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June 9, 2009

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Senate Finance Committee  
219 Dirksen Senate Office Building  
Washington, DC 20510

The Honorable Charles B. Rangel  
Chair  
House Ways and Means Committee  
1102 Longworth House Office Building  
Washington D.C. 20515

The Honorable Charles E. Grassley  
Ranking Member  
Senate Finance Committee  
219 Dirksen Senate Office Building  
Washington, DC 20510

The Honorable David Camp  
Ranking Member  
House Ways and Means Committee  
1139E Longworth House Office Building  
Washington, DC 20515

Re: Statement of Policy Regarding U.S. International Taxation

Dear Chairmen and Ranking Members:

On behalf of the Section of Taxation of the American Bar Association, I am pleased to transmit the enclosed Statement of Policy Regarding U.S. International Taxation. This statement represents the views of the Section of Taxation and has not been approved by the Board of Governors or the House of Delegates of the American Bar Association. Accordingly, it should not be construed as representing the position of the American Bar Association.

We appreciate your consideration of the enclosed statement. Representatives of the Section would be pleased to discuss this statement with you or your respective staffs. Please contact Armando Gomez, the Section's Vice Chair for Government Relations, at (202) 371-7868 if that would be helpful.

Sincerely,

Stuart M. Lewis  
Chair- Elect, Section of Taxation

Enclosure

cc: Honorable Timothy F. Geithner, Secretary, Department of the Treasury  
Honorable Douglas H. Shulman, Commissioner, Internal Revenue Service  
Mr. John L. Buckley, Chief Tax Counsel, House Ways and Means Committee  
Mr. Russell Sullivan, Staff Director, Senate Finance Committee  
Mr. Jon Traub, Republican Staff Director, House Ways and Means Committee  
Mr. Kolan Davis, Republican Staff Director, Senate Finance Committee  
Mr. Thomas A. Barthold, Chief of Staff, Joint Committee on Taxation

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**AMERICAN BAR ASSOCIATION  
SECTION OF TAXATION**

**Statement of Policy Regarding U.S. International Taxation**

This white paper is submitted on behalf of the American Bar Association Section of Taxation (the “Section”) and has not been approved by the House of Delegates or the Board of Governors of the American Bar Association. Accordingly, it should not be construed as representing the position of the American Bar Association.

The Section believes that the federal tax laws should be fair and economically efficient, and should raise revenue at a reasonable cost to the government and the taxpayer. In the international context, these criteria must be applied in a way that recognizes that U.S. rights and powers to tax international income must co-exist with the taxing rights of other nations. This paper provides a brief overview of these tax policy objectives in the international context, and then briefly considers issues arising in connection with: (i) U.S. source taxation of foreign persons’ U.S. business income earned directly or through a U.S. corporation, (ii) U.S. residence taxation of U.S. persons’ foreign portfolio income, (iii) U.S. source taxation of foreign persons’ U.S. source portfolio income, and (iv) international enforcement issues, including those relating to unreported offshore accounts and transfer pricing.

The Section encourages review of the existing U.S. international tax rules and consideration of reforms that reasonably balance the objectives of fairness, efficiency and administrability in the context of U.S. economic needs and global realities.

## Background

In 2006, the Section's Task Force on International Tax Reform issued a report that set out criteria by which to evaluate reform proposals for taxing income of U.S. persons from direct investment abroad and considered a series of modifications to current U.S. outbound tax rules.<sup>1</sup> The Task Force Report discussed the policy objectives of fairness, efficiency and administrability, and the application of those objectives in the international tax context. The Task Force Report then provided separate chapters discussing: (a) U.S. taxation of a U.S. person's foreign business income; (b) alternatives for reform of the international tax rules, specifically, exempting foreign income or curtailing deferral of foreign income; (c) entity classification and corporate residence; (d) the foreign tax credit; and (e) reform of subpart F. Each of those chapters provides background on current law, describes policy implications of those rules, and analyzes various proposals for change in law (without making any specific recommendations).

A number of factors suggest that the time may be ripe for a new look at how the United States taxes international income. The global economy is in turmoil, and the Federal government is facing short-term and long-term budget difficulties. In the past two years, both the House Committee on Ways & Means and the Senate Committee on Finance have held hearings considering international tax reform and enforcement issues. More recently, the Obama Administration has made several significant legislative proposals that could have significant effects on international taxation and enforcement. As those and other proposals are evaluated, the Section encourages policymakers to take into account the principles and policy objectives discussed in the Task Force Report, and the considerations discussed briefly in this white paper.

We begin with the tax policy criteria that should be taken into account in analyzing tax policy in an international context.

### Tax Policy Objectives in International Taxation

The primary focus of U.S. income tax policy generally should be to raise revenue in a manner that improves the lives and living standards of U.S. citizens and residents.<sup>2</sup> The Tax Section recently published another white paper emphasizing that this objective is served by achieving simplicity, stability and transparency in our tax laws.<sup>3</sup> Each of these objectives necessarily will have a different emphasis depending on the context.

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<sup>1</sup> American Bar Association Tax Section Task Force on International Tax Reform, "Report of the Task Force on International Tax Reform," 59 TAX LAW. 649 (2006) [hereinafter the "Task Force Report"].

<sup>2</sup> See Michael J. Graetz, *Taxing International Income: Inadequate Principles, Outdated Concepts, and Unsatisfactory Policies*, 54 TAX L. REV. 261, 284 (2001).

<sup>3</sup> American Bar Association Section of Taxation, Statement of Policy Favoring Tax Simplicity, Stability and Transparency, available at [http://www.abanet.org/tax/pubpolicy/papers/whitepaper\\_sopfavoringtaxsimplicitystabilityandtransparency.pdf](http://www.abanet.org/tax/pubpolicy/papers/whitepaper_sopfavoringtaxsimplicitystabilityandtransparency.pdf).

The arena of international taxation, involving as it does the intersection of two or more countries' tax systems, is inherently more complex than in the domestic sphere alone, but simplicity nonetheless remains an important objective. Stability also is highly desirable, however, it is recognized that the U.S. international tax rules require reform. To achieve stability, it is helpful to develop consensus in support of reforms so that they will have longevity. The goal of transparency is achieved if taxation is reasonably determinable and not subject to disguised base modifiers. Transparency in the international area is especially difficult because of the inherent complexity of meshing two tax systems, including the need to allocate expenses.

While there is consensus that international tax rules are in need of reform, there has been little consensus on what direction reform should take, at least in the area of foreign direct investment by U.S. persons. In order to facilitate consensus, it is helpful to agree on objectives.

#### Fairness, Efficiency and Administrability

U.S. tax policy for taxation of international income should have the same objectives as for taxation of domestic income. While serving the goal of raising revenue, U.S. tax rules should be consistent with U.S. fairness objectives, should be economically efficient and should raise revenue at a reasonable cost to the government and the taxpayer.<sup>4</sup> In the international tax context, however, these traditional income tax policy criteria must be applied in a way that recognizes that U.S. rights and powers to tax international income co-exist with the taxing rights of other countries.<sup>5</sup>

The perception that imposing a tax on income is fundamentally fair has played an important role in the continued importance of the income tax as a means of raising revenue in the United States. It is generally accepted that a fair tax should take account of a taxpayer's ability to pay.<sup>6</sup> One of the reasons to base a tax on a taxpayer's entire income is that total income, without regard to source, is a reasonable proxy for ability to pay.

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<sup>4</sup> See generally 1 U.S. Treas. Dept., TAX REFORM FOR FAIRNESS, SIMPLICITY, AND ECONOMIC GROWTH—GENERAL EXPLANATION OF THE TREASURY DEPARTMENT PROPOSALS 13-19 (Nov. 1984).

<sup>5</sup> The Sixteenth Amendment to the United States Constitution provides: "The Congress shall have the power to lay and collect taxes on incomes, from whatever source derived, without apportionment among the several States, and without regard to any census or enumeration." U.S. Const. amend XVI. The United States has long asserted jurisdiction to tax the worldwide income of U.S. citizens, *Cook v. Tait*, 265 U.S. 47 (1924) (upholding U.S. tax on income of nonresident U.S. citizen from property located in Mexico), and U.S.-source income of nonresident aliens, *DeGanay v. Lederer*, 250 U.S. 376 (1919) (upholding U.S. tax on income of a nonresident from an intangible located in the United States). The United States recognizes that other countries have the right to tax their own residents on U.S.-source income and U.S. residents on foreign-source income. See American Law Institute, *RESTATEMENT (THIRD) OF THE FOREIGN RELATIONS LAW OF THE UNITED STATES* 260-66 (1987).

<sup>6</sup> There is a rich academic literature about the theoretically appropriate bases on which to evaluate fairness claims and even whether such claims have normative content. See J. Clifton Fleming, Robert J. Peroni & Stephen E. Shay, *Fairness in International Taxation: The Ability-to-Pay Case for Taxing Worldwide Income*, 5 FLA. TAX REV. 299, 301 n. 12 (2001) (noting literature).

In the case of nonresidents, however, a source taxation regime reaches only income earned within the source country and can not take the taxpayer's full income into account. Source taxation therefore can not be grounded on ability-to-pay. The policy of fairness asserts itself differently with respect to nonresident persons. Source and residence taxation are inextricably linked by the practical fact that a country's taxation of its own residents will be perceived to be unfair if nonresidents with equal amounts of residence-country business income are paying less tax.<sup>7</sup> This ancillary "fairness" concern supports a tax policy that treats foreign-owned businesses no more favorably than comparably situated U.S. businesses. Conversely, fairness, and a concern for foreign country's adverse taxation of U.S. residents, supports a view that the United States should not discriminate against nonresidents and foreign-owned businesses.

The concept of efficiency in free market economies generally assumes that the value of society's goods and services can be maximized through the free market. Thus, laws and regulations, when utilized, optimally would distort pre-tax economic decisions as little as possible.<sup>8</sup> But, especially in the "outbound" international context, deploying the concept of efficiency is not a simple task. There is a lack of consensus among economists regarding what neutrality principle (i.e., principle or benchmark of economic efficiency) should guide U.S. tax policy in an open-economy, international setting.<sup>9</sup> We will not review these arguments here.<sup>10</sup> It will suffice to reiterate that the efficiency criterion generally supports rules that distort pre-tax economic decisions as little as possible.

The administrability criterion recognizes that the costs of administration and enforcement, to government and taxpayers, are not productive costs and should be kept to

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<sup>7</sup> T.S. Adams suggested the following in 1921: "If the members of a partnership engaged in business in Detroit all live in Canada, and the partnership competes with business concerns, the owners of which live in Detroit, our people will not consent to exempt the Canadians while the owners who live in the United States are taxed on their entire income . . .". Michael J. Graetz & Michael M. O'Hear, *The "Original Intent" of U.S. International Taxation*, 46 DUKE L.J. 1021, 1037, n.61 (1997) (quoting Thomas S. Adams, *Fundamental Principles of Federal Income Taxation*, 35 Q. J. Econ. 527, 542 (1921)).

<sup>8</sup> The President's Advisory Panel on Federal Tax Reform articulated a standard for evaluating proposals that favor one activity over another that should be applied to evaluate proposals to tax foreign income more or less favorably than domestic income:

Tax provisions favoring one activity over another or providing targeted tax benefits to a limited number of taxpayers create complexity and instability, impose large compliance costs, and can lead to an inefficient use of resources. A rational system would favor a broad tax base, providing special tax treatment only where it can be persuasively demonstrated that the effect of a deduction, exclusion, or credit justifies higher taxes paid by all taxpayers.

PRESIDENT'S ADVISORY PANEL ON FEDERAL TAX REFORM, FINAL REPORT xiii (Nov. 1, 2005), *available at* <http://www.taxreformpanel.gov/final-report/>.

<sup>9</sup> See Task Force Report, *supra* note 1, at 680–89.

<sup>10</sup> For a summary of the arguments and references, see David L. Brumbaugh & Jane G. Gravelle, Cong. Research Serv., REFORM OF U.S. INTERNATIONAL TAXATION: ALTERNATIVES 4–11 (2007); Task Force Report, *supra* note 1, at 680–89; Joint Committee on Taxation, *Economic Efficiency and Structural Analyses of Alternative U.S. Tax Policies for Foreign Direct Investment* (JCX-55-08) [Hereinafter "Joint Committee, Alternative Policies"].

the minimum possible.<sup>11</sup> While recognizing that taxpayers with international income are generally sophisticated and able to deal with complex provisions, a system whose complexity fosters wasteful tax planning is undesirable. Moreover, adopting tax rules that are difficult to administer by tax authorities at a reasonable investment of resources is problematic and benefits taxpayers willing to take advantage of enforcement gaps. Even where rules are administrable, to constrain taxpayers from taking undue advantage of the difficulties of tax administration in an international context, it is necessary to invest resources in enforcement. Such investment, up to the point of marginal return, also enhances efficiency.

The policy criteria of fairness, efficiency and administrability inevitably conflict with each other as well as with the objective of raising revenue. Coherent international tax policy requires balancing these objectives in the specific context of taxpayers engaging in cross-border economic activity.

A further observation is in order. While the United States has traditionally been a leader in the area of international tax policy, realities of the global economy require that it take account of measures adopted by other countries. Experience shows, however, that it takes time to determine whether what appear to be trends will be sustained or sustainable. In the 1970s, European governments moved significantly toward integrated corporate tax systems, which trend was heralded as a welcome move toward a reduction in distortion from corporate double taxation. Under the pressures of the EU single market, however, movement toward corporate integration has been abandoned and almost entirely reversed in the past decade. Similarly, there currently is a move toward territorial taxation of foreign income in the name of competitiveness (and in some cases as a response to the current economic crisis as a means of encouraging repatriation of foreign earnings). Some of the recently adopted territorial approaches are extremely expansive and inevitably will be modified in the future. Reforms to the U.S. international rules should be designed so as to achieve a balance between the competing objectives in the specific context of U.S. economic needs and global realities.<sup>12</sup>

### U.S. Taxation of U.S. Persons' Foreign Business Income

At year-end 2006, U.S. foreign direct investment was valued at \$2.89 trillion.<sup>13</sup> While roughly one third the size of foreign portfolio investment, foreign direct investment is an important part of the U.S. economy. The current U.S. tax rules provide more alternatives for taxation of foreign business income than what might be expected in a straight-forward

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<sup>11</sup> See Joel Slemrod, *Tax Minimization and Corporate Responsibility*, 96 TAX NOTES 1523 (2002).

<sup>12</sup> Similarly, there has been a move in recent years in the EU and elsewhere to establish carbon taxes or similar regimes, including emission cap and allowance trading regimes, either to address climate change concerns or revenue needs, or both. As the United States considers such proposals, it will be critical to take into account their tax policy impact in both the domestic and international contexts.

<sup>13</sup> Joint Committee, *Alternative Policies*, *supra* note 10, at 2, citing Joint Committee on Taxation, *Economic and U.S. Income Tax Issues Raised by Sovereign Wealth Fund Investment in the United States* (JCX-49-08) at 17. Portfolio investment was valued at \$9.34 trillion (with direct investment measured at current cost) *Id.*

foreign tax credit system. They allow cross-crediting of foreign taxes, so that high foreign taxes may be credited against U.S. taxes on low-taxed foreign income,<sup>14</sup> they allow current deductibility of expenses allocable to deferred income, and, subject to certain anti-deferral rules,<sup>15</sup> they allow deferral from U.S. tax on foreign business income earned in lower taxed countries.<sup>16</sup> In addition, differences between U.S. and foreign entity classification rules, which became more prevalent as a result of the check the box entity classification rules, can be used to allow earnings stripped from high tax countries to bring down the effective tax rates, which enhances the effectiveness of cross-crediting. Careful tax planning, including with respect to intangibles, is commonly used to shift income into lower-tax environments.

The current U.S. rules create an amalgam of inefficient incentives that affect different taxpayers in different ways. The effect of cross-crediting with the current deferral rules is to provide an incentive to a taxpayer with excess foreign tax credits to earn low-taxed foreign income and to credit the foreign tax against U.S. tax on this income. Excess foreign tax credits even can be used to offset U.S. tax on royalty income and income from export sales that is treated as foreign-source income for U.S. tax purposes (though this income generally would not be taxed by the source country). The overall effect of the current rules can be more beneficial to taxpayers than an exemption system.<sup>17</sup>

To the extent that the United States taxes foreign income less than domestic income, there is an incentive to make investments outside the United States that might have been made in U.S. assets.<sup>18</sup> On the other hand, as foreign income becomes more heavily taxed

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<sup>14</sup> The United States taxes the worldwide income of U.S. citizens, resident aliens and domestic corporations. Generally, the United States allows a taxpayer to elect to credit foreign income taxes paid or deemed paid. The credit for the foreign income tax paid is allowed against U.S. tax subject to a limitation that the credit may not exceed the pre-credit U.S. tax that otherwise would be paid by the taxpayer on foreign-source net income in the same limitation category as that on which the foreign tax is paid. Today, there are only two foreign tax credit limitation categories, one for passive income and another “general” category that includes all non-passive income.

<sup>15</sup> The tax rules relating to a United States shareholder’s share of income earned by a controlled foreign corporation limit deferral with respect to passive income and certain active business income that is earned through the use of “base companies” and is subject to an effective rate of foreign tax that is lower than the U.S. rate. The investment in U.S. property rules generally are designed to prevent earnings of a controlled foreign corporation that have not been taxed to a U.S. shareholder from being made available, directly or indirectly, to a U.S. shareholder.

<sup>16</sup> Most active foreign business income earned by a foreign (non-U.S.) corporation is not taxed to its U.S. shareholders until distributed. In international tax, this concept is referred to as “deferral.” If and when the foreign corporation’s earnings are distributed (or deemed to be distributed), the United States will allow a U.S. corporate shareholder who owns 10% or more of the voting power of the foreign corporation a credit for foreign income taxes paid.

<sup>17</sup> See e.g., Harry Grubert & Rosanne Altshuler, *Corporate Taxes in the World Economy: Reforming the Taxation of Cross-Border Income*, in John W. Diamond and George R. Zodrow (eds.) *FUNDAMENTAL TAX REFORM, ISSUES, CHOICES AND IMPLICATIONS* (MIT 2008).

<sup>18</sup> See e.g., Michael McDonald, *Income Shifting from Transfer Pricing: Further Evidence from Tax Return Data*, U.S. Dept. of Treasury, OTA Papers (July, 2008); GAO, *Effective Tax Rates Are Correlated with Where Income Is Reported*, GAO-08-950 (Washington, D.C.: August, 12, 2008); U.S. DEP’T OF THE TREASURY, *REPORT TO THE CONGRESS ON EARNINGS STRIPPING, TRANSFER PRICING AND U.S. INCOME*

by the United States, the incentive to employ foreign parent structures increases for enterprises that have that option,<sup>19</sup> and overseas competitiveness issues may be raised for U.S. enterprises generally.

There is a debate as to whether the problems in our current rules should be addressed by exempting foreign income or by expanding taxation of foreign income. These issues have been discussed elsewhere at length.<sup>20</sup> No solution is easy because of the effects on different businesses and industries. Nonetheless, any reform should be balanced between righting inappropriate incentives to shift investment out of the United States and harming the competitive position of U.S.-owned multinational companies.

### U.S. Taxation of Non-U.S. Persons' U.S. Business Income

The U.S. rules for taxation of foreign persons' income from a U.S. trade or business, conducted directly or through a U.S. affiliate also are deserving of review.<sup>21</sup> They are a critical element of the U.S. tax structure in that there is an increasing ability to structure a multinational business as U.S.- or foreign owned. In part for this reason, it is important to understand that a country's source taxation regime is related to and protects the integrity of its residence taxation of its own businesses.

The current U.S. rules are both over- and under-inclusive. The U.S. trade or business standard exposes to net basis U.S. taxation activity that has limited contact with the United States and results in unwarranted uses of resources to address compliance concerns. Consideration should be given to adoption of a permanent establishment standard like that used in treaties as a statutory rule. In the other direction, the absence of taxation of stock sale gains allows a non-U.S. strategic or financial buyer to exit an investment at a lower cost than a domestic buyer. Some countries address the discontinuity between source taxation of business conducted through a branch and through an affiliate by imposing source taxation on substantial stock interests held by non-U.S. persons but allowing net basis taxation as an alternative to gross withholding (in a manner similar to the existing rules for taxing U.S. real property holding companies).

The U.S. rules for taxation of U.S. trade or business income were last revised in the 1960s. Anti-earnings stripping rules only were adopted in the late 1980s. It would be appropriate to undertake a holistic review of these rules in connection with the rules for U.S. residence taxation of foreign business income. A full review of these issues should consider all alternatives, including in particular alternatives, such as taxing sales of

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TAX TREATIES 58 (2007) [hereinafter TREASURY TRANSFER PRICING REPORT] (evidence that correlates reductions in foreign effective tax rates of CFCs with income shifting from high nominal tax rate countries to low tax rate countries).

<sup>19</sup> The Section 7874 rules were adopted to combat certain corporate and partnership expatriations. These rules do not address newly formed foreign enterprises or existing foreign enterprises.

<sup>20</sup> Task Force Report, *supra* note 1, at Chapter 3; Joint Committee, *Alternative Policies*, *supra* note 10.

<sup>21</sup> For background on the current rules and a thorough review of the "effectively connected income" rules after the Tax Reform Act of 1986, see Harvey P. Dale, *Effectively Connected Income*, 42 TAX L. REV. 689 (1987).

substantial stock interests, that would not have been considered feasible decades ago. Of course, that review should carefully consider how any proposed changes might impact investments in the United States.

### U.S. Residence Taxation of U.S. Persons' Foreign Portfolio Income

At year-end 2006, U.S. foreign portfolio investment was valued at \$9.34 trillion.<sup>22</sup> U.S. persons' foreign portfolio investment now dwarfs foreign direct investment. Leaving aside compliance issues (discussed below), the U.S. tax rules with respect to foreign portfolio investment generally appear to be working appropriately with limited areas needing review. With respect to taxable U.S. investors, the passive foreign investment company anti-deferral rules occasionally have unintended over breadth as a result of employing a passive asset test that is rigid in its classifications and operation. The rules for qualified dividends from foreign corporations include some anomalies, such as applying to shares traded on a U.S. exchange but not to the shares of the same class traded on a non-U.S. exchange.<sup>23</sup> More significantly, if qualified dividend treatment is intended to relieve double taxation of corporate income, allowing such relief for investment in foreign equities where little or no corporate tax is imposed on corporate income arguably is incoherent from a policy perspective. There also may be a question about tax-exempt entities' use of offshore blockers to circumvent the debt financed unrelated business income rules, although many would question whether there is a valid rationale in the first instance for applying debt financed unrelated income tax rules to passive portfolio investments. Although these and other issues can be the subject of much debate, we do not perceive the rules in this area as having the highest priority for review.

### U.S. Source Taxation of Non-U.S. Persons' U.S. Source Portfolio Income

Inbound portfolio investment by non-U.S. persons presents the most important and difficult U.S. source taxation issues. These issues have not been systemically reconsidered since the Fowler Commission reviewed the scope of U.S. source taxation of inbound foreign investment in the mid-1960s.<sup>24</sup> The globalization of the capital markets and vastly increased importance of foreign portfolio investment, the growth of derivatives and the increased ability to enforce source taxation through the massive revision of the withholding rules in the late 1990s all have changed the context in which these taxing rules are applied. It is time for a fresh review of the issues and consideration of possible proposals for reform.

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<sup>22</sup> Joint Committee, *Alternative Policies*, *supra* note 10, at 2, citing Joint Committee on Taxation, *Economic and U.S. Income Tax Issues Raised by Sovereign Wealth Fund Investment in the United States* (JCX-49-08) at 17.

<sup>23</sup> See Notice 2003-71, 2003-2 CB 922 (stock must be "listed," not of a class that is listed).

<sup>24</sup> See The Task Force on Promoting Increased Foreign Investment in United States Corporate Securities and Increased Foreign Financing for United States Corporations Operating Abroad, reprinted in Legislative History of H.R. 13103, 89th Cong., 2d Sess. Foreign Investors Tax Act of 1966 (1967); Stanford Ross, *United States Taxation of Aliens and Foreign Corporations: The Foreign Investors Tax Act of 1966 and Related Developments*, 22 TAX L. REV. 279 (1967).

A threshold issue is whether U.S. policy should continue to be to attract foreign portfolio investment through limited source taxation of portfolio income. Once the policy direction in this regard is determined, there are a series of source taxation topics that might be reviewed to consider reforms that further the desired policy. These topics include: (i) taxation of interest paid to related foreign non-treaty residents and non-taxation of bank deposit interest, short-term OID, portfolio interest and interest paid to most treaty residents; (ii) taxation of dividends and non-taxation of redemptions, liquidating distributions and stock sales; (iii) taxation of cross-border derivatives and securities loans; (iv) taxation of real estate and non-taxation of gains on most other non-business tangible and intangible property; (v) taxation of foreign investors in investment pass-throughs, including partnerships, bank common trust funds, investment trusts, RICs and REITs; (vi) taxation of foreign sovereign wealth funds; and (vii) treaty policy toward inbound portfolio investment.

### International Enforcement Issues

The United States' self assessment tax system, aided by robust but relatively unobtrusive information reporting, is the envy of other countries around the world. The continued willingness of Americans to pay their taxes is a critical element of the American form of democracy and an invaluable societal asset. The current economic crisis requires reliance on use of governmental resources that is unparalleled in recent history; those resources must be paid for with tax revenues (currently or in future repayment of government obligations).

There is little more corrosive of voluntary compliance than the spectacle of Americans hiding income in offshore accounts without prosecution or assessment and appropriate penalty.<sup>25</sup> Clearly this is an area in which the IRS presently is devoting significant resources, and the Obama Administration has made a number of legislative proposals in connection with its Fiscal Year 2010 budget proposal to Congress. In light of what has been reported publicly regarding the use of offshore accounts, it is appropriate to review the reporting rules for U.S. persons with foreign accounts and the processes necessary to ensure compliance with respect to income earned through such accounts.

Separately, tax avoidance in the form of American companies effectively transferring profits offshore through arrangements that do not comply with accepted arm's-length transfer pricing standards result in dead weight efficiency loss. It should be a tax policy objective to reduce or counteract incentives that foster purely tax-motivated activity, and it is appropriate to consider whether changes to transfer pricing enforcement processes and penalties could assist in deterring overly aggressive transfer pricing.

International enforcement increasingly requires cooperation from and with other countries. There is a need to enhance the ability of countries and their financial institutions to exchange information on a confidential basis that protects legitimate taxpayer privacy rights but frustrates tax evasion and avoidance based in nondisclosure.

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<sup>25</sup> For a description of recent enforcement efforts and findings, see Joint Committee on Taxation, *Selected Issues Relating to Tax Compliance With Respect to Offshore Accounts and Entities* (JCX-65-08).

In this regard, progress on as apparently simple an item as international agreement on a formatting and numbering system for information that today is routinely exchanged but in largely unusable form could help identify tax noncompliance issues. The United States should continue to work with other countries to improve cooperative compliance efforts.