[COMMITTEE PRINT]

U.S. TAXATION OF FOREIGN SOURCE INCOME OF INDIVIDUALS AND CORPORATIONS AND THE DOMESTIC INTERNATIONAL SALES CORPORATION PROVISIONS

PREPARED FOR THE USE OF THE

COMMITTEE ON WAYS AND MEANS

BY THE STAFF OF THE

JOINT COMMITTEE ON INTERNAL REVENUE TAXATION

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I. AMENDMENTS PRIMARILY AFFECTING INDIVIDUALS

A. Repeal of Exclusion for Income Earned Abroad

1. Private Industry Employees

Present Law

U.S. citizens are generally taxed by the United States on their worldwide income, with the provision of a foreign tax credit for foreign taxes paid. However, U.S. citizens who are working abroad may exclude from their income up to $20,000 of earned income for periods during which they reside outside of the United States for 17 out of 18 months or during the period they are *bona fide* residents of foreign countries (sec. 911). In the case of individuals who have been *bona fide* residents of foreign countries for three years or more, the exclusion is increased to $25,000 of earned income. Currently approximately 100,000 U.S. citizens file returns excluding income from tax under this provision.

Issues

The exclusion of $20,000 (or $25,000) of income earned abroad provides a tax advantage to those U.S. citizens who live and work abroad compared with those who live and work in the United States. Moreover, in some cases the foreign governments in the country where U.S. citizens are employed do not impose income taxes on the U.S. citizens, particularly if the compensation is paid to a private employee outside of the foreign country (e.g., if the salary is sent to a bank outside of that country).

In those cases where a foreign tax is paid by the U.S. citizen, that tax is creditable directly against any U.S. tax that might otherwise exist (if the taxpayer otherwise itemizes his deductions) on income above the $20,000 or $25,000 excludable limits. This combination of an exclusion of $20,000 or $25,000 of income, plus the allowance of the full foreign tax credit attributable to all income (including the excluded income) gives taxpayers who do pay tax to foreign governments in effect a double benefit, in that they can offset the foreign taxes paid on the excluded income against any U.S. tax which may be due on additional income. The result is that in effect up to $40,000 or more of earned income can be exempted from U.S. tax if the U.S. employee pays any significant income tax to the foreign government (this is illustrated by table 1, on p. 5).

The exclusion of income earned abroad has frequently been justified by the argument that substantial cost of living differentials make it difficult to recruit U.S. individuals to work abroad without tax incentives. Although it is true that in many cases the cost of living for a U.S. citizen working abroad is higher than for many people working in the United States, that is by no means the general rule. State Department figures for 1973, for example, show that the costs of living in 1972 in 135 foreign cities having U.S. diplomatic posts were lower than the cost of living in Washington, D.C. In addition, the cost of living varies substantially among U.S. cities—for example, in 1973 Boston was 14 percent more expensive than Washington, D.C., while Atlanta was 17 percent less expensive. Despite this the tax law applies to the same extent to employees in all of these cities.

However, there are some expenses borne by those working abroad which are incurred to obtain services normally provided by State or local governmental agencies in the United States. The best example of this is schooling costs. In the United States the government would pay the cost of educating youngsters, but abroad a private school is often the only realistic alternative. Since in this case a cost is borne by a taxpayer which in the United States would be paid by the government, it might be appropriate to provide for some relief. These same arguments also apply to payments for other municipal type services (such as roads, parks, etc.) supplied by the employer for individuals working abroad.

It is felt by some persons that individuals working abroad are discriminated against because they are not allowed to deduct foreign value added or sales taxes. It should be noted, however, that Federal use taxes—which on some purchases are comparable—are not deductible. In addition, foreign local income taxes are allowed as a credit against U.S. tax while State and local income taxes paid in the United States are only deductible. Thus, considering the treatment of all foreign taxes it is difficult to argue that individuals working abroad are generally better off—or generally worse off—than those working in the United States; the result would vary depending on the extent to which a foreign country relies on value added or sales taxes rather than income taxes.

2. Federal Employees

Present Law

Section 912 excludes from gross income certain statutory allowances paid to civilian employees of the United States Government who work in foreign countries and, in certain instances, in the States of Hawaii and Alaska.[1]

While there are some minor variations in the coverage provided under the various Acts, there is some degree of uniformity in allowances authorized. The major categories of allowances are described below. As indicated below, some of these items are for payments which would be excluded from income, in whole or in part, under other provisions of the tax laws. Others are amounts for which the employee may be entitled to a deduction in computing taxable income.

Cost-of-Living Allowance (*Post Allowance*).—Using Washington, D.C., as a reference, additional cost-of-living expense allowances are provided to all U.S. Government civilians employed abroad. Moreover, permanently assigned U.S. Government civilians employed in Alaska and Hawaii and in Puerto Rico, the Virgin Islands and Guam are entitled to a cost-of-living allowance based on living costs and con-

[1] The Acts providing these allowances are: (1) title IX of the Foreign Service Act of 1946, as amended (22 U.S.C., sec. 1131 and following); (2) section 4 of the Central Intelligence Agency Act of 1949, as amended (50 U.S.C. sec. 403(e)); (3) title II of the Overseas Differentials and Allowances Act; (4) subsections (e) or (f) of the first section of the Administrative Expenses Act of 1946, as amended, and section 22 of such Act; (5) 5 U.S.C. sec. 5941 and (6) Peace Corps Act.

ditions, also using Washington, D.C., as a reference; this allowance is not to exceed 25 percent of the rate of basic pay involved.

Educational Allowance.—This allowance is intended to reimburse the employee for the additional tuition and education-related travel expenses of living abroad.

Temporary Lodging Allowance.—This allowance reimburses the employee for those temporary living expenses incurred while arranging for personal quarters at an overseas post. Expenses for this purpose, if not reimbursed, would in many cases be deductible.)

Living Quarters Allowance.—In many cases, the government provides housing to the employee and his family at no cost. In other instances, living quarter allowances are made to reimburse the employee for the cost of rent, electricity, gas, fuel, and water, and any taxes required to be paid by the employee.

Post Differential Allowance.—This allowance is intended to offset the hardship of serving in particularly dangerous or potentially unhealthy areas of the world. This allowance is not subject to the exclusion of section 912, and therefore it is subject to taxation.

Medical Allowances.—Generally, medical services are provided to the employee or officer and his dependents, and is without limitation if illness is caused by location abroad. (These amounts could often be excludible under other provisions of the code and if not, would generally be deductible to the extent they exceeded 3 percent of the employee's adjusted gross income.)

Travel and Transportation Allowances.—These allowances pertain to such expenses as transporting the employee and his family to and from his post of duty, and on home leave; transporting the employee and his family's effects to successive posts, including packing and storing; travel involved in rest and recuperation once every two years, or twice in three years when no home leave has been taken; and the importing of one motor vehicle each four years, if authorized. (Some of these expenses, if not reimbursed, would be deductible as moving expenses or possibly as business travel expenses.)

Representation Allowances.—These allowances are made in order to provide for the proper representation of the United States by officers or employees of the Foreign Service. An example of this would be an allowance for the entertainment expenses incurred by a Foreign Service officer. (Without the allowance, some of these expenses could be paid by the State Department, and other expenses might be deductible by the employee as business expenses.)

Other Allowances.—In certain cases, officers and employees may be provided with basic household furnishings and equipment for use on a loan basis in personally owned or leased residences. Special commissaries, eating, and recreation facilities are among other allowances or benefits provided these employees.

It is estimated that 100,000 U.S. citizen employees of the Government benefit under section 912. This total includes approximately 40,000 people employed in foreign countries (not including Peace Corps volunteers), an estimated 20,000 in territories and possessions, and 40,000 in Alaska and Hawaii. A recent GAO study [2] made a

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[2] Comptroller General of the United States, "Fundamental Changes Needed to Achieve a Uniform Government-wide Overseas Benefits and Allowances System for U.S. Employees", Sept. 9, 1974.

rough estimate of $500 million of funds obligated for these allowances and benefits. The revenue cost of the exemptions available under section 912 was estimated at $100 million.

Issues

The section 912 exclusion for allowances paid to U.S. Government employees serving abroad was added to the tax law in 1943 during World War II, when it was felt that relief was essential to government personnel stationed in foreign countries. During this time, government personnel stationed in foreign countries were faced with runaway inflation in these foreign countries. Having U.S. personnel in these overseas posts was viewed as a crucial part of the nation's war effort, and the Department of State indicated that it neither had the funds nor the authority to compensate its personnel for the extra tax burden resulting from the taxation of various allowances. Questions have been raised as to whether this exclusion, although perhaps appropriate or necessary during a major war, is appropriate during peacetime conditions.

While in many cases the cost of living and additional travel and educational expenses make total living costs for a U.S. employee working abroad higher than that of many U.S. citizens working in the United States, it should be observed that the cost of living varies greatly from area to area within the United States, and that the cost of living in some areas of the United States is significantly higher than in many areas abroad. In light of these wide variations, both within and without the United States, it is argued that the tax laws cannot, in practice, be fairly adjusted to take into account factors of this type.

One justification for the exclusion of overseas allowances is that they are not actually income to the recipient because they serve to reimburse him for expenses which would not otherwise be incurred, i.e., the expenses for which he is being provided allowances should be viewed as deductible employee business expenses. Of course, if section 912 were repealed, taxpayers who itemize their deductions would be able to take deductions for any legitimate business expenses they incurred. For example, as is described above, moving expenses (including temporary lodging) would be deductible, as would some travel and certain entertainment expenses.

The GAO study points out that inconsistencies exist in the rules under which allowances are granted by the various Federal agencies.[8] The section 912 exclusion tends to magnify these inconsistencies, since the exemption only benefits those employees who incur expenses which are reimbursable by the particular Federal agency employing them.

In addition, it is argued that if section 911 is repealed, section 912 would create an inequity between governmental and nongovernmental personnel abroad. In the committee's previous consideration of sections 911 and 912, it concluded that civilian employees of the Federal Government and private citizens working overseas should be treated equally under the tax laws. Although the benefits received under section 912 can vary greatly between employees, the table below indicates that, on the average, repeal of only section 911 would discriminate against nongovernmental foreign personnel.

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[8] For example, some agencies will reimburse employees for travel expenses for rest and recuperation, while others will not.

Table 1.—COMPARISON OF THE TAX BENEFITS TO PRIVATE EMPLOYEES AND GOVERNMENT EMPLOYEES WORKING ABROAD

	Civil servant employed abroad (including allowances)	Private citizen working abroad, foreign tax liability		
		None	Half U.S. rate	Equals U.S. rate
Ordinary taxable income	$40,000	$40,000	$40,000	$40,000
U.S. tax if no exclusion	12,000	12,000	12,000	12,000
Tax-free amount	[1] 10,000	20,000	20,000	20,000
Net taxable income	30,000	20,000	20,000	20,000
U.S. tax before foreign tax credit	8,000	4,400	4,400	4,400
Foreign tax	0	0	6,000	12,000
U.S. tax after foreign tax credit	8,000	4,400	0	0
U.S. tax saved by exclusion	4,000	7,600	6,000	0
Tax credit carryover resulting from exclusion	0	0	1,600	7,600

[1] Tax-free allowance for cost-of-living differentials, housing and education vary substantially with location, as well as to reflect income level and family size. The $10,000 figure is an approximation of the composite allowance for a married person with a family in the top civil service pay bracket working in the capital city of an industrial country. Two major exceptions are France ($18,000) and Canada ($5,000).

Note: Tax figures have been rounded.

It is argued that the allowances to which section 912 pertains cover increased living expenses, thereby enabling overseas employees to live at the same standard as they enjoyed in the United States, and that to tax these allowances only results in subjecting these employees to a lower standard of living. However, in many cases the allowances are provided for more than increased living costs. The GAO report indicates that in some cases the allowances not only compensate the employee for increased costs due to the foreign location, but also reimburse him for the entire cost involved. An example of this is State Department allowances providing for completely free housing.

Alternative Approaches

1974 committee bill.—Last year's bill provided that the exclusion from income under present law of $20,000 (or, in some cases, $25,000) for income earned abroad by U.S. citizens living or residing abroad is to be phased out over a four-year period. Also, the committee agreed to a similar four-year phaseout of the exclusion for allowances of government employees based abroad. In lieu of these exclusions, the committee agreed to a $1,200 deduction for tuition expenses of dependents of taxpayers employed outside the United States. Further, the committee agreed to an exclusion from gross income for municipal-type services furnished in a foreign country by an employer on a nondiscriminatory basis.

Mr. Ullman.—His proposal is the same as that in the 1974 committee bill except that he also provides that individuals claiming the standard deduction could also claim a foreign tax credit.

Mr. Pickle.—The proposal would limit the exclusion so that it would only apply to an individual for four years.

B. U.S. Taxpayers Married to Nonresident Aliens

Present Law

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

Issues

As a rule, a husband and wife find it desirable to file a joint return since it generally results in a lower aggregate tax liability than if they each filed separate returns of their own income and deductions. Taxpayers are encouraged to file joint returns due to the fact that it eliminates the administrative problems of otherwise having to allocate income and deductions between married taxpayers.

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

These disadvantages under the U.S. tax laws are, however, offset by a number of tax advantages for certain taxpayers. First, the foreign source income attributable to the nonresident alien spouse is not subject to any U.S. taxation. Second, if the marriage is subject to community property rules, one-half of the earned income of the taxable spouse is treated as being the income of the nonresident alien spouse and is not subject to U.S. taxation if it is from foreign sources.

The problems in this area are of particular concern to U.S. citizens living abroad who are married to nonresident alien individuals. If the committee repeals the earned income exclusion available to these taxpayers, the question of being able to file a joint return will be even of a greater concern. There are approximately 10,000 U.S. taxpayers who are married to nonresident alien individuals.

Alternative Approaches

Mr. Ullman proposes that a U.S. taxpayer married to a nonresident alien be allowed to file a joint return provided that an election is made by both taxpayers to be taxed on their worldwide income. Such an election could only be revoked in the case of divorce or separation. In addition, the community property laws would not be applied for income tax purposes in the case of a taxpayer married to a nonresident alien. A condition of the election would be that the husband and wife agree to supply all the necessary books and records.

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

Present Law

Under present law, the income of a trust is taxed basically in the same manner as the income of an individual, with limited exceptions (sec. 642). Just as nonresident alien individuals are generally taxed only on their U.S. source income other than capital gains and on their income effectively connected with a U.S. trade or business (and not on their foreign source income), so any trust which can qualify as being comparable to a nonresident alien individual is generally not taxed on its foreign source income. If a trust is taxed in a manner similar to nonresident alien individuals, it is considered (under sec. 7701(a)(31)) to be a foreign trust.[4]

Grantors (i.e., individuals who establish trusts) and other persons are treated as the owner of a trust under the grantor trust rules if they have certain powers or interests in the trust. These rules tax the income of those trusts to the grantor (see secs. 671 to 678) rather than to the trust and apply equally to foreign and domestic trusts. If a U.S. grantor establishes a foreign trust which comes within these provisions, the worldwide income of that trust is taxed by the United States to the grantor.

If a U.S. taxpayer is a beneficiary of a foreign trust, distributions to him are generally taxed in the same manner as are distributions to a beneficiary of a domestic trust. Any accumulation distributions are subject to throwback rules, under which the amount of tax to be paid by the beneficiary is determined by the tax bracket of the beneficiary in the year the trust originally earned the income rather than the year the income was distributed. However, in the case of an accumulation distribution by a foreign trust which was created by a U.S. person, any capital gains income earned by the trust is treated as distributed pro rata with other income (and taxed at favorable capital gains rates to the beneficiary) while in the case of these distributions by domestic trusts, capital gains income is treated as distributed only after all other income is distributed.

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

Issues

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

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

In recent years there has been a growing trend toward the establishment of foreign trusts in order for the grantor of the trust to obtain a tax-free accumulation of funds for his chosen beneficiaries. Little information is known about the value of assets held in foreign trusts, but some experts have concluded that $5 to $10 billion would not be an unreasonable estimate. This trend was accelerated by the introduction of legislative proposals to tax the earnings of foreign trusts to the grantor of the trust. This acceleration was based upon the belief that any new rules taxing the grantors of foreign trusts would not apply to trusts established prior to the enactment of the legislation. (Based upon this expectation, it has been said that one law firm established over 200 trusts for its clients.)

The proposals to tax foreign trusts have been criticized as being too harsh and covering cases where establishing a foreign trust is unrelated to tax avoidance, such as where a U.S. citizen who lives abroad establishes a trust for his children at his local bank. (Under the grantor trust rule proposed last year, such a U.S. citizen would have to establish the trust in the United States to avoid having the trust's income taxed to him.)

A further criticism of the grantor trust rule is that if individuals establishing foreign trusts relinquish all control over the funds placed in the trust, they will be required to pay tax on the income from funds over which they have no control. However, if the provision applies only to newly established trusts (as did last year's bill), any individual can avoid this result simply by choosing to establish all future trusts in the United States, rather than in a foreign jurisdiction. Furthermore, if a grantor decides to establish a foreign trust in the belief that the income will not be taxed to him (e.g., because the beneficiaries are not U.S. persons), he can avoid unexpected taxation by requiring in the trust agreement that the trust revert back to the grantor (or terminate with the proceeds going to beneficiaries) if the trust income would in any year be taxed to him.

Others have argued that the grantor trust rule is appropriate tax policy and should, in fact, be applied to existing foreign trusts as well as to newly established trusts. These individuals believe that the continuance of existing foreign trusts constitutes an abuse which should be corrected. Further, they believe that it may often be the case that grantors retain substantial powers over the foreign trusts and thus can alter or terminate the trusts if necessary to obtain funds to pay any income taxes.

In addition, it is argued that the grantor trust rule would have no effect on the establishment of foreign testamentary trusts (i.e., trusts established in a grantor's will) because these trusts do not take effect until the grantor dies. To solve this problem, it has been proposed that where the grantor of the foreign trust is no longer subject to U.S. taxation (by reason of death or any other reason), the beneficiaries of the trust who are U.S. persons should be taxed currently on their anticipated share of the trust's income. The committee bill adopted last year imposed an interest charge on the U.S. tax paid by U.S. beneficiaries on accumulation distributions from a foreign trust (in cases where the trust income was not taxed currently to a U.S. grantor). Such an interest charge would to some extent mitigate the problem resulting from not applying the grantor trust rule to testamentary trusts since, if the interest rate were substantial, the beneficiary would gain little through the tax-free accumulatioen of the trust income.

Finally, the excise tax on certain transfers to foreign trusts and other foreign entities may not be effective in preventing U.S. taxpayers from transferring appreciated property to foreign trusts or other entities without payment of a full capital gains tax. The excise tax of 27½ percent of the amount of appreciation is less than the maximum capital gains tax on individuals (which can be as high as 35 percent). Furthermore, the excise tax provision has been interpreted to exclude transfers to foreign entities to the extent that the entity provides some consideration to the transferor. For example, a U.S. taxpayer can transfer appreciated stock to a trust established by him and can receive in return from the trust a private annuity contract or other deferred payment obligation. In any such case, the transferor will pay U.S. tax on the gain only as the deferred payments are received and will have the benefit of the tax-free accumulation of income from the property transferred (or from the proceeds of any sale of the property by the trust).

Alternative Approaches

1974 committee bill

The bill reported out by the Ways and Means Committee last year (H.R. 17488) contained three separate sets of provisions intended to deal with these issues. First, to discourage U.S. taxpayers from establishing foreign trusts in cases in which the beneficiaries of the trusts are U.S. persons, the committee adopted a new grantor trust provision under which the income of a foreign trust with U.S. beneficiaries was taxed to the U.S. person transferring property to the trust. Second, to insure that U.S. beneficiaries of foreign trusts not subject to the above rule (either because the grantor of the trust is a foreigner or because the grantor has died) have no advantage over beneficiaries of U.S. trusts, the bill imposed an interest charge on the tax paid on any accumulated income distributed by the trust. The interest charge was equal to 6 percent of the tax, was not compounded, and was not deductible for Federal income tax purposes. Finally, the bill expanded the excise tax on transfers to foreign entities by applying the tax to transfers of all types of property (rather than only to transfers of securities), by taxing only any unrealized appreciation on these transfers (whether or not some consideration is received in return) and by increasing the rate of the tax from 27½ percent to 35 percent.[5]

Mr. Ullman

His proposal is the same as last year's bill.

[5] If the committee decides to adopt proposals expanding the excise tax on transfers of property out of the United States, the effective date of that provision should probably be established no earlier than transfers taking place after the date of the committee decision.

If the committee agrees to adopt an interest charge on taxable distributions received by U.S. beneficiaries, the interest charge could begin with distributions made in taxable years beginning in 1975. Distributions made in future years out of income earned by a trust in years before 1975 could carry an interest charge beginning with 1975 or 1974 (which was the year from which an interest charge would have begun under last year's bill).

If the committee agrees to adopt a grantor trust rule similar to that in last year's bill, the provision could first tax grantors on income of foreign trusts earned in taxable years beginning after 1975. In addition, the provision could apply only to trusts established after a date on which some notice of the potential change in the tax law was given so that grantors establishing trusts before that date, who had no chance to alter their decisions, given the new provision, would not be taxed. That date could either be the date this year on which the committee decides to adopt the provision or the date from last year's bill, which was May 21, 1974. Last year's proposal received a significant amount of publicity, particularly among lawyers who specialize in establishing foreign trusts.

II. TAX TREATMENT OF CONTROLLED FOREIGN CORPORATIONS AND THEIR SHAREHOLDERS

A. Exclusion for Earnings of Less Developed Country Corporations

In addition to the current taxation of certain categories of tax haven income under subpart F, present law treats as ordinary income any gain realized on the sale, exchange or redemption of stock in a controlled foreign corporation, to the extent of the tax-deferred earnings of the corporation. Present law provides that if a U.S. shareholder owns 10 percent or more of the total combined voting stock of a foreign corporation at any time during the 5-year period ending on the date of the sale or exchange (while the corporation was a controlled foreign corporation), the recognized gain is treated as a dividend to the extent of the foreign corporation's post-1962 retained earnings and profits attributable to the stock during the time it was held by the taxpayer and was a controlled foreign corporation. This dividend treatment does not apply to earnings and profits accumulated by a foreign corporation while it was a less developed country corporation if the stock in that corporation was owned by the U.S. shareholders for at least 10 years before the date of the sale or exchange.

The relationship of the tax benefits to companies from this exception to the benefits obtained by the developing country is erratic since the size of the tax benefits bears no necessary relationship to the amount of development capital invested or the number of new jobs created; rather, the benefit relates to the corporation's profitability and to the tax rate of the foreign country. While this provision may have from time to time benefited certain less developed countries, to a great extent the exception from the dividend treatment has benefited the U.S. shareholders by reducing their taxes without demonstrating a significant benefit to the economies of less developed countries.

Alternative Approaches

1974 committee bill

Last year's bill provided that the provision of present law providing for ordinary income treatment to U.S. shareholders on gains from the sale of stock of foreign corporations is to be applied in the same manner to less developed country corporations as it applies to other foreign corporations. However, the exception was still applicable with respect to those earnings of a foreign corporation which were accumulated during any taxable year before the proposed repeal of the provision.

Mr. Ullman

His proposal is the same as that in last year's bill.

B. Investment in U.S. Property by Controlled Foreign Corporations

Present law provides that the earnings of a controlled foreign corporation are to be treated as if they had been repatriated to the U.S. shareholders and thus are to be taxed currently to the U.S. shareholders as a dividend if they are invested in U.S. property. In general terms, U.S. property is defined as all tangible and intangible property located in the United States. This provision was added to the law in 1962 in the belief that the use of untaxed earnings by a controlled foreign corporation to invest in U.S. property was "substantially the equivalent of a dividend" being paid to the U.S. shareholders. Therefore, it was concluded that this should be the occasion for the imposition of a tax on those earnings to the U.S. shareholders of the controlled foreign corporation making the U.S. investment.

Present law is very broad as to the types of property which are to be classified as U.S. investments for purposes of this rule. For example, the acquisition by a foreign corporation of any tangible property located in the United States, or stocks or obligations of a domestic corporation or a U.S. person (even though unrelated to the investor), is considered an investment in U.S. property for purposes of imposing a tax on the untaxed earnings. It has been argued that the present scope of the provision is too broad and that it may have a detrimental effect upon our balance of payments by encouraging foreign corporations to invest their profits abroad. For example, a foreign corporation looking for a temporary investment for its working capital is often induced to purchase foreign rather than U.S. obligations. It could be argued, therefore, that only where a foreign corporation makes an investment which causes funds to be made available for use by its U.S. shareholders is there an effective repatriation of earnings which should be taxed.

Alternative Approaches

1974 committee bill

Last year's bill limited the definition of investment in U.S. property to investments in stocks or obligations of a related U.S. person or intangible property which is leased to, or used by, a related U.S. person.

Mr. Ullman

His proposal is the same as the 1974 committee bill.

III. SPECIAL CATEGORIES OF CORPORATE TAX TREATMENT

A. Western Hemisphere Trade Corporations

Present Law

Under present law, certain domestic corporations called "Western Hemisphere Trade Corporations" (WHTCs) are entitled to a deduction which may reduce their applicable corporate income tax rate by as much as 14 percentage points below the applicable rate for other domestic corporations.[6]

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

Issues

The WHTC provisions were originally enacted in 1942 during a period of high U.S. wartime taxes and generally low taxes in other Western Hemisphere countries. The provision was aimed at insuring that domestic corporations did not operate at a disadvantage in competing with foreign corporations within the Western Hemisphere. While not explicitly stated, it appears that the goal was to retain U.S. ownership of foreign investments, which if placed in a foreign corporation, might end up being owned by foreign interests.

Because the taxes imposed by other Western Hemisphere countries have been substantially increased since the original enactment of the provision, many companies which qualify as WHTCs receive little or no benefit from the deduction, after taking the foreign tax credit into account. Thus, in many instances the WHTC deduction merely adds to the complexity of preparing an income tax return without providing significant tax benefits. For example, in 1972, there were $219 million of WHTC deductions claimed on tax returns, $122 million of which were claimed by petroleum companies. However, the revenue loss from the deduction was $40 million, little of which is attributable to the deduction claimed by the petroleum companies.

The preferential rate granted to WHTCs has, however, encouraged some U.S. manufacturers to set the prices on sales of goods to related WHTCs so as to maximize the income derived by the WHTC, since

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

this income is taxed at the lower WHTC rate. These pricing practices have been the source of many controversies between taxpayers and the Internal Revenue Service. Finally, the broad interpretation given to the WHTC provisions by the Internal Revenue Service has enabled corporations to obtain the benefits of the WHTC provisions for goods manufactured outside the Western Hemisphere by causing the title to the goods which are sold to the WHTC to be passed within the Western Hemisphere.

Alternative Proposals

1974 committee bill

Last year's bill phased out over a five-year period the provision in present law which provides a 14-percent lower tax rate for Western Hemisphere Trade Corporations.

Mr. Ullman

His proposal is the same as that in the 1974 committee bill.

B. Tax Treatment of Corporations Conducting Trade or Business in Possessions of the United States

Present Law

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

Any dividends from a corporation which satisfies these requirements are not eligible for the intercorporate dividends received deduction (sec. 246(a)(2)(B)). This deduction, however, is allowed if the corporation did not satisfy these requirements in the current and preceding taxable year. In addition, since a corporation meeting the requirements of section 931 is a domestic corporation, no gain or loss is recognized to a parent corporation if it liquidates a posessions corporation (under sec. 332). Corporations satisfying the requirements of a possessions corporation and receiving some benefit from the exclusion of income are not entitled to be included in the consolidated return of an affiliated group of corporations (sec. 1504(b)(4)).

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

Issues

The special exemption provided (under sec. 931) in conjunction with investment incentive programs established by possessions of the

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

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

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

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

Any changes in the tax treatment of possessions corporations should, of course, take into account other changes, such as a limitation on tax deferral made in the U.S. tax treatment of controlled foreign corporations generally. Since Puerto Rico is attempting to attract the investors in these corporations, any change in the tax treatment of their foreign subsidiaries would directly affect the value of the tax incentives under the possessions corporation provisions.

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

This problem can be solved by requiring that a possessions corporation make an election to obtain the benefits of the possessions corporation status and that after making the election a corporation is ineligible to join in the filing of a consolidated return for a period of 10 years. This would permit a possessions corporation to reduce its U.S. tax on its other income by filing a consolidated return only in the case of initial or start-up losses.

In order to retain the present tax incentives given for investment in the possessions and to restrict that preference to possessions source income, it would be possible to provide a tax credit equal to the U.S. rate on possessions source income. This would have the effect of exempting that income as present law provides. However, in order to solve the problem of the earnings of possessions corporations being invested outside of the possession because they cannot be repatriated until liquidation, the normal dividends received deduction of 85 percent or 100 percent (in the case of affiliated corporations) could be extended to possessions corporations. This would enable the earnings to be repatriated from the possession on a current basis free of tax rather than waiting until the time of liquidation.

Alternative Approaches

1974 committee bill

Last year's bill provided for several changes in the treatment of possessions corporations. In lieu of the exclusion under present law, a new tax credit is provided for possessions corporations equal to the U.S. tax attributable to the corporation's income from a possessions trade or business and from qualified possessions investments. Other income of a possessions corporation is subject to the normal U.S. tax without any offset by this new credit. The requirements for qualifying as a possessions corporation are to remain the same as under present law except that such corporations are to qualify only if they elect for a period of 10 years to become a possessions corporation. Finally, the committee agreed to permit corporations receiving dividends from possessions corporations to be eligible for the dividends received deduction.

Mr. Ullman

His proposal is the same as that in the 1974 committee bill.

C. China Trade Act Corporations

Present Law

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

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

The special deduction is limited by a requirement that a dividend must be paid in an amount at least equal to the amount of Federal tax that would be due were it not for the special deduction. The "special dividend" must be paid to stockholders who, on the last day of the taxable year, were resident in Formosa, Hong Kong, or were either residents or citizens of the United States. For example, if the taxable income before the special deduction was $100,000, the special dividend would have to equal at least $41,500 (22 percent of the first $25,000 plus 48 percent of the remaining $75,000). In this example, upon payment of the special dividend of $41,500, the CTA corporation deriving all of its taxable income from sources within Hong Kong and Formosa ($100,000) would be entitled to a special deduction in an amount equal to its taxable income, i.e., $100,000. The special dividend deduction enables the CTA corporation to operate free of tax.[7]

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

Issues

The combination of benefits granted to CTA corporations and their shareholders is unprecedented. For example, if in a given year a CTA corporation, whose shareholders are U.S. citizens residing in Hong Kong or Formosa, has $500,000 of taxable income and pays a special

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

dividend of at least $233,500 to its shareholders, neither the corporation nor its shareholders will incur any U.S. tax liability, whereas a domestic corporation and its shareholders in this situation (assuming marginal tax brackets of 50 percent for the shareholders) would incur respective U.S. tax liabilities of $233,500 and $116,750. The tax savings to the CTA corporation and its shareholders in the above example would be $350,250. If the balance of the earnings of the CTA corporation were paid out, the tax savings would be even greater.

As originally enacted, the China Trade Act was intended to apply to mainland China, including Manchuria, Tibet, Mongolia, and any territory leased by China to any foreign government, the Crown Colony of Hong Kong, and the Province of Macao. However, since the early 1950's the provisions have only applied to business transactions by CTA corporations in Hong Kong and Formosa.

Since the enactment of the China Trade Act in 1922, Sino-U.S. trade has changed dramatically. In 1922, China was considered an unequal trade partner—a market which Western companies competed for under rules that were laid down by their own governments, not by the Chinese government. Prior to the Communist occupation of the China mainland in 1949, approximately 250 companies were conducting business there under the China Trade Act. This situation no longer exists, trade being restricted now to Hong Kong and Formosa; nor is it likely to exist in the foreseeable future. Currently, there are only three active CTA corporations, which reportedly account for a rather negligible amount of trade.

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

The tax advantages enjoyed by a CTA corporation, and particularly its shareholders, are almost without parallel. While, under current law, there are cases where U.S. tax would not be owing with respect to corporate income derived by a foreign subsidiary involved in an active trade or business abroad, dividend payments received from such corporations by U.S. shareholders would be subject to U.S. taxation. It is also argued that there is no current justification to exempting CTA corporation dividends paid to its Hong Kong and Formosa resident shareholders who are U.S. citizens.

Alternative Approaches

1974 Committee bill

Last year's Deadwood Bill repealed the China Trade Act Corporation provisions, but permitted a tax-free reorganization into a foreign corporation.

Mr. Ullman

His bill would repeal the China Trade Act corporation provisions without any exception to the normal rules for the taxation of transfers to foreign corporations.

Mr. Schneebeli

His proposal would repeal the provision prospectively.

IV. DOMESTIC INTERNATIONAL SALES CORPORATIONS (DISCs)

Present Law

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

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

If a DISC fails to meet the qualifications for any reason (including legislation excluding the corporations' products from export property), the DISC provisions provide for an automatic recapture of the DISC benefits received in previous years. This recapture is spread out over the number of years for which the corporation was qualified as a DISC but may not exceed 10 years.

Issues

Those who favor the retention of the DISC provisions believe that DISC was enacted to enable U.S. manufacturers to increase their exports and that DISC has accomplished exactly what it set out to do. Since the enactment of DISC in 1971, exports have increased from $43 billion to a nearly $109 billion annual rate for the first quarter of 1975. This is an increase of 250 percent. Although recognizing that other factors have played a significant role in the increase of U.S. exports, advocates of DISC conclude that a significant role in this increase has also been played by DISC.

It is argued that DISC increases U.S. exports in a number of ways. First, it enables U.S. manufacturers to reduce their prices to meet foreign competition. This assistance is necessary to counter the variety of ways in which foreign competitors receive export assistance from their governments (such as the rebate of value added taxes). Second, to the extent prices are not lowered, DISC provides increased funds to U.S. exporters to finance their export sales. Third, DISC provides funds to U.S. companies to expand their production facilities (which increases U.S. employment) for export sales. Finally, the existence of the DISC program indicates the importance which the Federal Government places upon export sales. Its repeal could be taken as a signal that the Federal Government no longer considers exports to be important.

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

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

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

Opponents of DISC note that U.S. merchandise exports have increased more than two and one-half times since 1971, the year in which the provision was enacted—increasing from approximately $43 billion to a nearly $109 billion annual rate in the first quarter of 1975. If the revenue loss, which is approximately $1.3 billion for 1975, were to be passed through in the form of lower prices, this would represent a change of less than one percent in the average price of our more than $100 billion of merchandise exports. This can be compared to the decline of the value of the dollar that has taken place since 1971. During this period of flexible exchange rates, the dollar has depreciated by 23 percent compared to the French franc, by 29 percent compared to the West German mark, by 15 percent compared to the Japanese yen, and by 18 percent compared to the Spanish peseta.

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

Questions have also been raised as to whether employment effects of export stimulation are frequently overemphasized. To the extent imports are increased by the higher dollar value resulting from DISC, U.S. corporations competing with imported goods (such as automobile companies) are worse off and many lose jobs. More fundamentally, they believe the limitation on total employment in the United States is imposed by the real resource limits of labor, equipment, etc., in conjunction with the appropriate monetary and fiscal policy to reach full employment. In principle, they see no reason why full employment cannot be achieved through production for domestic consumption at least as well as through production for exports. In fact, if employment is achieved through exports which must be subsidized in order to be competitive, they fear we may be sacrificing real income compared to what could be achieved if these resources were used in their most efficient domestic use.

It is difficult to measure accurately the additional exports that have resulted from the availability of the DISC provision primarily because of other more dramatic changes in the international economic system: the movement from fixed to flexible exchange rates and a more than doubling of the level of U.S. merchandise exports. Given the order of magnitude of these changes, it is not statistically possible to measure accurately the additional contribution DISC may have made to higher exports.

If DISC treatment is repealed (or substantially restricted), since it is a tax deferral program, Congress may want to deal with the deferral of tax on prior years' income. With no changes in existing law, companies would be taxed on prior DISC profits over the number of years for which the companies individually qualified for DISC benefits. Approximately $2 billion in aggregate deferred tax liability has arisen under DISC provisions for the three years (1972, 1973 and 1974) of the program's existence. If it is believed that repaying the entire $2 billion of deferred taxes over the short period of time of three years (or less for many companies) would create substantial hardships, it could be provided that taxpayers would have some period of time, perhaps up to 10 years, to repay the deferred tax liability resulting from the DISC provisions.

Even if a longer period for recapturing the deferred taxes is allowed, corporations may be required to report the entire deferred tax liability immediately to shareholders for financial purposes. The view has been expressed that reflecting the entire deferred tax liability in the report to its shareholders in the year immediately after the repeal of DISC would distort reports to shareholders for that period and that it would be more appropriate to report the deferred tax liability for the year in which the deferred tax liability is to be repaid to the Treasury. As a general rule, the question of reports to shareholders as to tax liabilities are left to the judgment of the accounting profession, the Securities and Exchange Commission, and the various other regulatory agencies of the Federal Government. However, since this distortion of tax liabilities would be caused by the enactment and the short-term repeal of DISC, the committee might want to provide in the statute that Federal regulatory agencies are not to take the DISC tax liability into account for rate making and other regulatory purposes any earlier than the year in which the DISC is to restore into income the deferred taxes.

Many suggestions have been made as alternatives to the complete repeal of the DISC provisions. Some of these suggestions could be adopted in combination while others are separate alternatives. One of the more frequently suggested alternatives is to provide DISC benefits on an incremental basis so that a DISC will only be entitled to defer one-half of its profits if it increased its exports over a base period. A similar approach was adopted by the Ways and Means Committee in its original consideration of DISC. Use of an incremental approach requires the determination of the base period over which the increment is measured. The base period selected could either be a fixed base period or a moving average determined by the taxpayer's earlier experience over a period of years. In addition, an incremental approach could have an inflation factor built into it so that taxpayers do not get DISC benefits for increases in sales brought about by increased prices due to inflation.

An incremental approach does tend to meet the argument that under present law taxpayers get tax relief for doing exactly what they would have done anyway. But it also creates more complexity in the tax law. Also, an incremental approach tends to assist those taxpayers whose products are in great demand and who probably would have increased their exports regardless of DISC.

A second way to modify the DISC provisions is to limit the benefits which can be accumulated by a DISC. This can be accomplished by restricting DISC treatment to companies whose asset size is not in excess of a prescribed amount or by restricting the amount of DISC income which a taxpayer could accumulate in any one year. Also, it has been suggested that the DISC benefits could be reduced by the amount of imports made by corporations which are under common ownership with the DISC.

Since DISC is viewed as a tax deferral mechanism, one alternative for reducing the size of the DISC benefits is to begin recapture of the deferral benefits after a period of years (for example, after 5 years recapture could begin). This approach could be coupled with the gradual phaseout of the DISC provision by providing that no company could receive DISC benefits after a 10-year period.

The committee could also adopt the balance of its limitations with respect to DISC from last year's bill. This would permit DISC benefits to be terminated as part of a negotiated trade agreement and would repeal DISC for agricultural products. However, if DISC is eliminated for agricultural products, the committee might wish to make an exemption for agricultural products for which large surpluses are available in the United States and for which the Federal Government is subsidizing exports in that year under Public Law 480 or similar programs.

Export Trade Corporation.—Under present law, a controlled foreign corporation which qualifies as an export trade corporation is able to reduce its subpart F income and thus avoid current taxation of that income. To qualify as an export trade corporation, a corporation must derive a substantial portion of its net income from the sale of U.S. manufactured goods to unrelated foreign persons. At the time of the enactment of the DISC legislation, it was felt that export trade corporations should be entitled to transfer their operations to a DISC. Accordingly, the DISC legislation permitted the transfer of the assets of an export trade corporation to a corporation which qualified as a DISC. At the same time the legislation provided that no new corporations could qualify as export trade corporations and that if a corporation which had qualified as an export trade corporation failed to qualify for 3 consecutive years it could no longer in the future be treated as an export trade corporation. Due to the above restrictions it is believed there are no more than 5 corporations which continue to qualify as export trade corporations. Further it is believed that none of these actively are engaged in a trade or business. If the committee decides to repeal or restrict DISC, it might want to consider the repeal of these provisions at the same time.

Alternative Approaches

1974 committee bill

Last year's bill would have made the DISC provisions inapplicable to agricultural and natural resource products and to goods subject to export control. As part of the Tax Reduction Act, DISC was made inapplicable to natural resources (which are depletable) and to goods subject to export control. Also, last year's bill gave the President's Special Representative for Trade Negotiations authority to negotiate the elimination of DISC benefits as part of multilateral agreements on trade.

Mr. Ullman

He would provide that the tax benefits to DISCs would be repealed and the accumulated benefits of DISC would be recaptured over a 10-year period. The exception to treatment of income as subpart F income for export trade corporations would be repealed.

Mr. Gibbons

The proposal would repeal DISC (with no phaseout for previously accumulated benefits) to comply with the Congressional Budget Resolution.

Messrs. Karth and Conable

The proposal would retain DISC but consider limiting dollar amount of benefits in any one year, limiting the number of years of benefits, using a consolidated net export approach, or extending benefits on an incremental approach.

Mr. Pickle

The proposal would adopt the rules in last year's bill.

Mr. Helstoski

The proposal would limit deferral benefit to 10 years with recapture beginning after the fifth year on a graduated basis.

V. MONEY OR OTHER PROPERTY MOVING IN OR OUT OF THE UNITED STATES

A. Investments by Foreigners in the United States

Present Law

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

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

Issues

A number of reasons have been given for the suggestion that interest and dividends paid to nonresident aliens and foreign corporations should be exempt from U.S. tax. First, it is argued that the exemption on bank deposits should be retained since amounts on deposit in bank accounts could be very easily transferred out of the United States in to foreign bank accounts. As indicated in Table 2, it is estimated that over $3.1 billion of interest was paid to foreign persons on over $36 billion of deposits.

TABLE 2.—SHORT AND LONG-TERM INTEREST BEARING LIABILITIES TO FOREIGN PERSONS

[Dollar amounts in millions]

Year	Total interest bearing liabilities to "private" foreign entities [1]	Interest rate [2] (percent)	Estimated interest paid
1970	$12,759	7.23	$922
1971	15,446	4.91	758
1972	19,683	4.52	890
1973	21,994	7.40	1,628
1974	36,287	8.62	3,128

[1] Source: "Treasury Bulletin", June 1975, tables CM-I-2, CM-I-6 and CM-III-1. Liabilities in foreign currency are excluded. Figures somewhat overstate amounts described in section 861(c) because they include liabilities of U.S. banks to their foreign branches, and liabilities of nonfinancial institutions to "private" foreign entities.

[2] Source: "Federal Reserve Bulletin," May 1975, p. A27. Rate is for finance company paper placed directly, 3 to 6 mo.

Source: U.S. Treasury Department.

In the case of interest it is pointed out that there are numerous exemptions under the Internal Revenue Code or under treaties by which a U.S. borrower can obtain funds from foreign sources without payment of any U.S. tax by the recipient of the interest. These exemptions, however, depend upon the nature of the issuer or the residence of the recipient of the interest. It has been pointed out that the lack of a broad exemption under present law has in some cases made it difficult to trade U.S. obligations in international bond markets since holders of U.S. obligations wish to be assured that there will be no withholding tax on any interest income which they may derive. To satisfy this desire of foreign lenders, U.S. borrowers often have to agree to reimburse holders of their debt instruments for any U.S. tax which may be due. This raises the cost which a U.S. borrower must incur when it goes into foreign markets to raise capital.

It is also argued that a U.S. exemption for bond issues of U.S. corporations sold to foreign lenders would lessen the administrative burden and cost to U.S. borrowers without resulting in any significant inroad on the revenues since most of these issues are exempt today. Further it is argued that a broad exemption covering all portfolio interest income would increase the supply of capital available to U.S. borrowers and make U.S. borrowing competitive with foreign borrowing which often is eligible for an exemption from tax.

The following table shows foreign portfolio investment in the United States by type and country.

TABLE 3.—FOREIGN PORTFOLIO INVESTMENT IN THE U.S. BY MAJOR TYPE AND COUNTRY[1]

[In billions of U.S. dollars]

	Canada	Western Europe	Latin America	Other countries	International organizations and unallocated	Total
All portfolio investment: [2]						
1962	1.5	9.1	1.4	0.5	0.2	12.6
1967	2.7	13.2	2.6	.8	1.0	20.3
1973	3.5	32.3	3.5	2.7	2.3	44.4
Stocks:						
1962	1.2	7.7	1.1	.2	.1	10.3
1967	2.5	10.5	1.9	.4	.1	15.5
1973	2.9	17.9	2.3	1.5	.3	24.8
Bonds: [2]						
1962	Negl.	.4	.1	.1	.1	.7
1967	Negl.	1.4	.1	.1	.4	2.1
1973	.4	9.6	.3	.2	1.4	11.9
Other (includes loans):						
1962	.2	1.0	.2	.2	Negl.	1.6
1967	.2	1.3	.5	.2	.4	2.6
1973	.2	4.9	.9	1.0	.6	7.7

[1] Year end.
[2] Market value.

Source: "International Economic Report of the President, for 1975."

While the flow of foreign portfolio investment into U.S. securities (excluding U.S. Government issues) fell from $4.8 billion in 1973 to $2.1 billion in 1974 the major reason for this decline in investment was due to a decrease in foreign purchases of stock which fell from $2.8 billion in 1973 to $0.5 billion in 1974.

The argument for exempting dividend income as well as interest paid to nonresident aliens and foreign corporations is that it would help U.S. industry accumulate capital. Some believe that this effect, however, is unlikely to be very strong. In cases where the foreign investor receives a tax credit for the U.S. withholding tax against the income tax in his own country, it is argued that giving him an exemption from the U.S. tax does not increase his incentive to invest in the United States. Under this argument only when the U.S. tax is not creditable, or when the foreign investor cannot use the credits, would exemption from the U.S. withholding tax increase the incentive for investment in U.S. securities.

To the extent that an exemption from the withholding tax does cause increased investment by foreigners in U.S. stocks and bonds, there could be some decline in U.S. interest rates, which would lead to more capital accumulation by U.S. businesses, but only if the Federal Resere does not counteract this inflow by slowing the growth in the money supply.

A further argument advanced for exempting interest and dividends is that it will encourage the recycling of OPEC dollars. Most oil dollars are owned by foreign governments, which can invest in the United States without paying tax under present law (sec. 892). A recent IRS ruling (Rev. Rul. 75-298) has broadened this exemption so that foreign central banks who were not previously entitled to the advantages of this exemption apparently may now use it. Thus, the Central Bank of Saudi Arabia apparently may purchase U.S. private securities and be exempt from tax.

The Treasury has estimated that in 1974 the 13 OPEC countries had approximately $60 billion available for investment abroad. The Treasury has further estimated that approximately $21 billion, or 35 percent went into the Euro-currency market basically in the form of bank deposits; $11 billion, or 18½ percent, was invested in the United States (about roughly $6 billion went into short- and long-term Government securities); $7½ billion, or 12½ percent, was invested in the United Kingdom; $5½ billion, or about 9 percent, was accounted for by direct lending by OPEC countries to official institutions in developed countries other than the United States and the United Kingdom; $3½ billion, or 6 percent, went into international financing institutions; $2½ billion, or 4 percent, went to developing countries; about $9 billion, or 15 percent, went into other sectors. It can be seen from the above figures that the OPEC capital flows were widely disbursed among markets in the oil importing nations. The balanced pattern of the OPEC investments has prevented any financial crisis which could have resulted if funds were not widely and broadly invested.

Alternative Approaches

1974 committee bill

Last year's bill provided that the 30-percent withholding tax on dividends and interest received from the United States by foreign persons is to be repealed except in the case of dividends and interest from investments that constitute a direct investment in U.S. securities rather than a portfolio investment. As part of this provision, the present exemption from the 30-percent withholding tax which applies to foreign deposits held in U.S. banks (which under present law would expire on December 31, 1976) is made permanent. In these cases where the withholding tax is not to apply, the stock and securities are to be exempt from U.S. estate tax.

Mr. Ullman

His proposal is the same as that in the 1974 committee bill.

B. Treatment of Reorganizations Involving Foreign Corporations

Present Law

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

In 1968, the Internal Revenue Service issued guidelines[8] as to when favorable rulings "ordinarily" would be issued. As a condition to obtaining a favorable ruling with respect to most transactions, the section 367 guidelines require the taxpayer to agree to include certain items in income (the amount to be included is called the section 367 toll charge). The amount required to be included in income generally reflects untaxed accumulated earnings and profits (in the case of transfers of property into the United States), or the immediate potential earnings from liquid assets or the untaxed appreciation from passive investment assets (in the case of transfers of property out of the United States).[9]

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

Issues

Several problems have developed insofar as the provisions of section 367 and section 1248 are concerned. First, the advance ruling require-

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

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

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

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

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

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

Alternative Approaches

1974 committee bill

The committee examined these problems last year and concluded that to the extent possible the taxation of these transactions should be governed by statute and regulations, rather than by individual rulings for each transaction. In this way it can be assured that the same rules apply to all taxpayers and taxpayers can know in advance what rules will apply to their transactions. The committee also agreed that in those cases where individual rulings are still required (primarily where factual determinations must be made regarding the types and value of property to be transferred out of the United States) taxpayers should be able to obtain the ruling within some limited time after that transaction has been begun. Finally, the committee agreed that the provisions of section 1248 should be applicable to certain nontaxable sales and exchanges where otherwise the earnings and profits could be brought back to the United States without ever being subject to U.S. tax.

In keeping with these decisions, the committee last year adopted a new version of section 367, under which individual rulings were required only for transfers of property out of the United States; these rulings could be requested up to 183 days after the beginning of the transaction. In the case of all other transactions, the IRS was to write regulations setting forth the types of transactions which were tax avoidance transactions and the extent to which tax avoidance was involved. Those items which were not treated in the regulations as tax avoidance transactions could be consummated by taxpayers without approval of the IRS (although in some cases with payment of a toll charge). The IRS was to have until January 1, 1977, to issue these regulations. Prior to that time taxpayers would be required to obtain from the IRS a determination that the transaction did not contain a tax avoidance purpose. The committee also amended section 1248 to end the deferral of tax in the case of certain nontaxable sales of stock of a foreign corporation.

Mr. Ullman

His proposal is the same as last year's bill.

VI. MISCELLANEOUS

A. Shipping Profits

Present Law

Under present law, the gross income of a nonresident alien (sec. 872(b)(1)) or a foreign corporation (sec. 883(a)(1)) does not include earnings derived from the operation of ships documented under the laws of a foreign country which grants an equivalent exemption to citizens and corporations of the United States. The determination that a foreign country grants an equivalent exemption is usually made by an exchange of notes between the two countries. These provisions have been interpreted by the Internal Revenue Service to mean that a foreign country which imposes no income tax is considered as having a reciprocal exemption.

The income which is exempt under these provisions also includes income from incidental activities directly related to the operations of a ship. For example, interest income from temporary bank deposits of ship charter fees and gains from the sale of a ship whose earnings were exempt are within the scope of the exemption.

While the main benefits of these provisions are derived by foreign operators, these provisions have allowed U.S. citizens and corporations organized in the United States to operate shipping businesses through foreign subsidiaries which are exempt from taxation. Although these provisions in general only exclude the income from the operation of a ship and thus do not exclude the income from a bareboat charter of a ship (i.e., the lease of a ship without a crew), bareboat charter income is generally not subject to significant U.S. tax since it is treated as rental income and thus primarily from foreign sources.

However, the repeal of the reciprocal exemption by itself would have a relatively small impact due to the fact that the present source rules for shipping income treat only a relatively small portion of the total international shipping income as from U.S. sources (i.e., that amount which the foreign corporation's costs incurred in the transportation business in the United States and a reasonable return on its assets used in the transportation business in the United States bears to the entire costs incurred in the transportation business and a reasonable return on all of the assets used in the transportation business).

Prior to the Tax Reduction Act of 1975, the law also contained an exception to subpart F which provided that the shipping income of foreign subsidiaries was not to be considered as tax haven income. That Act changed that rule to provide that shipping income is to be taxed currently to the U.S. shareholders except to the extent that it is reinvested in shipping assets.

Issues

The exclusion for shipping income for nonresident aliens and foreign corporations was added to the law by the Revenue Act of 1921. Prior to the adoption of this provision the Treasury had taken the position that income from outgoing business (i.e., exports) would be treated as U.S. source income while income from incoming business would be treated as foreign source.

At least two reasons were advanced for the 1921 change in the law. First, it was indicated that American ships were compelled to pay both U.S. and foreign taxes and that requiring the foreign country to grant an equivalent exemption would insure that U.S. shippers would not be subject to foreign taxes. Second, the view was expressed that the practice of taxing foreign shippers on U.S. source income was difficult from a collection standpoint due to the inability to determine net income and encouraged retaliation by foreign countries. With U.S. shipping on the increase at that time it was argued that retaliation by foreign countries would place a greater burden on U.S. shippers than would be placed on foreign shippers by the United States. At the time of the enactment of the 1921 legislation those in opposition argued that it would encourage U.S. shippers to form foreign corporations and operate foreign documented ships. (This prediction has turned out to be correct.)

As a general rule, foreign flag ships are generally owned through a corporation organized under the laws of the country of registration of the ships. The following is a table showing foreign flag ships owned by U.S. companies or their foreign subsidiaries, as of June 30, 1974. It should be noted that 432 ships owned by U.S. corporations and their subsidiaries were registered in Liberia, Panama and Honduras. An additional 88 ships were owned by foreign corporations controlled by U.S. citizens were also registered in Liberia, Panama and Honduras as of the end of 1971. No figures are available as to the additional number of foreign flag ships owned by foreign corporations controlled by U.S. citizens which are not registered in these three countries.

TABLE 4.—FOREIGN-FLAG SHIPS OWNED BY U.S. COMPANIES OR FOREIGN AFFILIATES OF U.S. COMPANIES INCORPORATED UNDER THE LAWS OF THE UNITED STATES AS OF JUNE 30, 1974

	Total			Tanker			Freighters			Bulk and ore carriers		
	Number	Gross tons	Deadweight tons	Number	Gross tons	Deadweight tons	Number	Gross tons	Deadweight tons	Number	Gross tons	Deadweight tons
Total	678	25, 264, 165	47, 925, 033	485	21, 793, 448	41, 739, 038	84	396, 921	392, 797	109	3, 073, 796	5, 793, 198
Liberia	321	14, 491, 604	28, 651, 732	224	11, 753, 858	23, 418, 121	9	58, 267	67, 508	88	2, 679, 479	5, 166, 103
United Kingdom	122	4, 415, 586	8, 155, 906	74	4, 098, 941	7, 748, 047	39	146, 892	151, 748	9	169, 753	256, 111
Panama	102	2, 103, 487	3, 627, 452	85	1, 979, 438	3, 463, 665	12	54, 590	48, 280	5	69, 459	115, 507
France	12	1, 022, 107	1, 978, 118	12	1, 022, 107	1, 978, 118						
Netherlands	25	716, 097	1, 251, 523	13	643, 844	1, 179, 852	12	72, 253	71, 671			
Germany (West)	11	525, 577	971, 720	11	525, 577	971, 720						
Spain	5	489, 149	931, 367	5	489, 149	931, 367						
Italy	10	333, 880	494, 091	10	333, 880	494, 091						
Norway	10	254, 916	453, 895	10	254, 916	453, 895						
Belgium	9	163, 159	259, 393	9	163, 159	259, 393						
Argentina	11	169, 791	258, 183	6	96, 037	141, 921				5	73, 754	116, 262
Denmark	6	109, 455	181, 649	6	109, 455	181, 649						
Venezuela	6	116, 113	172, 569	6	116, 113	172, 569						
Australia	3	98, 241	165, 857	1	16, 890	26, 642				2	81, 351	139, 215
British Colonies	1	59, 267	110, 187	1	59, 267	110, 187						
Canada	6	58, 517	88, 737	6	58, 517	88, 737						
Uruguay	2	50, 766	85, 830	2	50, 766	85, 830						
Honduras	9	46, 921	43, 618				9	46, 921	43, 618			
South Africa	1	14, 560	23, 421	1	14, 560	23, 421						
Greece	3	17, 998	9, 972				3	17, 998	9, 972			
Finland	3	6, 974	9, 813	3	6, 974	9, 813						

Source: Department of Commerce, "Foreign-Flag Ships owned by U.S. parent companies," as of June 30, 1974.

Ownership and operation of ships in this manner permits the persons involved to avoid payment of U.S. taxes on the shipping profits until the profits are repatriated to the U.S. shareholders. As a rule the country of registration of these ships imposes very little or no taxes on the profits or the capital of the shipping company. It should be recognized that historically international shipping has largely operated free of income tax anywhere in the world and that the United States has established a capital construction fund provision under the Merchant Marine Act as a method for U.S. shipping companies to avoid paying taxes currently on their shipping profits. Since shipping income is earned on the high seas, it is difficult for countries to determine what portion of the income is allocable to activities carried on within its taxing jurisdiction. Further, countries of registration have historically viewed a strong merchant fleet as a national priority and have been reluctant to impose a tax burden upon its own fleet which would make it less competitive with the merchant fleets of other nations.

One suggestion for dealing with the tax-exempt nature of the international shipping business is to repeal the reciprocal exemption provided for in the Internal Revenue Code and only provide a reciprocal exemption by means of tax treaty. In addition, one-half of the income from ships entering and leaving U.S. ports could be treated as U.S. source income and be subjected to tax as being effectively connected with the conduct of a trade or business in the United States. This proposal would require a method of computing the taxable income from the operation of the ship in the United States. The proposal could provide that in lieu of a taxpayer making available its books and records so that taxable income can be computed, a percentage tax on the gross value of the goods shipped into or out of the U.S. port could be imposed.

Alternative Approaches

Messrs. Vanik, Corman, Green, Gibbons, Karth, Rangel, Stark, Jacobs, Mikva and Mrs. Keys

The proposal would repeal the reciprocal exemption for shipping and tax as U.S. source income one-half of the income from shipping activities involving U.S. ports.

B. Allocations of Deductions Between Domestic and Foreign Source Income

Present Law

Present law provides special rules (secs. 861 to 863) for determining the country from which income is earned and for allocating deductions to that income. These rules are important for computing the foreign tax credit limitation (as well as other purposes) because the amount of any credit allowed for taxes paid to any country is determined by the amount of taxable income from sources within that country or all foreign countries.

The Internal Revenue Code requires that expenses be allocated to items of gross income from foreign sources or from a particular country in cases where the expense can be directly allocated to that gross income. However, expenses which cannot definitely be allocated to any particular item or class of gross income are generally apportioned pro rata to all gross income. The Internal Revenue Code presently sets out the statutory standards governing these questions in fairly general terms and leaves most of the detailed rules to be delineated in Treasury regulations. The present Treasury regulations are also very general in nature as to when expenses can be allocated on a pro rata basis to all gross income.

Issues

The Treasury Department has recently proposed new regulations governing the treatment of deductions for purposes of determining the amount of taxable income from foreign sources or from any particular foreign country. These regulations establish new rules that primarily affect the treatment of deductions for research and development expenditures, interest costs, and administrative overhead expenses. The regulations require that some costs be allocated on a basis (such as gross sales) other than a gross income basis. According to comments received by the Treasury Department from numerous companies, the net effect of these proposed regulations, if adopted, would be to increase the amount of costs required to be allocated to foreign source income. This would reduce taxable income from foreign sources for these taxpayers and, thus, reduce the amount of foreign tax credits which could be used to offset U.S. tax liability.

One concern over the proposed regulations is that items of expense which are allocated by the Internal Revenue Service to foreign source income will not be allowed as deductions by the foreign tax authorities in computing the income from that country. This, in effect, results in the loss of deduction by the taxpayer. Concern has been particularly expressed over the question of research and development expenses, with some companies indicating that the loss of substantial tax deductions for research and development expenditures could cause them to move research activities outside of the United States.

Alternative Approaches

Mr. Stark and Mrs. Keys

They propose to amend the statutory rules for determining the source of income and deductions (under sections 861 through 863) to make it clear that indirect costs (including interest, research and development and home office expenses) should be allocated between domestic and foreign source income to reflect most accurately their relationship to the net income earned from both sources. They also would make it clear that a pro rata allocation to gross income is not usually an accurate allocation.

C. State Taxation of Foreign Source Income

Present Law

Federal law contains no restrictions on the power of States to tax interstate or foreign income except to deny any State the power to tax the income of nonresidents whose contact with that State is limited to soliciting orders for sales to be approved and shipped outside of the State (15 U.S.C. 381).

The Uniform Division of Income for Tax Purposes Act is a model act which establishes the basic rules followed by most States for the taxation of corporate income from interstate business operations. Under this model Act as adopted by most States, business income is apportioned among the States according to a 3-factor formula. This formula is based on the ratio of the tangible property, payroll, and sales of the corporation within a State to the total tangible property, payroll, and sales of the corporation in every State. The amount of income eligible to be taxed by that State is determined by applying this ratio to the total business income of the corporation.

Investment income of corporations is generally taxed by the domiciliary State of the corporation. For example, a corporation incorporated in Massachusetts but operating in a number of States is taxed on its dividend income by Massachusetts. In some States, dividends from wholly-owned subsidiary corporations are treated as investment income and thus taxed by the domiciliary State of the parent corporation; in other States, however, such dividend income is treated as business income to the parent and is subject to the 3-factor apportionment formula.

Under this broad framework, the States have followed two general approaches to the taxation of foreign source income. California and Oregon have applied a "unitary" system of taxing corporation profits. Under this system, the 3-factor formula is applied not only to the corporation itself doing business in California, for example, but also to all corporations, including foreign subsidiaries, having common ownership with that corporation. Thus, the 3-factor formula is applied essentially on a consolidated basis, with the numerator containing all the California sales, tangible property, and payroll of all of the related group of corporations, while the denominator includes the worldwide totals of these three factors for the related group. In other States, export sales and foreign branch operations are treated in a manner basically similar to California, while foreign subsidiaries are taxed through their dividends to the parent corporation (which dividends are treated as investment income or business income).

Issues

It has been argued that the existing systems of State corporate income taxation lead to an overreaching of State tax jurisdiction because income from foreign sources in many cases is subject to State taxation. Those States not applying the "unitary" system tax foreign source income directly when it is repatriated by taxing the dividends from foreign corporations. States with the "unitary" system do not tax foreign source income directly in this fashion (because foreign income is thrown into the 3-factor apportionment formula); however, if the payroll, tangible property or sales amounts in foreign countries are lower per dollar of income than they are in the United States, the apportionment formula would work to increase the amount of State taxes owed because of the inclusion of foreign operations in the formula.

It is argued that double taxation results when a State taxes income that has already been taxed by a foreign country. The Federal Government avoids this double taxation through the foreign tax credit. Given the low rate of State taxation, a foreign tax credit would in most cases eliminate any State revenues from this income. Moreover, it can be argued that with the Federal foreign tax credit for all foreign income taxes, including local and provincial income taxes, State taxation of foreign source income produces no more double taxation than does State taxation of domestic income (which also is subject to Federal taxation).

Alternative Approaches

Mr. Jones

He has proposed that the Federal Government prohibit the States from taxing foreign source income by requiring the States to follow the income source rules of the Internal Revenue Code (secs. 861–863), and limiting their taxation to domestic source income under those rules.

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