# REPORT OF THE TASK FORCE ON INTERNATIONAL TAX REFORM*

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# CHAPTER 1: OBJECTIVES AND OVERVIEW OF REPORT

## I. INTRODUCTION

### A. *Objectives of the Report*

The American Bar Association Section of Taxation convened the Task Force on International Tax Reform (the "Task Force") to provide policymakers with objective criteria by which to evaluate reform proposals and to identify and analyze possible specific modifications to the U.S. international tax rules. This Report considers the taxation of U.S. persons' foreign business income.[1] The

[1]The Report does not discuss taxation of the U.S. income of foreign persons or rules that principally affect nonresident owners of U.S. corporations. The views expressed in this Report solely reflect the personal views of the authors and of the participants in the Task Force and do not represent the position of the American Bar Association, or of the Section of Taxation or any of its committees.



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Report identifies and evaluates possible changes to current law, but does not make legislative recommendations.[2]

While there is current questioning as to whether an income tax should be replaced with a consumption tax, the income tax is unlikely to be displaced. The problems of transition and the rates that would be required to achieve revenue neutrality, as well as other problems, are extremely daunting.[3] The Report proceeds on the assumptions that the income tax will be retained as a material element of the U.S. tax system and that the United States will continue to impose an income tax on business income.[4]

The remainder of this Part I discusses topics covered in subsequent chapters and reasons to consider reforms of the international tax rules. Part II of this Chapter provides an executive summary of the discussion in each subsequent chapter of the Report.

Chapter 2 of the Report discusses tax policy criteria for evaluating international tax rules, including fairness, efficiency, and administrability. Chapter 3 provides an overview of existing U.S. international tax rules and describes how current U.S. rules are applied in practice by taxpayers. Chapter 4 evaluates the following alternatives to the current rules, under the policy objectives described in Chapter 2: (1) an exemption system for taxing foreign income, and (2) taxing currently foreign income earned through a controlled foreign corporation.

Chapters 5 through 7 review structural elements of the current U.S. rules. These chapters identify and evaluate selected proposals for change in light of the policy objectives set out in Chapter 2. Chapter 5 discusses the foreign entity classification rules in the cross-border context and the rules for determining when a corporation (or a business entity treated as a corporation for tax purposes) should be treated as a U.S. tax resident. Chapter 6 analyzes selected aspects of the U.S. foreign tax credit rules for avoiding double taxation, including what income should be treated as foreign for purposes of the foreign tax credit limitation, when deductions should be considered to offset foreign income, how losses should be treated and the extent to which a credit for a foreign

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[2]Individual members of the Task Force do not agree with certain of the alternatives discussed and do not agree with all of the observations made in the Report.

[3]*See* A.B.A. Tax Sec. Tax Systems Task Force, *A Comprehensive Analysis of Current Consumption Tax Proposals* (1997). We also do not consider the effects of enacting broad federal consumption tax in addition to the existing income tax. *See* Michael J. Graetz, *100 Million Unnecessary Returns: A Fresh Start for the U.S. Income Tax System*, 112 YALE L.J. 261 (2002); Reuven S. Avi-Yonah, *Risk, Rents, and Regressivity: Why the United States Needs Both an Income Tax and a VAT*, 105 TAX NOTES (TA) 1651 (Dec. 20, 2004) [hereinafter Avi-Yonah, *Risk, Rents, and Regressivity*].

[4]The President's Advisory Panel on Federal Tax Reform has proposed two tax reform plans, the "Simplified Income Tax Plan" and the "Growth and Investment Tax Plan." While the Growth and Investment Tax Plan moves the federal tax system much closer to a consumption tax system, it retains some taxation of capital income. The tax on business income is very limited, for example, the plan permits businesses to expense most new investment. PRESIDENT'S ADVISORY PANEL ON FEDERAL TAX REFORM, SIMPLE, FAIR & PRO-GROWTH: PROPOSALS TO FIX AMERICA'S TAX SYSTEM, REPORT OF THE PRESIDENT'S ADVISORY PANEL ON FEDERAL TAX REFORM (Nov. 2005), *available at* http://www.taxreformpanel.gov/final-report/ [hereinafter the "PRESIDENT'S ADVISORY PANEL REPORT"].



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income tax should be allowed against U.S. tax on other foreign income (cross-crediting). Chapter 7 analyzes the taxation of foreign active business income earned by a U.S. person through a foreign corporation and makes proposals for reforming the subpart F base company sales and services rules. These subpart F proposals would have equal applicability if one of the proposals to move to a system for exempting foreign income were adopted.

The discussion in each of these chapters is summarized in Part II of this Chapter.

B. *Reasons to Consider International Tax Reforms*

A fundamental review of our rules for taxing foreign business income is long overdue for a number of reasons. There has been no such review since the 1960s. The Tax Reform Act of 1986 adopted substantial changes to the income source, expense allocation, and foreign tax credit rules largely in response to a concern that the 1986 Act's substantial reduction in U.S. corporate income tax rates would result in use of excess foreign tax credits to erode the U.S. tax base. Other changes, such as the passive foreign investment company rules, were adopted as responses to perceived abuses. The possibility of fundamentally altering the existing rules was given very limited consideration.[5] The American Jobs Creation Act of 2004 (the "AJCA") cannot be considered to have constituted international tax reform in any fundamental sense. The driving force behind adoption of the Act was to repeal the Extraterritorial Income Exclusion, which, as discussed in Chapter 3, benefits U.S. exporters that do not have foreign operations subject to high foreign taxes. In connection with that repeal, the Congress adopted a rate reduction on domestic manufacturing income and a series of other changes that reduced taxation of foreign business income. These changes continued the direction of existing U.S. rules that, as described more fully in Chapter 3, may be applied to achieve a very low effective rate of taxation of foreign business income.

For example, the AJCA's changes to the foreign tax credit limitation rules substantially expand the extent to which high foreign taxes can be "cross-credited" against U.S. tax on other, low-taxed foreign income. As discussed below, cross-crediting is inconsistent with a position that income earned in another

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[5]U.S. TREAS. DEP'T, PRESIDENT'S TAX REFORM PROPOSALS TO THE CONGRESS FOR FAIRNESS, GROWTH AND SIMPLICITY 383 (May 1985). There have been several discussions of international issues released or issued by the Staff of the Joint Committee on Taxation and the Treasury Department since 1986. *E.g.*, STAFF OF JOINT COMM. ON TAX'N, BACKGROUND AND ISSUES RELATING TO TAXATION OF INVESTMENT OUTSIDE THE UNITED STATES BY U.S. PERSONS, JCS-6-91; U.S. TREAS. DEP'T, INTERNATIONAL TAX REFORM: AN INTERIM REPORT, 1993 TAX NOTES TODAY 15-30 (Jan. 22, 1993) [hereinafter U.S. Treas. Dept., INTERNATIONAL TAX REFORM]; U.S. TREAS. DEP'T, THE DEFERRAL OF INCOME EARNED THROUGH U.S. CONTROLLED FOREIGN CORPORATIONS: A POLICY STUDY (2000), *available at* http://www.treas.gov/offices/tax-policy/library/subpartf.pdf [hereinafter U.S. TREAS. DEPT., DEFERRAL STUDY]; STAFF OF JOINT COMM. ON TAX'N, 107TH CONG., STUDY OF THE OVERALL STATE OF THE FEDERAL TAX SYSTEM AND RECOMMENDATIONS FOR SIMPLIFICATIONS, PURSUANT TO SECTION 8022(3)(B) OF THE INTERNAL REVENUE CODE OF 1986 (2001).



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country should be taxed at the rate imposed by that country, because it effectively lowers the burden of the source country tax by allowing it as a credit against the U.S. tax on other foreign income.[6] At the same time, the AJCA also included a supposedly one-time 85% dividends-received deduction for so-called homeland dividends that will be utilized principally with respect to foreign earnings that have borne a low rate of foreign tax. The consistent feature of these and other AJCA international tax provisions is that they further reduce the U.S. taxation of foreign income of U.S. multinational corporations.[7]

The President's Advisory Panel Report also did not undertake a fundamental review of the international tax provisions. The Panel recommends adoption of a territorial system in its Simplified Income Tax Plan, citing research that "*suggests* this reform *could* lead to both efficiency and simplification."[8] Yet, the Report also argues that the proposal provides "no additional incentive to invest abroad, if, in response to the current system, firms have already arranged their affairs to avoid the repatriation tax" and that the "Simplified Income Tax Plan would produce no less revenue from multinational corporations than the current system."[9]

The analysis in the President's Advisory Panel Report rests on the assumption that eliminating the tax on repatriation would not open up the benefits of low-taxed foreign income to new taxpayers, which, as discussed in Chapter 4, would appear to be clearly incorrect. The President's Advisory Panel Report does not discuss the conflicting research on the efficiency effects of moving to an exemption system, and does not analyze any alternatives to exempting foreign business income.

The President's Advisory Panel Report appears to have accepted current law treatment of foreign income as a measure of an appropriate level of taxation of foreign income. This was not a requirement of its mandate to propose reform plans that are revenue neutral overall. The effective rate of U.S. and foreign income taxation of foreign income is understood to be materially lower than the

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[6]As discussed in Chapter 4, under an exemption system, high foreign taxes on exempt income cannot be taken as a benefit against other income.

[7]As discussed below, the justification for taxing foreign income favorably is to provide an incentive for foreign investment that will advance the welfare of U.S. citizens and residents. *Ex post facto* tax relief can have no effect on the original decision to invest abroad. The homeland dividend provision did not include rules that meaningfully directed the re-investment of the repatriated earnings in productive investment, which, even when attempted with seriousness, is a difficult task (as may be seen from the history of the now repealed investment tax credit). The homeland dividend measure was justified as an economic stimulus measure. It likely will be shown to be deficient in this regard because money is fungible, and in most cases the effect will be to reduce borrowing or to shift borrowing from the U.S. parent corporation to the foreign subsidiary. Homeland dividend relief, which was opposed by the Bush Administration Treasury Department, effectively rewards earning low-taxed foreign income whether or not there was a sound business purpose for the original business investment. Such relief might have been justified were it a "price" of transition for modified international tax rules, but this was not the case. The only rational explanation for the homeland dividend measure is by reference to objectives that are outside the realm of economic or tax policy.

[8]PRESIDENT'S ADVISORY PANEL REPORT, *supra* note 5, at 134 (emphasis added).

[9]*Id*. at 135.



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effective rate on domestic income.[10] The President's Advisory Panel Report does not discuss this fact, question whether a disparity in taxation is good policy, or explore justifications for such a policy.

The President's Advisory Panel Report set out the following standard for consideration of proposals that favor one activity over another:

> 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.[11]

Instead of rigorously applying this standard to the taxation of foreign business income, including whether foreign income should be exempt from tax, the President's Advisory Panel uncritically accepts the need for continued favorable taxation of foreign business income without analyzing its consequences for the overall U.S. taxation system. This Report takes a different approach and examines the taxation of international business income under standards that are consistent with the standard articulated above.

Before undertaking a review of U.S. international tax rules, the following sections describe changes in the context in which international tax rules are applied that have occurred since the adoption of the subpart F regime in the 1960s. These changes should be taken into account in connection with evaluating possible changes to current international tax rules.

1. *Fairness*

Recently, policymakers have been challenged to take account of fairness as a criterion in international tax policy and an analysis of our international rules should include consideration of fairness issues.[12] While there may be differences regarding the ideal tax base or rate structure to employ in taxing income, there is a broad consensus supporting application of fairness criteria to policy analysis of the income tax system.

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[10]The effective U.S. tax rate on currently-taxed foreign-source income of U.S. manufacturing firms in 1994 was estimated by the U.S. Treasury to be 26.4%. U.S. Treas. Dep't, Deferral Study, *supra* note 6, at 195.

[11] President's Advisory Panel Report, *supra* note 5, at xiii.

[12]*See* Michael J. Graetz, *Taxing International Income: Inadequate Principles, Outdated Concepts and Unsatisfactory Policies,* 54 Tax L. Rev. 261, 294, 307 (2001) [hereinafter Graetz, *Taxing International Income*]; 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, 301-306 (2001) [hereinafter Fleming, Peroni & Shay, *Fairness in International Taxation*]; Nancy H. Kaufman, *Fairness and the Taxation of International Income*, 29 Law & Pol'y Int'l Bus. 145 (1998).



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One of the objectives of this Report is a balanced discussion of the consequences of different ways of taxing foreign income.[13] The Report identifies ways in which the international tax rules may be used to achieve a low level of taxation of income from U.S. economic activity that is treated as foreign income as well as on other "real" foreign income. A lower tax burden on foreign business income should be justified by benefits to U.S. citizens and residents that exceed the costs of the resulting increased taxation on domestic income.

2. *Global Economic and Political Change*

Our international tax rules need to take account of the economic and political context in which they are applied, including our relations with other countries and their peoples. Over the last half century, elimination of exchange controls and adoption of free exchangeability of currencies, increasingly efficient global capital markets, revolutions in communications and information processing, reductions in barriers to trade and movements of people, and faster and cheaper transportation of goods and people have contributed to a reconfiguration of our economy and its relationship to the global economy. The transaction costs of cross-border economic activity have been dramatically reduced.[14] Whole U.S. industries have died or moved to other countries and new U.S. industries have been born and thrive. These changes have contributed to a vastly increased economic and political interdependence of countries within and between regions of the world.

While the United States is currently the dominant global economic power, lowered barriers between markets for goods, services, labor, and knowledge are supporting economic growth and development in the European Union, the Peoples Republic of China and formerly less developed countries such as India. Certainly, the stability and economic prosperity of developing countries is in the United States' long-term interest. However, U.S. citizens and residents are competing in a global economic marketplace, and our government's highest priorities should include the need to advance (and certainly not impede) the ability of American individuals, and the businesses that employ them, to be successful in the competition to sustain and create strong jobs in the United States.

3. *Changes in Business Practice*

Our international tax rules were designed when cross-border economic activity consisted principally of the sale of manufactured goods and certain services.

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[13]Most federal income tax revenue derives from the taxation of domestic economic activity. Individual and corporate income taxes are the largest category of federal revenue. In 1999, federal and state individual and corporate income taxes accounted for 49% and social security and other payroll taxes accounted for 23.9% of total U.S. tax revenue. Taxes on property, goods and services (so called indirect taxes) accounted for only 27.1% of 1999 U.S. tax revenue.

[14]*See generally* Robert H. Gordon & James R. Hines, Jr., INTERNATIONAL TAXATION, WORKING PAPER 8854, NBER WORKING PAPER SERIES, *available at* http//www.nber.org/papers/w8854 (April 2002); Reuven S. Avi-Yonah, *International Taxation and Electronic Commerce*, 52 TAX L. REV. 507 (1997).



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Today, services and transfers of intangible property have dramatically increased in importance. International tax rules based on a paradigm of property being manufactured and sold do not readily accommodate the deconstruction of economic functions that characterizes modern business. Services are outsourced to related or unrelated providers. Manufacturing is performed at multiple locations, using related or unrelated vendors and employing just-in-time inventory and modern logistics. Intangible values are recognized in the market and legally protected intangibles are used as commercial swords and shields, and are located to maximize tax efficiency. These phenomena place pressure on the ability to apply transaction-based tax and intercompany transfer pricing rules to a range of common transactions.

In the past decade, multinational taxpayers have brought increased resources and focus to reducing their overall tax costs. Partly as a consequence of transfer pricing documentation requirements and partly as part of an effort to lower tax costs, multinational taxpayers pay increasing attention to transfer pricing, including transfer pricing planning. Taxpayers' advisors routinely bring tax reduction planning ideas to their attention. In designing international tax rules, policy makers must take account of the effects of business pressures to lower tax costs on U.S. and foreign business activity, as well as broader competitive pressures arising from global markets.

4. *Preservation of U.S. Tax Base*

There is evidence that U.S. multinationals are shifting increasing portions of their profits to low- or zero-tax foreign countries.[15] Some of the profits shifted to low-tax countries likely are from the United States as well as from foreign countries.[16] While looking to international income as a source of additional revenue, it also should be evaluated in relation to other applicable tax policy criteria; it is important to analyze whether existing international rules adequately protect the intended U.S. tax base.[17] The description in Chapter 3 of current international tax rules and how they are employed in planning suggests that these rules permit substantial erosion of a reasonably defined U.S. tax base. If fundamental reform proposals are made that increase taxation of U.S. income, it will be important to assure U.S. taxpayers that foreign business income is not

[15]Martin A. Sullivan, *U.S. Multinationals Move More Profits to Tax Havens*, 102 TAX NOTES (TA) 690, 690 (Feb. 9, 2004).

[16]The largest international item in President Bush's FY 2005 tax expenditure budget under the "normal tax method" base line is deferral of income earned through controlled foreign corporations ($48.010 billion for the 5-year period 2005 – 2009). OFFICE OF MGMT. & BUDGET, EXECUTIVE OFFICE OF THE PRESIDENT, ANALYTICAL PERSPECTIVES, BUDGET OF THE UNITED STATES GOVERNMENT 287 (Fiscal Year 2005).

[17]The Joint Committee proposal for a dividend exemption system would increase revenues, when measured against a base line of current law, by $54.8 billion over the 10-year fiscal 2005 – 2014 period (and $25.8 billion for the 5-year period 2006 – 2010). STAFF OF JOINT COMM. ON TAX'N, OPTIONS TO IMPROVE TAX COMPLIANCE AND REFORM TAX EXPENDITURES, JCS-02-05, 427 (Jan. 27, 2005) [hereinafter JOINT COMMITTEE STAFF, OPTIONS].



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inappropriately advantaged. While changes to international tax rules generally have not been a source of revenue, changes that redress incursions into the U.S. tax base would indeed raise revenue.

5. *Accretive Complexity*

An additional reason for fundamental review of our current international tax rules is the burden of "accretive complexity" resulting from numerous changes to these rules (including by the AJCA) without a consistent tax policy direction. Indeed, most of the amendments to the international rules over the last two decades have been stop-gap responses to perceived abuses without significant consideration of underlying policies.[18] There is widespread consensus that our international tax rules are complex and impose substantial compliance burdens. It is appropriate to consider reforms that would meaningfully reduce this burden consistent with other policy objectives.

## II. EXECUTIVE SUMMARY OF REPORT

This Part II summarizes the discussion of issues addressed in the following chapters of the Report. Each of the following sections summarizes the analysis and conclusions of a Chapter.

### A. *Policy Objectives for Taxing Foreign Business Income (Chapter 2)*

Chapter 2 discusses the policy objectives for taxing foreign business income. In particular, the chapter addresses how the three general tax policy objectives of fairness, efficiency, and administrability are applied with respect to our international tax rules.[19]

Chapter 2 recognizes that the distinguishing feature of foreign income which introduces additional considerations in applying the traditional tax policy criteria is that another country may assert the right to tax the same income. The international tax rules provide for the interaction between the U.S. federal income tax system and the income tax systems (or absence of income tax systems) of other countries in order to address potential double taxation, and double non-taxation, of the same income.

A starting point for the analysis in this Report is that the measure of U.S. welfare is the well being of individual U.S. citizens and residents. Accordingly,

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[18]Recent proposals by the Staff of the Joint Committee on Taxation to improve compliance and reform tax expenditures in the international area, other than a dividend exemption proposal, would continue this trend. JOINT COMMITTEE STAFF, OPTIONS, *supra* note 17, at 174-185.

[19]These criteria ask whether tax rules (1) are fair, taxing equals equally and taxing based on the ability to pay, (2) are efficient in that they minimize distortion of economic decisions and allocation of resources (unless the rule has an explicit subsidy or deterrent objective), and (3) are as simple and administrable as possible. *See* U.S. TREAS. DEP'T, TAX REFORM FOR FAIRNESS, SIMPLICITY AND ECONOMIC GROWTH 13-19 (1984). These criteria also are used to evaluate options for tax reform in the 2005 Economic Report to the President by the Council of Economic Advisors, except this Report refers to "efficiency" instead of "growth" as the second criterion. *See* COUNCIL OF ECON. ADVISORS, ECONOMIC REPORT OF THE PRESIDENT 77 (2005).

the tax policy objectives of fairness, efficiency, and simplicity should be applied to advance the welfare of individual U.S. citizens and residents.[20]

*1. Fairness*: The taxation of foreign business income should be consistent with U.S. concepts of fairness, including the "ability to pay" criterion. As further discussed in Chapter 2, fairness is relevant only in relation to individuals who bear the taxes paid by business entities; and is not applicable in any meaningful way in relation to corporations. It also is not appropriate to apply the ability to pay principle to individuals who are taxed by the United States solely on a source basis, because it is not possible to factor in their non-U.S. income. The fairness criterion in this Report is measured exclusively in relation to U.S. citizens and residents.

There is no a priori reason for excluding foreign income from the analysis of a person's ability to pay. This is true whether the income is earned directly by individual U.S. citizens or residents or indirectly through foreign activities of U.S. or foreign corporations. If U.S. taxation on U.S. taxpayers' foreign business income is lower than the same taxpayers' domestic business income, U.S. persons who do not earn such income will be subject to heavier taxation solely because of where the business is located. This would violate the ability-to-pay norm. To justify relief from U.S. tax on foreign business income, there should be an identifiable benefit to individual U.S. citizens and residents from such relief.

Measures taken to mitigate international double taxation, such as allowing a credit for foreign income taxes or exempting active foreign business income, will not be fully consistent with the ability to pay criterion measured by reference to U.S. citizens and residents. Relief from double taxation may be justified, however, by the expectation that the "comparative advantage" benefits of international trade will accrue to individual U.S. citizens and residents. It is a more difficult question whether relief from double taxation on foreign income should be extended so that foreign income is actually treated more favorably than domestic income (for example, through deferral or exemption of foreign income) and whether this can be justified notwithstanding that it is inconsistent with the ability to pay criterion.

*2. Efficiency*: Rules are efficient if they distort economic decisions as little as possible. There has been an ongoing debate over how to apply the efficiency criterion in the context of foreign business income of U.S. taxpayers earned from cross-border direct investment. As discussed in Chapter 2, historically, the debate has centered around whether taxation of investment should be neutral in relation to the residence of the taxpayer (capital export neutrality - which may be

[20]Consistent with this premise, the fact that a policy may advance global welfare on the one hand, or the interests of U.S. corporations or other U.S. business entities over foreign business entities on the other hand, should not be determinative unless there is a reasonable basis to conclude that individual U.S. citizens and residents will realize a benefit in relation to overall costs.



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thought of as residence-based taxation) or in relation to where the investment is located (capital import neutrality - which may be thought of as source-based taxation).

Capital export neutrality would be satisfied if the decision of a taxpayer regarding where to invest is independent of the level of taxation in the place where the investment is made (the source country). Under the capital export neutrality principle, foreign income would be taxed currently with an unlimited foreign tax credit. Capital import neutrality is satisfied if the income from an investment is subject to the same tax irrespective of where the owner is resident. To fully implement capital import neutrality, all residence countries would exempt foreign income and tax would be levied by only the country where income is earned (the source country). Capital export and capital import neutrality each may be satisfied only if there is uniformity of taxation by all residence and source countries, which of course is never the case. Neither form of neutrality is achieved in full by the United States or any of its major trading partners.[21]

There is no consensus on what form of neutrality is in the overall U.S. interest and this Report does not attempt to resolve this debate. There is not sufficient evidence for the members of the Task Force to reach a consensus that any one of the competing efficiency principles should be determinative in the design of the international tax rules. Instead, the Report adopts a pragmatic approach and evaluates how rules are applied or likely would be applied by taxpayers in practice and considers their actual or expected effects. The Report generally favors reducing effective tax rate differentials with respect to foreign income because of the resulting potential to distort investment decisions. If foreign income is subject to a materially lower effective tax than domestic income, transfer pricing rules will not be effective to stem tax-motivated income shifting. The Report is concerned with whether a taxation rule, or more relevantly, a combination of taxation rules, have the effect or would have the effect of either encouraging foreign business activity or discouraging international investment because of unrelieved double taxation or excessive administrative burden.

3. *Administrability*: The Report recognizes the burdens that complexity places on the government and taxpayers. The costs of raising revenue for government services are productive expenditures. These costs, both direct and indirect by reason of the distortion of taxpayer behavior, become unproductive when they are disproportionate to the benefit achieved. To the extent that complexity causes excessive costs of raising revenue, whether for taxpayers or the U.S. Government, it is harmful.

[21]As discussed further in Chapter 2, Professors Desai and Hines have proposed a concept of capital ownership neutrality. *See infra* text accompanying notes 40-43, *infra*. The idea is that global efficiency is enhanced if an asset is owned by the person or company that is in the best position to achieve the highest value from the asset. Capital ownership neutrality may be satisfied by uniform taxation by the residence and source countries or unilaterally by exemption of foreign income.

There are many sources of income tax complexity: the inherent difficulty of defining and taxing income; the complexity of our economy and modern business transactions; competing policy objectives, including a desire to address perceived inequities; the nature of our political process; and, more and more in recent years, legislative and administrative efforts to confront the "creative compliance" of taxpayers and their tax advisers. The potential for double taxation or for double non-taxation are potentially major sources of additional complexity with respect to international income.

Complexity derives both from provisions that favor taxpayers and from provisions designed to restrict tax avoidance or limit tax benefits. Indeed, if rules permit substantial differences in effective tax rates on a particular category of income, such as foreign income, inevitably additional rules will be required to police the boundaries of the favored category of income. Thus, to decrease complexity, one must reduce the number and scope of such "preferential" rules.

As discussed in Chapter 3, the international tax rules are rife with elections. Every election, though by definition potentially advantageous to taxpayers, also increases complexity and compliance burdens. Meaningful simplification will not be achieved in the absence of policy changes that restrict the degree of electivity that currently is one of the hallmarks of the U.S. international tax rules.

The Report does not favor over-emphasizing simplicity in the design of international tax rules. The weight of technical complexity and administrative burden of international rules falls primarily, although not exclusively, on the largest and most sophisticated taxpayers in the U.S. income tax system. Indeed, there is a "Catch 22" in that simple rules are also the most easily taken advantage of by sophisticated taxpayers. Simplicity should not come at an unacceptable cost in relation to other policy objectives.

4. *Combinations of Policy Objectives*: The policy criteria of fairness, efficiency, and administrability to some degree conflict. Very broadly, it is possible to articulate two alternate mixes of policy objectives that represent the principal different views regarding U.S. international tax policy.

One set of objectives would give weight to the ability to pay criterion (among U.S. citizens and residents), evaluate efficiency in relation to the tax burdens on foreign versus domestic income of the same taxpayer, seek to enhance administrability by narrowing the differential in taxation of foreign and domestic income and continue to assert a U.S. claim to tax the worldwide business income of its residents. These criteria would favor moving toward taxing comprehensive income by expanding current taxation of foreign income and allowing a foreign tax credit only to the extent there is actual double taxation of U.S. income.

A second set of objectives would weigh the fairness objective less heavily as it applies to foreign income beneficially owned by U.S. citizens and resident individuals, evaluate efficiency in relation to the ability of U.S.-owned businesses to compete abroad, seek to enhance administrability by excluding active



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foreign business income from taxation, and relinquish claims to active foreign income as a source of U.S. tax revenue. This set of criteria could support going beyond alleviating double taxation to deferring, or exempting from U.S. taxation, certain active foreign business income subject to taxation by another country.

B. *U.S. Taxation of a U.S. Person's Foreign Business Income (Chapter 3)*

Chapter 3 provides an overview of the current U.S. rules for taxation of U.S. persons' foreign business income. Current law may be applied to achieve very low effective rates of combined foreign and U.S. taxation of foreign income earned in or shifted to countries that tax at lower rates than the United States or countries that do not tax income at all. Taxpayers operating in high-tax foreign countries may average down their high foreign tax rates by taking advantage of current income source and expense allocation rules to credit high foreign taxes against U.S. tax on income from U.S. economic activity as well as U.S. tax on other low-taxed foreign income. For example, taxpayers that earn low-tax foreign income can benefit from deferral of the imposition of the higher U.S. tax rate through use of foreign corporations that avoid the anti-deferral rules of current law. Taxpayers that earn high-tax foreign income can use excess foreign tax credits against income from export sales that is treated as foreign-source income for U.S. tax purposes and thereby avoid U.S. tax on what in most countries would be considered domestic income.

The review of U.S. tax rules in Chapter 3 does not support a conclusion that the U.S. rules for taxing international business income unfairly disadvantage U.S. multinational taxpayers. With proper planning, U.S. income tax rules may be applied to achieve, with respect to low-taxed foreign income, effective tax rates comparable to those possible under a territorial tax system that exempts foreign income. But, in addition, high foreign taxes may be cross-credited against U.S. tax on other "foreign" income in the same foreign tax credit limitation category. The latter benefit may be contrasted with an exemption system that generally does not allow a benefit for high foreign taxes. For U.S. multinational taxpayers, despite their complexity, the current U.S. rules can be the best of all worlds.

Examples of well known planning techniques in Chapter 3 illustrate the flexibility of the international rules with respect to both low- and high-taxed foreign income. Examples in Chapter 3 illustrate: (1) the value of deferral, (2) the flexibility to claim losses in a deferral structure (in which losses generally would not be allowed under an exemption system), (3) the use of intercompany debt and other deduction-generating arrangements to reduce foreign taxes without increasing U.S. income, (4) how to accelerate foreign tax credits without recognizing the foreign income being taxed in U.S. income, and (5) the use of transfer pricing to maximize the benefit from low effective foreign tax rates.

One of the important observations to be made from the examples in Chapter 3 is that one tax rule may be used in interaction with another tax rule to achieve unintended effects. Thus, in one example, the so-called technical taxpayer rule

may be used to cause creditable foreign taxes to be treated as paid by a disregarded entity owned by a U.S. taxpayer while the associated income is treated as earned by a foreign corporation so that the U.S. taxpayer-shareholder enjoys the benefits of deferral of U.S. tax on such income. This interaction achieves a result that arguably is inconsistent with the purposes of the foreign tax credit regime. Yet, taken separately, both the technical taxpayer rule and the elective entity classification rules were intended to achieve administrative simplicity.

A number of rules, such as the asymmetry of foreign loss recapture without domestic loss recapture and a "waters edge" allocation of interest expense between domestic and foreign income, arguably over-burden foreign income. These rules, however, were amended prospectively in the AJCA. Generally, the areas in which the international tax rules have disfavored foreign income have been modified, while the rules that favor foreign income have not been addressed to the same extent.

The complexity of the international tax rules requires sophisticated planning to achieve favorable results and may end in traps for taxpayers that are not well advised. As discussed in Chapter 2, however, simplicity is not an end in itself. Indeed, the most effective way to reduce the burden of complexity is to reduce the number of elections and effective tax rate differentials that are the driving force behind most planning.

### C. *Fundamental Reform Alternatives to International Tax Rules: Exemption Versus Current Taxation (Chapter 4)*

Chapter 4 reviews two fundamental reform alternatives to the current international tax rules: exempting active foreign business income and curtailing deferral on foreign business income earned through a foreign corporation. Chapter 4 reviews two exemption proposals: one proposed by the Staff of the Joint Committee on Taxation (which is similar in most respects to the exemption proposal included in the President's Advisory Panel on Federal Tax Reform's Simplified Income Tax Proposal (SITP)) and the other put forward in summary form by H. David Rosenbloom.[22] Chapter 4 also considers a proposal to reform the taxation of foreign income by taxing a U.S. shareholder in a controlled foreign corporation on the U.S. shareholder's share of the earnings of the foreign corporation in the year earned, whether or not the earnings are distributed. The proposal raises the possibility of using a simplified measure of foreign income.

The Joint Committee Staff exemption proposal (and the President Advisory Panel's exemption proposal) would exempt a domestic corporation from tax on dividends of earnings from a foreign corporation attributable to certain active

[22]Joint Committee Staff, Options, *supra* note 17, at 186-197; H. David Rosenbloom, *From the Bottom Up: Taxing the Income of Foreign Controlled Corporations*, 26 Brook. J. Int'l L. 1544 (2001) [hereinafter "Rosenbloom, Taxing CFCs"]. This Report's comments on the Joint Committee Staff proposal generally are applicable to the exemption system proposed in the President's Advisory Panel's SITP proposal.



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business income. The proposal would not require any minimum level of foreign tax (or even a subject-to-tax requirement), as a condition for exemption. In other words, the proposal would extend exemption to foreign earnings of a CFC so long as they are not taxed under subpart F even if the foreign country in question imposed no tax on the income.

Both the Joint Committee Staff and the President's Advisory Panel exemption proposals would tax foreign royalties (and interest). Both proposals would retain current taxation and allowance of a foreign tax credit for subpart F income (or Mobile Income under the President's Advisory Panel proposal).

Mr. Rosenbloom proposes to exempt foreign business income, whether earned directly or through a foreign corporation controlled by a U.S. taxpayer, attributable to a substantial business presence in designated foreign countries with "serious" tax systems. To achieve simplification, the Rosenbloom proposal would tax all other income currently with only a deduction for foreign taxes. A minority shareholder either (1) would be allowed to exempt income of the foreign corporation attributable to a permanent establishment if the shareholder had sufficient information to determine the amount, or (2) would not be taxed until the shareholder receives income (and would not be eligible for a tax credit for corporate level taxes).

None of the foregoing exemption proposals attempt to justify exemption of foreign business income on fairness grounds. An exemption proposal that provides greater relief from U.S. tax than is required to relieve double taxation is difficult to justify under any fairness analysis. Exemption conditioned on exempt income being subject to foreign tax at an effective rate close to the taxpayer's U.S. effective rate would commensurately reduce the force of this criticism if the foreign tax were considered equivalent to a U.S. tax.

Under current law, deferral is beneficial principally to U.S. taxpayers that have non-U.S. businesses in which to invest the deferred earnings. Under the Joint Committee Staff (and President's Advisory Panel) exemption proposal, however, any kind of non-subpart F income (non-Mobile Income in the President's Advisory Panel proposal) that can be earned at a lower tax rate outside the United States could benefit from exemption *and* the cash could be repatriated to the United States. This opens the door to use of low- or zero-tax jurisdictions that would go beyond what is possible under current law because there would be no limit on repatriating the untaxed or low-taxed earnings. These proposals would offer the greatest possible incentive to shift income to zero- or low-taxed jurisdictions without regard to whether the taxpayer has a foreign business in which to invest the exempt earnings. The Rosenbloom proposal is designed to limit exemption to cases where there likely would be a source country tax without applying an effective tax rate or minimum level of foreign tax as a condition for exemption.

The Joint Committee Staff (and President's Advisory Panel) exemption proposals would put pressure on a range of collateral rules. First, consideration would have to be given to whether property should be permitted to be transferred tax-free for use in a trade or business outside the United States that would

then generate exempt income and gains. Transfer pricing would mean higher stakes for both the taxpayer and the U.S. government. Likely, the rules would need to be reviewed, and stronger enforcement practices put into place. There would be pressure to expand the range of income subject to current taxation, particularly in relation to sales back to the United States, to backstop the inability to adequately police the shifting of income offshore. The expense allocation rules would have to be rigorously enforced with respect to every taxpayer earning exempt foreign dividends to prevent allowance of deductions for expenses generating exempt income. Under current law, enforcement of expense allocation rules only yields a tax adjustment for the government where the taxpayer has or will have excess foreign tax credits.

Under the Joint Committee Staff (and President's Advisory Panel) proposal, foreign interest, royalties, and non-exempt dividend income would be taxed currently and a foreign tax credit would be allowed with respect to foreign income taxes on this income under current law rules. In contrast, under the Rosenbloom proposal, foreign interest and dividends and non-exempt income of a controlled foreign corporation would be taxed currently and only a deduction allowed for foreign taxes.

The Joint Committee Staff and President's Advisory Panel proposals to employ the foreign tax credit regime for non-exempt income retains the complications of the foreign tax credit regime (without reforms prescribed) in parallel with the new exemption regime. Once again, a disparity in treatment of foreign business income and other income will create incentives at the margin for planning to push low-taxed income into the exemption regime and high-taxed income into the foreign tax credit regime to the extent cross-crediting may relieve the burden of the high tax. The simplicity benefits of exemption are compromised by retaining the foreign tax credit regime for non-exempt income. The Rosenbloom proposal, in contrast, would only allow a deduction for foreign taxes on non-exempt income. Contrasting the two proposals highlights the fact that the broader the range of non-exempt income, the greater the pressure will be to allow a credit rather than a deduction for foreign income taxes.

International provisions principally affect large or sophisticated businesses or investors. Justifying exemption in part on simplicity grounds, as both the Joint Committee Staff and President's Advisory Panel do, is misleading if exemption is implemented in a manner that does not protect the U.S. tax base. The effective rate differentials would promote substantial tax planning. Moreover, simplicity gains from an exemption system would not be realized if the foreign tax credit regime is retained, unless it is restricted to a very narrow range of cases or credit rules are reformed to minimize cross-crediting.

The alternative fundamental reform would retain taxation of worldwide income of U.S. persons and substantially reduce the scope for deferral of U.S. tax on foreign income. This alternative should be considered in conjunction with reforms to the foreign tax credit addressed in Chapter 6.

Under the current taxation proposal, U.S. persons who own 10% or more, by vote or value, of a controlled foreign corporation (including for this purpose a



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foreign corporation that has a 25% U.S. shareholder group) would be taxed currently on their share of the foreign corporation's earnings. Less-than-10% U.S. shareholders and 10% U.S. shareholders (each by vote or value) in foreign corporations that did not have a 25% U.S. shareholder group would be taxed under current law rules on distributions when received. The passive foreign investment company (PFIC) taxing rules – a deferred tax with an interest charge, qualified electing fund pass through taxation, or market-to-market taxation – would continue to apply to a U.S. shareholder in a PFIC. The PFIC asset test, however, would be eliminated and the passive income threshold would be reduced to 50% from 75%.

Consideration would be given to permitting U.S. shareholders in a foreign corporation to use a modified earnings and profits calculation that relies on foreign financial income, determined under Internationally Accepted Accounting Standards (IAAS) or an equally accepted standard, as the starting point for a measure of corporate income subject to current shareholder-level taxation. These financial earnings would be adjusted as necessary to constitute an acceptable simplified earnings and profits measure for determining shareholder income. Income effectively connected with a United States business would not be subject to current shareholder taxation, and these earnings would be determined under regular U.S. tax accounting principles.

A U.S. shareholder subject to current taxation of foreign corporate earnings would first apply distributions to earnings previously taxed to the shareholder (which would be exempt), and then to the shareholder's share of effectively connected earnings. Distributed amounts in excess of these measures would be applied to recover the shareholder's basis, and any excess would be treated as capital gain with respect to the share. This approach to distributions would eliminate the need to track earnings and profits. Previously taxed earnings would be measured at the shareholder level and would not transfer to a new shareholder. Simplified reorganization rules should be applied that would permit rollover of tax basis in shares.

A ten percent corporate shareholder would continue to be allowed an indirect foreign tax credit for the foreign corporate-level taxes deemed distributed with the current inclusion of earnings. "Effectively connected" earnings distributed to a domestic corporate shareholder would be allowed a regular dividends received deduction.

The current taxation alternative would reduce the opportunities for U.S. taxpayers to benefit from lower tax rates in foreign countries, whether under a local tax holiday or as a consequence of tax planning designed to lower the foreign effective tax rate, and would be supported by the ability to pay criterion. Current taxation of low-taxed foreign income would decrease the after-tax returns of such non-U.S. investments below what they would be to an investor-resident in the local country or in a third country that exempts foreign active business income, as well as in relation to the current law deferral system.

A reduction in the elective nature of the U.S. tax on foreign income and the rate differential between domestic and international income would reduce the



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scope for taxpayer planning to take advantage of differences between effective tax rates. It would act as a "backstop" to transfer pricing enforcement to frustrate income shifting to lower-tax jurisdictions. Combined with other base broadening measures and lower corporate tax rates, it would enhance the fairness, efficiency and administrability of the U.S. international tax rules.

### D. *Foreign Entity Classification and Corporate Residence (Chapter 5)*

Chapter 5 reviews the foreign entity classification and corporate tax residence rules and possible modifications to those rules.

#### 1. *Foreign Entity Classification*

Under current elective check-the-box entity classification rules, except for certain per se foreign corporations, it is possible to elect to classify a foreign business entity for U.S. tax purposes as a corporation or pass-through entity without regard to the entity's classification under foreign law. If a pass-through entity has a single owner, it will be disregarded for U.S. tax purposes. Classification of a foreign legal entity as a corporation for U.S. tax purposes does not cause the entity to be subject to an entity level corporate tax in the United States unless the entity earns income effectively connected with a U.S. trade or business.

The ability to employ inconsistently classified entities in foreign structures to achieve planning objectives, and the relatively "frictionless" ability to change a foreign entity's form for U.S. tax purposes, has made elective entity classification an unparalleled planning tool to minimize both foreign and U.S. tax on non-U.S. earnings. Examples of such planning are provided in Chapter 3 and additional planning opportunities are described in Chapter 5. Elective check-the-box classification rules put pressure on the structural infirmities of other tax rules. Deferral, cross-crediting of foreign tax credits, overly favorable source rules, and other second-best structural features of the U.S. international rules may have been viewed as yielding acceptable trade-offs in the context in which they were adopted. The revenue loss and inefficiencies resulting from the heightened international planning following adoption of the check-the-box rules (as well as other changes in the business environment described in Part I of this Chapter) are substantial and a review of elective foreign entity classification is appropriate.

The U.S. tax classification of a foreign business entity as a pass-through entity or a corporation determines whether for U.S. tax purposes (1) the owner includes income and loss under conduit principles, or (2) income and loss is determined at the entity level and U.S.-source income is subject to entity level taxation (foreign-source income only being taxed at the member level). As discussed in Chapter 5, no rationale other than the difficulty of administering a conduit tax regime for entities that are publicly-traded or that have many members has acquired widespread acceptance as a basis to impose an entity-level tax.

In the international context, there is no U.S. entity level tax on foreign income of a foreign corporation. It is argued by some that conduit taxation should be the norm for taxation of all private business enterprises. Alternatively, in light of the

fact that substantive U.S. international tax rules apply to income subject to the taxing jurisdiction of the country in which the foreign business entity is tax resident, it would be logical to relate in some rational way the classification of a foreign business entity to the taxation of the entity under the income tax law in its country of tax residence insofar as that taxation is likely to affect taxation of a U.S. owner. This would decrease the scope for tax avoidance resulting in double non-taxation and increase the likelihood that the U.S. international tax rules will operate in the manner intended. Elective U.S. classification without regard to whether or how the entity is taxed in its jurisdiction of residence fosters the use of intentionally inconsistent classification by taxpayers to achieve results not intended by the United States (or the foreign jurisdiction), and increases the likelihood that the taxpayer will take advantage of inconsistencies in the tax rules to the detriment of the United States.

Elective entity classification was adopted as a simplification measure in the domestic context. In the international context, however, the range of choices requires substantial analysis of alternatives to determine the optimal tax structure, taking into account all of the opportunities presented by elective entity classification. The transaction costs of determining and making an election, and the costs of establishing and maintaining tax accounts for inconsistently classified entities, impose a substantial administrative burden that is only justified for taxpayers by the potential U.S. tax savings.

Chapter 5 considers two proposals to modify the current elective foreign entity classification rules: (1) the Joint Committee Staff proposal to prohibit disregarded entity status for a single member foreign business entity and treat such entity as a foreign corporation; and (2) an alternative that would classify a foreign business entity as a corporation if the entity is subject to an entity-level income tax (under U.S. foreign tax credit principles) under the law of its country of tax residence, or otherwise would classify an entity as a pass-through entity. Other elements of U.S. law governing entity classification, such as section 7704, or the rules for domestic entities, would remain unchanged.

Subject to issues of transition, there do not appear to be strong reasons to treat a foreign business entity that is "regarded" in its country of residence as "disregarded" for U.S. tax purposes. The Joint Committee Staff proposal effectively would preclude: (1) disregarded entity planning to separate income and credits in a disregarded parent structure, (2) disregarded entity planning to permit a foreign entity to incur debt from a related party and take a deduction for foreign purposes without triggering subpart F, and (3) check-and-sell transactions. The Joint Committee Staff proposal would not affect the use of a local law partnership classified as a corporation for U.S. tax purposes (a so-called "reverse hybrid") to separate income and credits and other techniques that use inconsistent classification with respect to local law pass-through entities.

The alternative proposal, which would require corporate classification if the foreign entity were subject to entity-level income tax, would not allow corporate classification for a foreign entity that is not subject to an entity-level foreign income tax in its country of tax residence. The alternative proposal would also



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deny disregarded entity status to a foreign entity that is subject to an entity-level tax. This alternative would align the U.S. entity classification more closely with the treatment of the entity for foreign tax purposes, and would be more comprehensive than the Joint Committee Staff proposal in reducing the electivity allowed under the current rules. The entity taxation test would be based on existing section 901 principles already in application, which should not impose a material, additional administrative burden.

The alternative proposal would have the effect of contracting the availability of deferral to circumstances where an entity-level tax is imposed. This would preclude deferral for entities that are tax resident in zero-tax countries. To deal with circumstances where it would be difficult to implement pass-through accounting, consideration could be given to allowing the entity to elect to be treated as a domestic corporation, or allowing an appropriate portion of its U.S. members to elect to treat the entity as a corporation subject to their agreement to currently include their share of the entity's earnings in income.

2. *Corporate Tax Residence*

The United Stated generally taxes a domestic corporation on its worldwide net income (although, subject to a limitation, a foreign tax credit is allowed with respect to foreign income taxes paid on foreign-source income). A foreign corporation is taxed by the United States on its U.S. effectively connected income on a net income basis and on its U.S.-source fixed or determinable annual or periodical income on a gross income basis. Thus, the manner in which, and the extent to which, U.S. tax will be imposed depends on whether the particular corporation is domestic or foreign.

Whether a corporation will be treated as a domestic or foreign corporation under current U.S. federal income tax law depends solely on its place of organization. This rule has been the subject of controversy because of the ease with which a corporation may change its place of residence. The discussion in Chapter 5 reviews the factors that create a connection between a corporation, itself a legal fiction, and a jurisdiction that may justify residence-based taxation as opposed to mere source based-taxation. These include the benefits of incorporation and the agency theory that a corporation acts for its shareholders. The Chapter reviews alternatives to the place of incorporation residence rule, including (1) forms of an effective management test similar to that used in other countries, (2) a stronger place of management test proposed by the Joint Committee on Taxation (and by the President's Advisory Panel), and (3) shareholder composition tests. None of these alternatives result in a residence test that is practical to implement. Nor do such tests materially restrict the electivity available under the place of incorporation test. Moreover, in the vast preponderance of cases, the place of incorporation effectively represents the place where either most of the corporation's shareholders reside or most of the corporation's operations are carried on.

The principal observation made is that no residence rule can serve effectively as a bulwark against the difference in effective taxation of a U.S. shareholder in



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a domestic versus a foreign corporation. Indeed, the solution to the issue of corporate residence with respect to U.S. taxpayers may be best found in modifying substantive tax rules to make more neutral the taxation a U.S. shareholder realizes with respect to foreign income irrespective of whether the corporation is domestic or foreign.

### E. *The Foreign Tax Credit and Its Limitation (Chapter 6)*

The foreign tax credit is a central part of the U.S. system for taxing foreign income. The scope of the credit allowed to a U.S. taxpayer reflects policy choices regarding the degree to which foreign investment will be treated neutrally with U.S. investment or encouraged (or discouraged) in relation to U.S. investment. Chapter 6 reviews a series of issues relating to the operation of the foreign tax credit and the foreign tax credit limitation. These include how the source of income and expense allocation rules apply in the context of the foreign tax credit limitation, the rules for determining the person allowed to claim a credit for foreign taxes and the extent to which high foreign taxes should be allowed to offset U.S. tax on other foreign income (cross-crediting).

Under current law, the United States taxes income on a worldwide basis subject to deferral of tax on undistributed income earned through a foreign corporation. The objective of the foreign tax credit is to mitigate double taxation of foreign income. The foreign tax credit limitation is intended to prevent a credit for foreign taxes from reducing U.S. tax on U.S.-source income as determined under U.S. principles.

Cross-crediting of excess foreign taxes on high foreign-taxed foreign income against U.S. tax on low foreign-taxed foreign income concedes the residual U.S. tax on such low-taxed foreign income to the high-tax foreign country (not to the source country imposing a low foreign tax). A foreign tax credit system that allows excessive crediting of foreign taxes is more generous to investment in high-tax countries than an exemption system. This is because under an exemption system excess tax credits from high-tax countries cannot be used as credits against tax on other income. The U.S. tax rules already allow substantial cross-crediting and this will be increased after the AJCA's reduction in foreign tax credit limitations becomes effective in 2008. This is one of several reasons why the U.S. rules are more generous to investment in high-tax countries than under an exemption regime.

The foreign tax credit limitation can only protect the U.S. tax on income from U.S. economic activity from being offset by high foreign taxes with strong source and expense allocation rules. Under present U.S. rules, foreign taxes are allowed as a credit against income from U.S. economic activity because source rules inappropriately treat income from certain U.S. economic activity as foreign income, expense allocation rules over-allocate expenses against U.S.-source income, and the general limitation category permits extensive cross-crediting of foreign taxes. The Report considers several proposals to address these deficiencies in current law.

The Report considers whether the source rules for sales of property and royal-



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ties should be aligned to reflect that they can be substitutes for each other, and to thus treat both categories of income as U.S.-source income in the hands of a U.S. person in circumstances in which the source country would not tax the income. In the case of a royalty subject to a foreign withholding tax, foreign source characterization would be allowed only to the extent necessary to credit the withholding tax. Specifically, the Report considers a proposal to treat gain on the sale of inventory by a U.S. resident, as defined in section 865(g), as U.S.-source income unless the gain is attributable to a foreign fixed place of business of the taxpayer and the gain is taxed at an effective rate of ten percent or more. Royalty income of such a U.S. resident would be U.S.-source unless the income is attributable to a foreign fixed place of business and the net income is taxed at an effective rate of ten percent or more. If royalty income is not attributable to a foreign office or fixed place of business, but is subject to a foreign withholding tax on the gross amount of the royalty, the royalty income would be treated as foreign source in an amount equal to the product of the royalty income times a percentage equal to the foreign withholding tax rate divided by the highest rate of U.S. tax applicable to the taxpayer. These source rules would reduce the differentiation between realizing returns to intangible income through licensing instead of sales and would reduce the scope for cross-crediting high foreign taxes against U.S. tax on income that is from U.S. economic activity and not subject to foreign tax. There should be a general review of the U.S. source rules to rethink their application in the context of the foreign tax credit limitation.

The Report also considers an alternative that would address the issue of cross-crediting more generally: use of a per-country foreign tax credit limitation. Under this proposal, the foreign tax credit limitation would be determined with respect to U.S. tax on income earned in or by a qualified business unit in a country. (It is possible that countries with similar tax bases or effective tax rates could be grouped together in applying this limitation.) The separate limitation for passive income would be retained. As under current law, income from a controlled foreign corporation would be analyzed on a look-through basis. A loss in one country would offset income from other countries, including the United States, pro rata in proportion to the income from other countries. Subsequent income in the loss country would be "recaptured" as income from the country the loss offset.

Restricting cross-crediting seeks to treat investment in a high-tax country no better than it would be under an exemption system, while preserving worldwide taxation with a foreign tax credit for investment in low-tax countries. Any proposal to restrict cross-crediting involves trade-offs, principally relating to complexity. A per-country limitation strikes a different balance in these trade-offs, but takes advantage of the practical fact that smaller taxpayers generally are taxable in a limited number of countries. Large multinational taxpayers operate in many countries and have the greatest incentive to achieve cross-crediting, but they also are best able to bear the burden of the additional complexity.

The Report also addresses use of the technical taxpayer rule to disassociate foreign tax claimed as a credit from the income taxed by the foreign country.



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While the scope for this planning would be substantially reduced by adoption of either of the entity classification proposals discussed in Chapter 5, the Report also considers a separate proposal to address the issue. Under the proposal, the Service would be authorized to make allocations of foreign taxes among commonly controlled persons to the person that realizes the income to which the taxes relate under U.S. tax principles. In other words, the Service would be directed to achieve matching of income and taxes. Appropriate correlative allocations would be made as necessary to account for deemed transfers of cash.

F. *Subpart F Reform (Chapter 7)*

Chapter 7 considers certain structural changes to subpart F that would restore its effectiveness but retain its existing scope. These proposals may be contrasted with the fundamental reforms proposed in Chapter 4 to end deferral for U.S. shareholders in controlled foreign corporations. A proposal to modernize subpart F would be important if the exemption proposals of either the Joint Committee Staff or the President's Advisory Panel were adopted, since each would retain the subpart F regime.

Subpart F subjects U.S. shareholders to current taxation on passive income and certain active income derived by a controlled foreign corporation (CFC). The two principal categories of active income that are subject to the anti-deferral rules are foreign base company sales income and foreign base company services income.

Chapter 7 describes two alternative proposals for modifying the current subpart F rules with respect to sales and services income. The first proposal would modernize the operation of the base company rules. Reference to a corporation's place of incorporation generally would be replaced by reference to the place where essential business activities occur, whether through a branch or a separate corporation (a "business locus country"). This first proposal would permit deferral for sales and services income earned in the country where the essential business activities giving rise to the income occur, but would subject to current taxation sales and services income shifted away from such a country to a low-tax country. Deferral would be permitted for sales and services income subject to tax in a third country where the tax rate on the income is similar to the rate of tax that would apply to the income in the business locus country. This proposal would eliminate deferral for income shifted away from a business locus country to a tax haven country. Dividends, interest, rents, and royalties received from a related CFC would be subject to look-through rules to the extent such payments are made out of sales or services income. Payments eligible for look-through treatment would qualify for an exception only to the extent an exception would apply if the income were actually treated as sales or services income.

The critical issue under this first proposal is what level of taxation is required to treat as eligible for deferral income earned in the country where the essential business activities are conducted. The Report identifies three alternatives that signify different objectives for those anti-deferral rules. One alternative is to require that the income be subject to an income tax. Under a subject-to-tax test,

income earned in zero-rate tax havens would not be eligible for deferral, but income earned in low-rate countries such as Barbados and Ireland would still be eligible for deferral if other conditions are satisfied. Two alternative conditions for deferral are to require that income be taxed (1) at a rate of at least 15%, which would preclude deferral for income subject to low tax rates and tax holidays; or (2) at a rate of at least 75% of the otherwise applicable U.S. rate, which would further restrict tax motivated location of investment abroad.

The proposal does not base its determinations on the CFC's country of incorporation or whether transactions are conducted in a separate CFC or a branch. This proposal also does not distinguish between related and unrelated person transactions. There does not seem to be any fundamental policy rationale for distinguishing between the two types of transactions in carrying out the business locus country approach to taxing income shifted away from a business locus country to a low-tax country.

The proposal uses an objective rate test for applying the similar tax rate exception to income not earned in a business locus country. Such an approach should reduce the tax incentive to shift income away from a business locus country to a third country (although when tax rates in a business locus country are low, the similar rate exception may be less effective, so a same rate test is described as an alternative).

A second alternative for modifying subpart F is to provide as a general rule that all sales and services income is excluded from the definition of subpart F income. This could generally be achieved by repealing the foreign base company income categories for foreign base company sales income and for foreign base company services income. This proposal would provide a corollary rule that would apply subpart F to dividends, interest, rents, and royalties received by a CFC from a related CFC using look-through rules. Therefore, to the extent such amounts are paid out of the related CFC's sales and services income, the CFC receiving such income could exclude the payments from its subpart F income.

An exception may be provided to the above general rule where the activities or income have a connection to the United States. One alternative is that deferral would not be available for sales income where the goods are both produced in the United States and sold to U.S. customers. Another possible exception to a general repeal of the foreign base company sales and services income provisions might apply to income shifted to certain tax haven countries.

## III. RELATION OF PROPOSALS TO POLICY OBJECTIVES

It may useful to align the proposals with one of the two combinations of policy objectives described in Part II, Section A of this Chapter. The first set of objectives gives weight to the ability to pay criterion (among U.S. citizens and residents), evaluates efficiency in relation to a comparison of tax burdens on foreign versus domestic income of the same taxpayer, seeks to enhance administrability by narrowing the differential in taxation of foreign and domestic



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income, and continues to assert a U.S. claim to tax the worldwide business income of its residents. Very generally, this set of policy objectives supports moving toward a comprehensive tax base and not favoring taxation of foreign income ("Comprehensive Tax Base Objectives").

The second set of objectives weighs the fairness objective less heavily as it applies to foreign income beneficially owned by U.S. citizens and resident individuals, evaluates efficiency in relation to the ability of U.S.-owned businesses to compete abroad, seeks to enhance administrability by excluding active foreign business income from U.S. taxation, and relinquishes claims to active foreign income as a source of U.S. tax revenue ("Foreign Income Preference Objectives").

Finally, there is a third category of proposals that would advance both sets of objectives. Proposals that may be considered as properly aligning the U.S. tax base, such as revising the source and expense allocation rules, should be considered to be consistent with both sets of policy objectives. Proposals that minimize taxpayer manipulation of form versus substance, such as the entity classification proposals, similarly could be considered to advance both sets of policy objectives. Accordingly, a third classification of proposals will be referred to for this purpose ("Infrastructure Proposals").

The classification of proposals according to these policy objectives is necessarily somewhat arbitrary. The proposals nonetheless may be classified as follows:

*Comprehensive Tax Base Proposals*

Fundamental Reform

End deferral of U.S. tax for ten percent of U.S. shareholders in foreign corporation with a concentrated U.S. ownership group (Chapter 4).

Incremental Reform

Adopt a per-country foreign tax credit limitation (Chapter 6).

Reform subpart F to restrict deferral unless income is earned in the business locus country and is taxed at a rate equal to or greater than 75% of the highest applicable U.S. tax rate on the income (Chapter 7).

*Foreign Income Preference Proposals*

Fundamental Reform

End U.S. taxation of foreign business income that is not subpart F income (Chapter 4).

Incremental Reform

Reform subpart F and permit deferral if income is subject to tax in the business locus country or if income is shifted to a country that



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would tax the income at an effective rate that is 90% of, or less than five percentage points lower than, the rate of tax in the business locus country (Chapter 7).

Infrastructure Proposals

Revise elective entity classification of foreign business entities to either:

- Treat a disregarded foreign entity as a corporation (Chapter 5); or
- Limit foreign corporate classification to a foreign business entity subject to income tax in its country of tax residence, and deny disregarded entity status to a foreign business entity that is subject to an entity level tax (Chapter 5).

Revise inventory sales source rule to limit foreign source characterization to circumstances where income is attributable to a foreign permanent establishment and subject to ten percent foreign tax (Chapter 6).

Revise royalty source rule to treat royalty of a U.S. resident as U.S.-source except to the extent needed to credit foreign tax on the royalty (Chapter 6).

Revise expense allocation rules to achieve economic allocation of research and development between U.S. and foreign income (Chapter 6).

Restrict use of the technical taxpayer rule to separate creditable foreign taxes from associated income (Chapter 6).

Revise subpart F to apply base company sales and services rules on qualified business unit basis using business locus (Chapter 7).



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