made (sec. 962).

The bill contains four additional provisions related to controlled foreign corporations. First, the bill repeals the limitation on look-through treatment (for foreign tax credit separate limitation purposes) of dividends from controlled foreign corporations to U.S. shareholders out of earnings from periods in which the payor was a controlled foreign corporation, but the dividend recipient was not a U.S. shareholder of the controlled foreign corporation. Second, the bill provides regulatory authority to develop a simplified mechanism for computing indirect foreign tax credits and increases in foreign tax credit limitations resulting upon certain distributions by controlled foreign corporations of previously taxed earnings and profits. Third, the bill clarifies the effect of a treaty exemption or reduction of the branch profits tax on the determination of subpart F income. Fourth, the bill extends application of the indirect foreign tax credit to fourth-, fifth-, and sixth-tier controlled foreign corporations where the necessary ownership thresholds (as extended under the bill to these tiers) are satisfied.

Lower-tier controlled foreign corporations

Characterization of gain on stock disposition

The bill provides that if a controlled foreign corporation is treated as having gain from the sale or exchange of stock in a foreign corporation, the gain is treated as a dividend to the same extent that it would have been so treated under section 1248 if the controlled foreign corporation were a U.S. person. This provision, however, does not affect the determination of whether the corporation whose stock is sold or exchanged is a controlled foreign corporation.

Thus, for example, if a U.S. corporation owns 100 percent of the stock a foreign corporation, which owns 100 percent of the stock of a second foreign corporation, then under the bill, any gain of the first corporation upon a sale or exchange of stock of the second corporation is treated as a dividend for purposes of subpart F income inclusions to the U.S. shareholder, to the extent of earnings and profits of the second corporation attributable to periods in which the first foreign corporation owned the stock of the second foreign corporation while the latter was a controlled foreign corporation with respect to the U.S. shareholder.

As another example, assume that the U.S. corporation has always owned 40 percent of the voting stock and 60 percent of the value of all of the stock of a foreign corporation, which has always owned 40 percent of the voting stock and 60 percent of the value of all of the stock of a second foreign corporation. All the other stock of the foreign corporations has always been owned by foreign individuals unrelated to the U.S. corporation. In this case, the second foreign corporation has never been a controlled foreign corporation. Therefore, none of the gain of the first corporation upon a sale of stock of the second corporation is treated as a dividend.

The bill provides that for purposes of this provision, a controlled foreign corporation is treated as having sold or exchanged stock if, under any provision of subtitle A of the Code, the controlled foreign corporation is treated as having gain from the sale or exchange of such stock. Thus, for example, if a controlled foreign cor-

poration distributes to its shareholder stock in a foreign corporation, and the distribution results in gain being recognized by the controlled foreign corporation under section 311(b) as if the stock were sold to the shareholder for fair market value, the bill makes clear that for purposes of this provision, the controlled foreign corporation is treated as having sold or exchanged the stock.

The bill also repeals a provision added to the Code by the Technical and Miscellaneous Revenue Act of 1988 [48] (the "1988 Act") which, except as provided by regulations, requires a recipient of a distribution from a controlled foreign corporation to have been a United States shareholder of that controlled foreign corporation for the period during which the earnings and profits which gave rise to the distribution were generated in order to avoid treating the distribution as one coming from a noncontrolled section 902 corporation. Thus, under the bill, a controlled foreign corporation is not treated as a noncontrolled section 902 corporation with respect to any distribution out of its earnings and profits for periods during which it was a controlled foreign corporation, whether or not the recipient of the distribution was a U.S. shareholder of the corporation when the earnings and profits giving rise to the distribution were generated.

Adjustments to basis of stock

The bill also provides that when a lower-tier controlled foreign corporation earns subpart F income, and stock in that corporation is later disposed of by an upper-tier controlled foreign corporation, the resulting income inclusion of the U.S. shareholders are, under regulations, adjusted to account for previous inclusions, in a manner similar to the adjustments currently provided to the basis of stock in a first-tier controlled foreign corporation. Thus, just as the basis of a U.S. shareholder in a first-tier controlled foreign corporation rises when subpart F income is earned and falls when previously taxed income is distributed, so as to avoid double taxation of the income on a later disposition, it is intended that by regulation the subpart F income from gain on the disposition of a lower-tier controlled foreign corporation generally would be reduced by income inclusions of earnings that were not subsequently distributed by the lower-tier controlled foreign corporation. It is intended that the Secretary will have sufficient flexibility in promulgating regulations under this provision to permit adjustments only in those cases where, by virtue of the historical ownership structure of the corporations involved, the Secretary is satisfied that the inclusions for which adjustments can be made can be clearly identified.

For example, assume that a U.S person is the owner of all of the stock of a first-tier controlled foreign corporation which, in turn, is the sole shareholder of a second-tier controlled foreign corporation. In year 1, the second-tier controlled foreign corporation earns $100 of subpart F income which is included in the U.S. person's gross income for that year. In year 2, the first-tier controlled foreign corporation disposes of the second-tier controlled foreign corporation's

[48] P.L. 100-647, sec. 1012(a)(10).

stock and recognizes $300 of income with respect to the disposition. All of that income would constitute subpart F income. Under the bill, the Secretary is granted regulatory authority to reduce the U.S. person's year 2 subpart F inclusion by $100—the amount of year 1 subpart F income of the second-tier controlled foreign corporation that was included, in that year, in the U.S. person's gross income. Such an adjustment would, in effect, allow for a step-up in the basis of the stock of the second-tier controlled foreign corporation to the extent of its subpart F income previously included in the U.S. person's gross income.

As another example, assume the same facts as in the preceding paragraph except that in year 2, the first-tier controlled foreign corporation distributes the stock of the second-tier controlled foreign corporation to the U.S. person. Assume that as a result of the distribution, the first-tier controlled foreign corporation recognizes taxable income of $300 under section 311(b). This income represents subpart F income, $100 of which is due to no adjustment having been made to the basis of the second-tier controlled foreign corporation's stock for its year 1 subpart F income. The bill contemplates that in such a situation, the $300 of subpart F income would be reduced under regulations to $200 to account for the year 1 subpart F income inclusion.

Subpart F inclusions in year of disposition

If a U.S. shareholder acquires the stock of a controlled foreign corporation from another U.S. shareholder during a taxable year of the controlled foreign corporation in which it earns subpart F income, the bill reduces the acquirer's subpart F inclusion for that year by a portion of the amount of the dividend deemed (under sec. 1248) to be received by the transferor. The portion by which the inclusion is reduced (as is currently the case if a dividend was paid to the previous owner of the stock) would not exceed the lesser of the amount of dividends with respect to such stock deemed received (under sec. 1248) by other persons during the year or the amount determined by multiplying the subpart F income for the year by the proportion of the year during which the acquiring shareholder did not own the stock.

Avoiding double inclusions in other cases

The bill clarifies the appropriate scope of regulatory authority with respect to the treatment of cross-chain section 304 dividends out of the earnings of controlled foreign corporations that were previously included in the income of a U.S. shareholder under subpart F. The bill contemplates that in such a case, the Secretary in his discretion may by regulation treat such dividends as distributions of previously taxed income, with appropriate basis adjustments. It is also anticipated that other occasions may arise where the exercise of similar regulatory authority may be appropriate to avoid double income inclusions, or an inclusion or exclusion of income without a corresponding basis adjustment. Therefore, the bill states that, in addition to cases involving section 304, the Secretary may by regulation modify the application of subpart F in any other case where there would otherwise be a multiple inclusion of any item of income (or an inclusion or exclusion without an appro-

priate basis adjustment) by reason of the structure of a U.S. shareholder's holdings in controlled foreign corporations or by reason of other circumstances. The bill is not intended to create any inference as to the application of present law in these cases.

Foreign tax credit in year of receipt of previously taxed income

With respect to the present-law provisions which permit a foreign tax credit to be claimed in the case of a distribution of previously taxed income, the bill provides authority for Treasury regulations to establish a simplified method for computing the increase in foreign tax credit limitation that results from the application of these provisions. It is understood that the Secretary has regulatory flexibility in the determination of the amount of creditable foreign taxes on or with respect to the accumulated earnings and profits of a foreign corporation from which a distribution of previously taxed income is made, which were not deemed paid by the domestic corporation in a prior taxable year.

The bill makes clear that the regulations may require taxpayers to use any simplified methods so established, rather than making the use of such methods elective by taxpayers. The bill does not mandate, however, that regulations provide such simplified methods, or in the case that such methods are provided, that they be made uniformly applicable to all taxpayers.

For example, in certain situations the Treasury Secretary might deem it appropriate not to require taxpayers to trace specific items of previously taxed income of specific controlled foreign corporations and to associate those items with specific amounts of excess foreign tax credit limitation. Rather, regulations might allow for some sort of simplified approach for accounting for excess limitation amounts (allocated to the various foreign tax credit separate limitation categories from which they originally arose) and for utilization of portions of these amounts upon distributions of previously taxed income from the same categories.

Treatment of United States income earned by a controlled foreign corporation

The bill provides that an exemption or reduction by treaty of the branch profits tax that would be imposed under section 884 on a controlled foreign corporation does not affect the general statutory exemption from subpart F income that is granted for U.S. source effectively connected income. For example, assume a controlled foreign corporation earns income that generally would be subpart F income, and that income is earned from sources within the United States in connection with business operations therein. Further assume that repatriation of that income is exempted from the U.S. branch profits tax under a provision of an applicable U.S. income tax treaty. The bill provides that, notwithstanding the treaty's effect on the branch tax, the income is not treated as subpart F income as long as it is not exempt from U.S. taxation (or subject to a reduced rate of tax) under any other treaty provision.

Indirect foreign tax credit

The bill extends the application of the indirect foreign tax credit (secs. 902 and 960) to certain taxes paid or accrued by certain

fourth-, fifth-, and sixth-tier foreign corporations. In general, three requirements must be satisfied by a foreign company at any of these tiers to qualify for the credit. First, the company must be a controlled foreign corporation. Second, the domestic corporation referred to in section 902(a) must be a U.S. shareholder (as defined in section 951(b)) with respect to the foreign company. Third, the product of the percentage ownership of voting stock at each level from the U.S. corporation down must equal at least 5 percent. The bill limits the application of the indirect foreign tax credit below the third tier to taxes paid or incurred in taxable years during which the payor is a controlled foreign corporation. No inference is intended as to the availability of indirect foreign tax credits, under present law, for taxes paid by foreign corporations in the first three tiers, for periods prior to the time when the present-law ownership requirements were met as to those corporations. All foreign taxes paid below the sixth tier of foreign corporations remain ineligible for the indirect foreign tax credit.

Effective Dates

Lower-tier controlled foreign corporations

The provision treating gains on dispositions of stock in lower-tier controlled foreign corporations as dividends under section 1248 principles applies to gains recognized on transactions occurring after date of enactment of the bill. The provision that expands look-through treatment, for foreign tax credit limitation purposes, of dividends from controlled foreign corporations is effective for distributions after the date of enactment.

The provision providing for regulatory adjustments to U.S. shareholder inclusions, with respect to gains of controlled foreign corporations from dispositions of stock in lower-tier controlled foreign corporations that previously had subpart F income, is effective for determining inclusions for taxable years of U.S. shareholders beginning after December 31, 1992. Thus, the bill permits regulatory adjustments to an inclusion occurring after the effective date to account for previous subpart F income inclusions occurring both prior to and subsequent to the effective date of the provision.

Subpart F inclusions in year of disposition

The provision permitting dispositions of stock to be taken into consideration in determining a U.S. shareholder's subpart F inclusion for a taxable year is effective with respect to dispositions occurring after the date of enactment.

Distributions of previously taxed income

The provision allowing the Secretary to make regulatory adjustments to avoid double inclusions in cases such as those to which section 304 applies takes effect on the date of enactment.

Foreign tax credit in year of receipt of previously taxed income

The provision granting regulatory authority to establish simplified methods for determining the amount of increase in foreign tax credit limitation resulting from a distribution of previously taxed income is effective on the date of enactment.

Treatment of United States source income earned by a controlled foreign corporation

The provision concerning the effect of treaty exemptions from or reductions of the branch profits tax on the determination of subpart F income is effective for taxable years beginning after December 31, 1986.

Indirect foreign tax credit

The provision which extends application of the indirect foreign tax credit to certain controlled foreign corporations below the third tier is effective for foreign taxes paid or incurred by controlled foreign corporations for taxable years of such corporations beginning after the date of enactment.

In the case of any chain of foreign corporations the taxes of which would be eligible for the indirect foreign tax credit, under present law or under the bill, but for the denial of indirect credits below the third or sixth tier, as the case may be, no liquidation, reorganization, or similar transaction in a taxable year beginning after the date of enactment shall have the effect of permitting taxes to be taken into account under the indirect foreign tax credit provisions of the Code which could not have been taken into account under those provisions but for such transaction. As one example, no such transaction shall have the effect of permitting credits for taxes which, but for such transaction, would have been noncreditable (given the effective date provisions of the bill) because they are taxes of a fourth-, fifth-, or sixth-tier corporation for a year beginning *before* the date that the bill is enacted. No inference is intended regarding the creditability or noncreditability of such taxes under present law.

Subtitle C. Other Provisions

1. Translation of foreign taxes into U.S. dollar amounts (sec. 521 of the bill and secs. 986(a) and 905(c) of the Code)

Present Law

Translation of foreign taxes

Foreign income taxes paid in foreign currencies are required to be translated into U.S. dollar amounts using the exchange rate as of the time such taxes are paid to the foreign country or U.S. possession (sec. 986(a)(1)). This rule applies equally to foreign taxes paid directly by U.S. taxpayers, which are creditable only in the year paid or accrued (or during a carryover period), and to foreign taxes paid by foreign corporations that are deemed paid by a U.S. corporation, and hence creditable, in the year that the U.S. corporation receives a dividend or income inclusion.

Redetermination of foreign taxes

For taxpayers who utilize the accrual basis of accounting for determining creditable foreign taxes, accrued and unpaid foreign tax liabilities denominated in foreign currencies are translated into U.S. dollar amounts at the exchange rate as of the last day of the

taxable year of accrual.[49] In certain cases where a difference exists between the dollar value of accrued foreign taxes and the dollar value of those taxes when paid, a redetermination (or adjustment) of foreign taxes is required.[50] Generally, such an adjustment may be attributable to one of three causes. One such cause would be a refund of foreign taxes. Second, a foreign tax redetermination may be required because the amount of foreign currency units actually paid differs from the amount of foreign currency units accrued. These first two cases generally give rise to a so-called "section 905(c) regular adjustment." Third, a redetermination may arise due to fluctuations in the value of the foreign currency relative to the dollar between the date of accrual and the date of payment giving rise to a so-called "section 905(c) translation adjustment."

As a general matter, a redetermination of foreign tax paid or accrued directly by a U.S. person requires notification of the Internal Revenue Service and a redetermination of U.S tax liability for the taxable year for which the foreign tax was claimed as a credit. Exceptions to this rule apply for de minimis amounts of foreign tax redeterminations.[51] In the case of redeterminations of foreign taxes that qualify for the deemed-paid foreign tax credit under sections 902 and 960, taxpayers generally are required to make appropriate adjustments to the pools of earnings and profits and foreign taxes.[52]

Explanation of Provision

In general

The bill sets forth two sets of operating rules for the translation of foreign taxes. The first set establishes new rules for the translation of certain accrued foreign taxes. The other set modifies the rules of present law for translating all other foreign taxes.

Translation of foreign taxes

Translation of certain accrued foreign taxes

With respect to taxpayers who take foreign income taxes into account when accrued for purposes of determining the foreign tax credit, the bill generally permits foreign taxes to be translated at the average exchange rate for the taxable year to which such taxes relate. If tax in excess of the accrued amount is actually paid, such excess amount would be translated using the exchange rate in effect as of the time of payment.

This set of rules does not apply (1) to taxpayers that are not on the accrual basis for determining creditable foreign taxes, (2) with respect to taxes of an accrual-basis taxpayer that are actually paid in a taxable year prior to the year to which they relate, or (3) to the extent provided in regulations, to tax payments denominated in a currency determined to be an inflationary currency in accordance with such regulations. It is intended that the Secretary will have discretion to define "inflationary" for this purpose so as to

[49] Temp. Treas. Reg. sec. 1.905-3T(b)(1).
[50] Temp. Treas. Reg. sec. 1.905-3T(c).
[51] Temp. Treas. Reg. sec. 1.905-3T(d)(1).
[52] Temp. Treas. Reg. sec. 1.905-3T(d)(2); Notice 90-26, 1990-1 C.B. 336.

take into account the particular need under this provision to avoid distortions in the computation of the foreign tax credit. In addition, as discussed in detail below, this set of rules does not apply to, and thus a redetermination of foreign tax is required for, any foreign income tax paid after the date two years after the close of the taxable year to which such taxes relate.

For example, assume that in year 1 a taxpayer accrues 1,000 units of foreign tax that relate to year 1. Further assume that as of the end of year 1 the tax is unpaid and the currency involved is not treated as inflationary by the Secretary for translation purposes. In this case, the provision provides that the taxpayer would translate 1,000 units of accrued foreign tax into U.S. dollars at the average exchange rate for year 1.[53] If the 1,000 units of tax were paid by the taxpayer in either year 2 or year 3, no redetermination of foreign tax would be required. If, any portion of the tax so accrued remained unpaid as of the end of year 3, however, the taxpayer would be required to redetermine its foreign tax accrued in year 1 to account for the accrued but unpaid tax.

As another example, assume a taxpayer accrues 1,000 units of foreign tax in year 2, but pays the tax in year 1. Also assume that the tax relates to year 2. In this case, the taxpayer would translate the tax using the exchange rate as of the time the tax is paid (i.e., using the applicable year 1 exchange rate) since the tax is paid in a year prior to the year to which it relates.

As an illustration of what is meant by the taxable year to which taxes relate, assume that a foreign corporation is charged by a foreign government with an income tax of 100 units for 1993. Assume that the currency involved is not treated as inflationary by the Secretary for translation purposes under the provision. Due to a contest between the foreign government and the corporation that ends in 1994, the 100 units of tax are not paid until 1994. Assume that under the U.S. rules governing accrual, the foreign tax accrues *for* 1993 but does not do so *until* 1994.[54] Under the bill, the taxes will be translated at the rate in effect for 1993, because the taxes relate to 1993, even though they did not accrue until 1994. If instead the contest was over, and the taxes were accrued and paid, in 1998, the translation rate used would be that of 1998, rather than 1993 because 1998 is more than 2 years after the end of 1993. Now assume that the contest was over in 1998, but the taxes were deposited in 1994 and not accrued until 1998. These taxes are paid before the beginning of the year in which the taxes were accrued (1998), but after the year to which the taxes relate (1993). Thus, under the bill, the taxes may be translated at the rate for the year (1993) to which the taxes relate. If the taxes are instead paid in 1996, under the provision they will be translated at the relevant rate for 1996 because 1996 is more than 2 years after the end of 1993.

Finally, assume that under foreign law, a foreign income tax liability accrues in 1998 under a long-term contract method of accounting, but advance deposits of that liability accruing in 1998 are made in each of the years 1993 through 1997. It is intended that if the payments in 1993 through 1997 are treated as relating to 1998,

[53] The same result would occur if the 1,000 units of tax were both accrued and paid in year 1.
[54] See, e.g., Rev. Rul. 84-125, 1984-2 C.B. 125.

these payments are nevertheless to be translated at the relevant rates for 1993 through 1997. Although the bill provides a rule for translation of the taxes in this case, no change is intended as to the application of present law accounting rules determining the year for which the taxes are eligible for credit or deduction for U.S. income tax purposes.

Translation of all other foreign taxes

Foreign taxes not eligible for application of the preceding rules generally are translated into U.S. dollars using the exchange rates as of the time such taxes are paid. The bill grants the Secretary of the Treasury authority to issue regulations that would allow foreign tax payments made by a foreign corporation or by a foreign branch of a U.S. person to be translated into U.S. dollar amounts using an average U.S. dollar exchange rate for a specified period. It is anticipated that the applicable average exchange rate would be the rate as published by a qualified source of exchange rate information for the period during which the tax payments were made.

Redetermination of foreign taxes

As revised by the bill, section 905(c) requires foreign tax redeterminations to occur in three cases: (1) if accrued taxes when paid (in foreign currency) differ from the amounts claimed (in foreign currency) as credits by the taxpayer, (2) if accrued taxes are not paid before the date two years after the close of the taxable year to which such taxes relate, and (3) if any tax paid is refunded in whole or in part. Thus, for example, the bill provides that if at the close of the second taxable year after the close of the accrual year any tax so accrued has not yet been paid, a foreign tax redetermination under section 905(c) is required for the amount of such unpaid tax. That is, the accrual of any tax that is unpaid as of that date would be retroactively denied. In cases where a redetermination is required, as under present law, the bill specifies that the taxpayer must notify the Secretary, who shall redetermine the amount of the tax for the year or years affected.

The bill provides that in the case of accrued taxes not paid within the date two years after the close of the taxable year to which such taxes relate, whether or not such taxes were previously accrued, any such taxes if subsequently paid are taken into account for the taxable year in which paid, and no redetermination with respect to the original year of accrual is required on account of such payment. In such a case, those taxes would be translated into U.S. dollar amounts using the exchange rates in effect for the period during which such taxes are paid. Nothing in the bill is intended to change present law as to the length of time after the year to which the redetermination relates within which redeterminations may be made or required.[55]

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[55] See sec. 6501(c)(5). See also, e.g., *Pacific Metals Corp. v. Commissioner*, 1 T.C. 1028 (1943); *Texas Co. (Caribbean) Ltd. v. Commissioner*, 12 T.C. 925 (1949).

Effective Date

The provision is effective for taxes paid (in the case of taxpayers using the cash basis for determining the foreign tax credit) or accrued (in the case of taxpayers using the accrual basis for determining the foreign tax credit) in taxable years beginning after December 31, 1992.

2. Foreign tax credit limitation under the alternative minimum tax (sec. 522 of the bill and sec. 59(a) of the Code)

Present Law

Computing foreign tax credit limitations requires the allocation and apportionment of deductions between items of foreign source and U.S. source income. Foreign tax credit limitations must be computed both for regular tax purposes and for purposes of the alternative minimum tax (AMT). Consequently, after allocating and apportioning deductions for regular tax foreign tax credit limitation purposes, additional allocations and apportionments generally must be performed in order to compute the AMT foreign tax credit limitation.

Explanation of Provision

The bill permits taxpayers to elect to use as their AMT foreign tax credit limitation fraction the ratio of foreign source *regular* taxable income to entire alternative minimum taxable income, rather than the ratio of foreign source *alternative minimum* taxable income to entire alternative minimum taxable income. Foreign source regular taxable income may be used, however, only to the extent it does not exceed entire alternative minimum taxable income.

The election under the bill is available only in the first taxable year beginning after December 31, 1992, for which the taxpayer claims an AMT foreign tax credit. A taxpayer will be treated, for this purpose, as claiming an AMT foreign tax credit for any taxable year for which the taxpayer chooses to have the benefits of the foreign tax credit, and in which the taxpayer is subject to the alternative minimum tax or would be subject to the alternative minimum tax but for the availability of the AMT foreign tax credit. The election applies to all subsequent taxable years, and may be revoked only with the permission of the Secretary of the Treasury.

Effective Date

The provision applies to taxable years beginning after December 31, 1992.

3. Inbound and outbound transfers (secs. 523 and 524 of the bill and secs. 367, 1057, and 1491-1494 of the Code)

Present Law

Outbound transfers

Corporate nonrecognition provisions

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 its shareholders. In 1932 Congress enacted an exception to the nonrecognition rules, which became section 367 of the 1954 Code, for the case where such an exchange involves a foreign corporation. The legislative history indicates that the exception was enacted in order to prevent tax avoidance that might have otherwise occurred upon the transfer of appreciated property outside U.S. tax jurisdiction.[56] Under that provision, in determining the extent to which gain (but not loss) was recognized in these exchanges, a foreign corporation was not considered a corporation unless it was established to the satisfaction of the IRS that the exchange was not in pursuance of a plan having as one of its principal purposes the avoidance of Federal income taxes.

The Code now provides that if a U.S. person transfers property to a foreign corporation in connection with certain corporate organizations, reorganizations, or liquidations, the foreign corporation will not, for purposes of determining the extent to which gain is recognized on such transfer, be considered to be a corporation (sec. 367(a)(1)). Various exceptions to the operation of this rule are provided, including a broad grant of authority to provide exceptions by regulation. The statutory language has changed substantially since 1932, but it has retained in large part its primary operative result—that of treating a foreign corporation as not a corporation. Since corporate status is essential to qualify for the tax-free organization, reorganization, and liquidation provisions, failure to satisfy the requirements of section 367 could result in the recognition of gain to the participant corporations and shareholders.

Excise tax on transfers to a foreign entity

At the same time that Congress enacted the original predecessor of current section 367, Congress also enacted an excise tax on outbound transfers that might not constitute income tax recognition events even after imposition of the anti-avoidance income tax rule adopted for corporate transactions. As in the case of the corporate nonrecognition override provision, the purpose of the excise tax was to check transfers of property in which there was a large appreciation in value to foreign entities for the purpose of avoidance of taxes on capital gains.[57] Therefore, as in the case of the corporate provision, the excise tax generally has been imposed only in certain cases where it has been believed necessary or appropriate to preserve U.S. tax on appreciated assets.

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[56] H. Rep. No. 708, 72d Cong., 1st Sess. 20 (1932).
[57] *Id.* at 52.

Under present law, the excise tax generally applies on transfers of property by a U.S. person to a foreign corporation—as paid-in surplus or as a contribution to capital—or to a foreign estate, trust, or partnership. The tax is 35 percent of the amount of gain inherent in the property transferred, but not recognized for income tax purposes at the time of the transfer (sec. 1491). For income tax purposes, the basis of the property whose appreciation and transfer triggers the tax is not increased to account for imposition of the tax.

The excise tax does not apply in certain cases where the transferee is exempt from U.S. tax under Code sections 501-505 (sec. 1492(1)). In addition, the excise tax does not apply in some cases where income tax rules governing outbound transfers apply, either by their terms or by the election of the taxpayer. Thus, the excise tax does not apply to a transfer described in section 367, or to a transfer not described in section 367 but with respect to which the taxpayer elects (before the transfer) the application of principles similar to the principles of section 367 (sec. 1492(2)).

In addition, a taxpayer may elect (under regulations prescribed by the Secretary) to treat a transfer described in section 1491 as a sale or exchange of the property transferred and to recognize as gain (but not loss) in the year of the transfer the excess of the fair market value of the property transferred over the adjusted basis (for determining gain) of the property in the hands of the transferor (sec. 1057; Treas. Reg. sec. 7.0). To the extent that gain is recognized pursuant to the election in the year of the transfer, the transfer is not subject to the excise tax, and the basis of the property in the hands of the transferee will be increased by the amount of gain received (sec. 1492(3)). The legislative history of the elective income recognition provision indicates that the making of an election which has as one of its principle purposes the avoidance of Federal income taxes is not permitted.[58]

The excise tax is due at the time of the transfer (sec. 1494(a)). Under regulations, the excise tax may be abated, remitted, or refunded if the taxpayer, after the transfer, elects the application of principles similar to the principles of section 367 (sec. 1494(b)).

Inbound corporate transfers

Although the legislative history of the 1932 Act indicated a concern with outbound transfers, the statutory standard for determining that a transaction did not have as one of its principal purposes tax avoidance evolved through administrative interpretation into a requirement that, in the case of transfers into the United States by a foreign corporation, tax-free treatment generally would be permitted only if the U.S. tax on accumulated earnings and profits was paid. For example, in 1968, the IRS issued guidelines (Rev. Proc. 68-23, 1968-1 C.B. 821) as to when favorable rulings "ordinarily" would be issued. As a condition of obtaining a favorable ruling with respect to certain transactions, the section 367 guidelines required the taxpayer to agree to include certain items in income (the amount to be included was called the section 367 toll charge).

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[58] Staff of the Joint Committee on Taxation, 94th Cong., 2d Sess., *General Explanation of the Tax Reform Act of 1976,* at 226 (1976).

For example, if the transaction involved the liquidation of a foreign corporation into a domestic parent corporation, a favorable ruling was issued if the domestic parent agreed to include in its income as a dividend for the taxable year in the which the liquidation occurred the portion of the accumulated earnings and profits of the foreign corporation which were properly attributable to the domestic corporation's stock interest in the foreign corporation (Rev. Proc. 68-23, sec. 3.01(1); see also sec. 3.03(1)(b)).

Absence of a toll charge on accumulated earnings of a foreign corporation upon liquidation or asset reorganization into a U.S. corporation clearly would permit avoidance of tax. For example, if a U.S. corporation owns 100 percent of the stock of a U.S. subsidiary, no tax is imposed either on a dividend from the subsidiary to the parent (sec. 243) or the liquidation of the subsidiary into the parent (secs. 332 and 337). In each case, the earnings of the subsidiary already have been subject to U.S. tax jurisdiction, and the liquidation provisions allow nonrecognition of gain inherent in appreciated property of the subsidiary. On the other hand, if a U.S. corporation owns 100 percent of the stock of a foreign subsidiary, earnings of the subsidiary generally are not subject to current U.S. tax. Instead, tax generally is imposed on a dividend from the subsidiary to the parent, net of creditable foreign taxes. If a liquidation of the subsidiary could be accomplished tax-free under the Code, U.S. tax on its earnings would be avoided; more generally, the parent would be able to succeed to the basis and other tax attributes of the foreign corporation without having subjected to U.S. tax jurisdiction the earnings that gave rise to those tax attributes.

Outbound transfers since the Tax Reform Act of 1976

For purposes of the transactions described above, section 367 (and its predecessors) remained largely unchanged between 1932 and 1976. In 1976, however, a number of problems caused Congress to revise section 367. One result of the 1976 revision was to separate the provision into 2 sets of rules: one set dealing with outbound transfers, where the statutory aim is to prevent the removal of appreciated assets or inventory from U.S. tax jurisdiction prior to their sale (sec. 367(a)), and the other set dealing with both transfers into the United States and those which are exclusively foreign (sec. 367(b)).

Section 367(b) now provides, in part, that in the case of certain exchanges in connection with which there is no transfer of property described in section 367(a)(1), a foreign corporation will be considered to be a corporation except to the extent provided in regulations which are necessary or appropriate to prevent the avoidance of Federal income taxes.

Although it is clear that absence of a toll charge on accumulated earnings of a foreign corporation upon liquidation or reorganization into a U.S. corporation leads to avoidance of tax, and Congress in 1976 noted without disapproval the adoption of IRS positions that would prevent the avoidance of tax in these cases,[59] neither

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[59] E.g., Staff of the Joint Committee on Taxation, 94th Cong., 2d Sess., *General Explanation of the Tax Reform Act of 1976,* at 264 (1976).

section 367(b) as revised in 1976, nor its predecessors, were drafted in such a way that directly causes tax to be imposed on foreign earnings.

For example, assume that a U.S. corporation owns 100 percent of the stock of a liquidating foreign corporation, and, pursuant to regulations under section 367(b), the foreign corporation is not treated as a corporation for purposes of section 332. In that case, the U.S. corporation would be required under the Code to recognize the difference between the basis and the value of its stock in the foreign corporation. That gain, however, may be more or less than the accumulated earnings of the foreign corporation attributable to the period when the U.S. corporation owned the stock of the foreign corporation.

Perhaps as a result, neither the present temporary regulations nor the recently proposed regulations under section 367(b) mandate a tax based on the accumulated earnings of a foreign corporation that liquidates or reorganizes into a U.S. corporation. The temporary regulations allow the taxpayer to elect treatment of the foreign corporation as a corporation if the tax on earnings is paid. If the taxpayer chooses not to make the election, the foreign corporation is not treated as a corporation under the relevant nonrecognition provision (e.g., sec. 332, 354), but *is* treated as a corporation for other purposes, such as for purposes of the basis rules (secs. 334, 358, 362), and carryover provisions (sec. 381) (Temp. Treas. Reg. secs. 7.367(b)-5(b) and 7.367(b)-7(c)(2)). The proposed regulations generally require that the foreign corporation be treated as a corporation, and permit the taxpayer to elect either to pay the tax on earnings, or to pay tax on the gain; but if the latter option is chosen, adjustments must be made to either net operating loss carryovers, capital loss carryovers, or asset bases (Proposed Treas. Reg. sec. 1.367(b)-3(b)(2)).

Explanation of Provisions

Outbound transfers

The bill repeals the excise tax on outbound transfers. In its place, the bill requires the full recognition of gain on a transfer of property by a U.S. person to a foreign corporation as paid-in surplus, or as a contribution to capital, or to a foreign estate, trust, or partnership. The Secretary may, however, in lieu of applying this full recognition rule, provide regulations under which principles similar to the principles of section 367 (modified, if necessary, as appropriate in light of the bill's other provisions) shall apply to any such transfer. Moreover, the Secretary may provide rules under which recognition of gain will not be triggered by section 1491 in cases where the Secretary is satisfied that application of other Code rules (such as those relating to partnerships or trusts) will prevent the avoidance of tax consistent with the purposes of the bill. Full recognition of gain can also be avoided in the case of a transfer described in section 367. The committee anticipates that prior to the promulgation of regulations, the Secretary generally will continue to permit taxpayers to elect the application of principles similar to the principles of section 367, provided the election is

made by the time for filing the income tax return for the taxable year of the transfer.

Inbound transfers

The bill provides that in the case of certain corporate organizations, reorganizations, and liquidations described in section 332, 351, 354, 355, 356, or 361 in which the status of a foreign corporation as a corporation is a condition for nonrecognition by a party to the transaction, income shall be recognized to the extent provided in regulations prescribed by the Secretary which are necessary or appropriate to prevent the avoidance of Federal income taxes. This provision is limited in its application, under the bill, so as not to apply to a transaction in which the foreign corporation is not treated as a corporation under section 367(a)(1). Thus, the bill permits the IRS to provide by regulations for recognition of income, without regard to the amount of gain that would be recognized in the absence of the relevant nonrecognition provision listed above. As under current law, such regulations will be subject to normal court review as to whether they are necessary or appropriate for the prevention of avoidance of Federal income taxes.

In addition, the bill clarifies that rules for income recognition under section 367(b) may also be applied in a case involving a transfer literally described in section 367(a)(1), where necessary or appropriate to prevent the avoidance of Federal income taxes.[60]

Effective Dates

The provision that amends the outbound rules and repeals the excise tax applies to transfers after date of enactment. The provision that amends section 367(b) applies to transfers after December 31, 1993.

[60] See Temp. Treas. Reg. sec. 7.367(b)-4(b); Proposed Treas. Reg. sec. 1.367(a)-3(a).

Title VI—Studies

Explanation of Provisions

The bill requires three Treasury studies relating to the competitiveness of the U.S. economy, value added taxes, and transfer pricing rules.

(1) International competitiveness (sec. 601 of the bill).—The Secretary of the Treasury is to conduct a study of tax issues relating to the maintenance and enhancement of the competitiveness of the American economy in light of changing economic policies in Europe and the increasing globalization of the world economy.

(2) Value added tax (sec. 602 of the bill).—The Secretary of the Treasury is to conduct a study of administrative and compliance issues related to a value added tax.

(3) Transfer pricing rules (sec. 603 of the bill).—The Secretary of the Treasury is to conduct a study of issues related to transfer pricing rules and the proper taxation of foreign persons doing business in the United States. The study is to include an examination of the effectiveness of provisions contained in the bill, issues related to the unitary method of taxation, and compliance issues including the advisability of providing additional confidentiality for information provided by domestic corporations for use in formulating third-party comparable information.

Effective Date

Treasury reports on these three studies are due by January 1, 1994. The reports are to be submitted to the House Committee on Ways and Means and the Senate Committee on Finance.

55-780 (104)