

Volume II

The NFTC Foreign Income Project:

International Tax Policy

for the

21st Century

Conclusions and Recommendations

Prepared by the National Foreign Trade Council, Inc.

Fred F. Murray • Editor-in-Chief

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The NFTC Foreign Income Project:*

International Tax Policy
for the
21st Century

Part Three

Conclusions and Recommendations

Preface

The foreign competition faced by American companies has intensified as the globalization of business has accelerated. At the same time, American multinationals increasingly voice their conviction that the Internal Revenue Code places them at a competitive disadvantage in relation to multinationals based in other countries. In 1997, the NFTC launched an international tax policy review project, at least partly in response to this growing chorus of concern. The project is divided into three parts, the first dealing with the United States anti-deferral regime, subpart F**, and the second dealing with the foreign tax credit, together published as Volume I, and the third dealing with our conclusions and recommendations, published as Volume II.

* The National Foreign Trade Council, Inc. (NFTC) is an association of businesses founded in 1914. It is the oldest and largest U.S. association of businesses devoted to international trade matters. Its membership consists primarily of U.S. firms engaged in all aspects of international business, trade, and investment. Most of the largest U.S. manufacturing companies and most of the largest U.S. banks are Council members.

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Summary of Recommendations

The NFTC recommends three principal reforms to the U.S. tax rules that apply to U.S.-based companies with international operations:

1. Substantially narrow the circumstances in which subpart F would accelerate U.S. taxation of the active business income of a foreign subsidiary;
2. Rationalize the operation of the foreign tax credit to ensure that it prevents the double taxation of international earnings; and
3. Reduce the extraordinary complexity of the rules, which makes compliance difficult, expensive and uncertain.

All three reforms would improve the ability of U.S.-based multinationals to compete with companies headquartered in jurisdictions with less sweeping tax rules and all three can be accomplished with limited legislative changes that are fully consistent with the bedrock principles of U.S. international tax policy established decades ago.

I. Introduction

A. Scope

This report, Part Three of the NFTC's Foreign Income Project, offers the NFTC's legislative recommendations for the modernization and reform of subpart F and the foreign tax credit. The first section of this report provides an overview of the issues and summarizes the findings of Parts One and Two of the Project.¹ In the next section we discuss the principal tax policy considerations that have shaped the development of our recommendations for the modernization of these rules. Finally, the third and fourth sections of this report describe our specific legislative recommendations regarding subpart F and the foreign tax credit.

B. Overview of the Issues

When a U.S.-based corporation operates abroad, three major U.S. tax policy issues arise:

- Whether to impose any U.S. tax on income earned in other countries;
- If foreign income is to be taxed, whether and when to tax the income of a foreign subsidiary: when it is earned, or only when it is repatriated to the United States; and
- If foreign income is to be taxed, whether and how double taxation should be prevented when that income is also taxed by another country.

The basic contours of the U.S. international tax rules were established when these issues were resolved more than 75 years ago with the following core policy decisions:

- The United States taxes the worldwide income of its citizens and residents;
- The income of foreign subsidiaries is taxed only when received by U.S. shareholders (typically in the form of a dividend), subject to certain anti-abuse rules; and

¹ On March 25, 1999, the NFTC published a report analyzing the competitive impact on U.S.-based companies of the subpart F rules, which accelerate the U.S. taxation of income earned by foreign subsidiaries. THE NFTC FOREIGN INCOME PROJECT: INTERNATIONAL TAX POLICY FOR THE 21ST CENTURY; PART ONE: A RECONSIDERATION OF SUBPART F [hereinafter "Part One" or "Subpart F Report"]. Simultaneously with the publication of this report, the NFTC is publishing its study of the operation of the U.S. foreign tax credit rules. THE NFTC FOREIGN INCOME PROJECT: INTERNATIONAL TAX POLICY FOR THE 21ST CENTURY; PART TWO: RELIEF OF INTERNATIONAL DOUBLE TAXATION [hereinafter "Part Two" or "Foreign Tax Credit Report"].

- Double taxation is primarily avoided by granting a credit against U.S. tax for the foreign taxes paid on foreign income, subject to certain limitations.

These core policy decisions have remained remarkably stable through the years: at the beginning of the 21st century, the United States still taxes the worldwide income of its residents, in general only when received by a U.S. taxpayer, and subject to the allowance of a credit for foreign taxes paid. However, over the years, these core policy decisions have become encrusted with exceptions, additions and alterations, each one responding to particular tax or non-tax policy concerns prevalent at the time it was enacted, and often reflecting an effort to balance competing policy goals. Decades of incremental change have produced an unduly complex accretion of rules that is sorely in need of systematic reevaluation. Thus, it is now appropriate to reassess whether the balance among competing policies reflected in the current rules remains appropriate in light of practical experience with their operation—particularly at a time of global economic integration that would have been unimaginable when many of these rules were first enacted. In 1997, the NFTC initiated its Foreign Income Project to carry out a systematic review of the history and current operation of the U.S. international tax rules, compare those rules with the analogous policies of the United States' principal trading partners, evaluate their competitive effects in today's global economy, and make recommendations for reform.

C. Principal Findings of the Foreign Income Project

Based on the data and analysis presented in Parts One and Two of the Foreign Income Project, the NFTC believes that the core principles and basic structure of the U.S. international tax rules remain sound. However, the balance of competing policies reflected in current law has not kept pace with the rapid development of a global economy. Consequently, the NFTC believes that it is time for a significant modernization of the U.S. rules, both as they relate to the taxation of foreign subsidiary income (*i.e.*, the anti-deferral, or income acceleration, rules of subpart F) and as they relate to the foreign tax credit. The principal findings of Parts One and Two may be briefly summarized as follows:

(i) Part One—subpart F:

- Since the enactment of subpart F nearly 40 years ago, the development of a global economy has substantially eroded the economic policy rationale of the rules.
- The breadth of subpart F exceeds the international norms for such rules, adversely affecting the competitiveness of U.S.-based companies

by subjecting their cross-border operations to a heavier tax burden than that borne by their principal foreign-based competitors.

- Most importantly, subpart F applies too broadly to several categories of income that arise in the course of active foreign business operations, including:
 - Income from payments between active foreign affiliates;
 - Income earned by centralized sales and services companies;
 - Income earned by active businesses in the financial services and shipping sectors;
 - Incidental investment income of active businesses, such as interest on working capital; and
 - Income from the “downstream” activities of active oil businesses.

(ii) Part Two—foreign tax credit:

- The development of a global economy has confirmed the soundness and heightened the importance of the U.S. rules’ core policy of avoiding international double taxation.
- In too many circumstances, however, the U.S. rules fail to achieve their purpose, leading to the double taxation of international income in many common scenarios. Flaws in the rules that lead to double taxation include:
 - The 90 percent alternative minimum tax foreign tax credit limitation;
 - The structural over-allocation of interest expense against foreign-source income (exaggerating foreign effective tax rates and thus denying credits);
 - The asymmetrical treatment of foreign and domestic losses; and
 - The excessive separation of income into multiple “baskets.”
- The foreign tax credit rules are unjustifiably complex, rendering them virtually inadministrable, and should be substantially simplified.

In view of the serious concerns about the current operation of the subpart F and foreign tax credit rules, the NFTC developed legislative recommendations to modernize these rules. The following section discusses the major tax policy considerations taken into account in formulating the NFTC’s recommendations.

II. Tax Policy Considerations

A. Major Considerations Identified by Treasury

Treasury officials from both Republican and Democratic administrations have in recent years highlighted five tax policy considerations in connection with discussions of potential changes to U.S. international tax rules:

- Efficiency;
- Fairness;
- Competitiveness;
- Compatibility with international norms; and
- Administrability and simplicity.²

As discussed below, each of these policy considerations has been taken into account in formulating the NFTC's legislative recommendations.

1. Efficiency

a. Underlying Economic Principles

A *neutral* tax system is a system in which investment decisions are made in the same way as they would be made in the absence of taxes. In principle, such neutrality will maximize the efficiency of capital allocation. In the international context, this principle is referred to as capital export neutrality. Under a tax system that achieved capital export neutrality, investments made outside the investor's home country would bear tax at the home country rate.

By contrast, the principle of *competitiveness* requires that all investments made in the same country be subject to the same amount of tax, regardless of where the investor is resident. When countries impose different tax rates, cross-border investment cannot simultaneously be subject to neutral taxation (taxed at the home country rate) and competitive taxation (taxed at the host country rate).³

Because the principles of neutrality and competitiveness conflict in a world where countries have unequal tax rates, policymakers must strike a

² For example, the same five factors were cited during both the senior Bush and the Clinton administrations, with only minor differences in emphasis or nomenclature. *Compare*, for example, the May 1992 testimony of Assistant Secretary Fred T. Goldberg before the Ways and Means Committee on H.R. 5270 (the Gradison-Rostenkowski International Tax Reform Bill), and DEPT. OF THE TREASURY, OFFICE OF TAX POLICY, THE DEFERRAL OF INCOME EARNED THROUGH U.S. CONTROLLED CORPORATIONS: A POLICY STUDY (December 2000) [hereinafter "Policy Study"].

³ See JOINT COMMITTEE ON TAXATION, FACTORS AFFECTING THE INTERNATIONAL COMPETITIVENESS OF THE UNITED STATES, JCS-6-91, 245 (May 30, 1991).

balance between these principles. If the *neutrality* principle is adopted, foreign investment must bear the same rate of tax as home country investment. As a practical matter, this would require current taxation of foreign-source income (whether or not remitted) and an *unlimited* credit for foreign taxes. By contrast, if the *competitiveness* principle is adopted, foreign investment must bear the same rate of tax as host country investment. As a practical matter, this would require the home country to *exempt* foreign-source income. As of 1999, about half of the 29 Organisation for Economic Cooperation and Development (OECD)-member countries taxed income on a worldwide basis; the remainder generally *exempted* active foreign business income from home country taxation, either by statute, by treaty, or in the case of income derived from listed countries.

b. Efficiency in the Subpart F Context

The principle of capital export neutrality has tended to arise most prominently in connection with discussions of subpart F, and in particular has been cited recently by Treasury both in defense of controversial proposed rule changes⁴ and more broadly in connection with its Policy Study.⁵ By contrast, the implications of capital export neutrality have been less emphasized by Treasury in connection with the foreign tax credit, as Treasury has thus far shown no inclination to promote the unlimited foreign tax credit that neutrality would require.

Based on the analysis in the NFTC Subpart F Report (Part One of the NFTC's Foreign Income Project), the NFTC does not believe that capital export neutrality should be given dominant weight in the design of the U.S. international tax regime. The historical significance of capital export neutrality in the enactment of subpart F has come to be exaggerated by subsequent commentators. More importantly, the NFTC Subpart F Report finds numerous reasons to reject treating capital export neutrality as the touchstone of U.S. international tax policy. These reasons include:

- The futility of attempting to achieve globally efficient capital allocation by unilateral U.S. action.
- The similar futility of attempting to advance investment neutrality by focusing solely on direct investment, particularly in light of the fact that U.S. international portfolio investment now significantly exceeds direct investment.⁶

⁴ See, e.g., Notice 98-11, 1998-6 I.R.B. 13.

⁵ See discussion in II.B.1. of this part of the Foreign Income Project.

⁶ As noted in the NFTC Subpart F Report, *supra* note 1, capital export neutrality would require imposition of a U.S. corporate level tax, on an accrual basis, on income earned by U.S. individual and

- The fact that no country, including the United States itself, has consistently or fully adopted capital export neutrality principles in its tax law.
- Growing criticism of capital export neutrality in the economics literature.
- The anomaly presented by a tax policy that encourages the payment of higher taxes to foreign governments.

The conclusion that capital export neutrality should not dominate U.S. international tax policy is particularly well illustrated by the last item. Based on the principle of capital export neutrality, several provisions of subpart F have the effect of penalizing a taxpayer that reduces its foreign tax burden. Presumably these provisions are motivated by the idea that preventing U.S. taxpayers from reducing foreign taxes will ensure that they do not make investment decisions based on the prospect of garnering a reduced rate of foreign taxation (while deferring U.S. taxation until repatriation). However, insisting that U.S. taxpayers pay full foreign tax rates when market forces require that they do business in a high-tax jurisdiction is a flawed policy from several perspectives:

- First, from the perspective of the tax system, insisting on higher foreign tax payments increases the amount of foreign taxes available to be credited against U.S. tax liability, and thus decreases U.S. tax collections in the long run.
- Second, from the perspective of competitiveness, it leaves U.S.-based companies in a worse position than their foreign-based competitors: U.S. companies must either pay tax at the high local rate or, if they attempt to reduce that tax they will instead trigger subpart F taxes at the U.S. rate. By contrast, foreign competitors can reduce their local taxes (for example, by way of routine transactions such as paying interest on loans from affiliates), without triggering home country taxes.⁷
- Third, there is very little empirical support for the view that U.S. investment abroad results in a corresponding reduction in investment in the United States. Indeed, there is a large body of economic research showing that the foreign employment of U.S. multinationals

institutional investors from portfolio investments in foreign corporations. This has become a far more important, though frequently overlooked, aspect of capital export neutrality because foreign portfolio investment flowing out of the United States is about twice as large as foreign direct investment.

⁷ Local tax authorities may well scrutinize the amount of outbound deductible payments under transfer pricing and thin capitalization rules, but subject to that discipline there is nothing inherently objectionable about an allocation of functions and risks among affiliates that gives rise to a deductible payment in a high-tax jurisdiction. Protection of foreign governments' tax bases should in any event be no concern of the U.S. tax system.

is complementary to their domestic employment, and that U.S. companies with the greatest foreign investment also tend to have the highest level of exports.

- Finally, the basic suggestion that tax motives are what drive U.S.-based companies into the international marketplace is seriously antiquated in the context of the global economy. Thus, subpart F's general presumption that foreign tax reduction is a cause rather than a consequence of foreign expansion is not merely out of touch with economic reality, but seriously harmful to the competitiveness of U.S.-based companies (as further discussed below).

The NFTC submits that the capital allocation benefits that may be achieved by subpart F's haphazard pursuit of capital export neutrality principles are questionable, and do not justify the fiscal and competitive damage caused by hampering the ability of U.S. companies to reduce local taxes on the foreign businesses that are critical to their future prosperity. Accordingly, the NFTC believes that capital export neutrality is not a sound basis on which to build U.S. international tax policy for the 21st century, and recommends that in modernizing subpart F it be given no greater weight than it has been given in the case of other major U.S. international tax provisions, such as the foreign tax credit.

c. Efficiency in the Foreign Tax Credit Context

Turning now to the role of capital export neutrality in the design of the foreign tax credit rules, we have already noted that U.S. enthusiasm for capital export neutrality seems to stop at the borders of subpart F. An unlimited foreign tax credit was allowed only during the first three years of the foreign tax credit's existence (1918–1921). Ever since, the United States has limited the credit to the U.S. tax on foreign income. The purpose of this limitation is to ensure that foreign tax credits cannot be used to offset U.S. tax on U.S.-source income, thus preserving the United States' primary taxing jurisdiction over such income. Accepting that this consideration overrides neutrality concerns, it is nevertheless worth considering whether the current U.S. foreign tax credit rules are otherwise consistent with neutrality principles. The NFTC Foreign Tax Credit Report (Part Two of the NFTC's Foreign Income Project) suggests that in the current environment they are not, because of the extent to which they prevent “cross-crediting.”

Cross-crediting refers to the ability of a taxpayer to use credits arising from high-taxed foreign income to offset the U.S. tax that would otherwise apply to low-taxed foreign income. In connection with the enactment of the 1986 Act, Treasury believed that the dramatic lowering of the U.S. corporate tax rate would leave many U.S.-based companies

with significant excess foreign tax credits (to the extent that they continued to pay foreign taxes at higher rates). Due in part to concerns that the ability to use such excess credits would encourage U.S. taxpayers to make investments in low-tax jurisdictions, Congress enacted several provisions designed to limit cross-crediting.

Whether or not it was sensible at the time, the NFTC Foreign Tax Credit Report suggests that this approach is increasingly inefficient in a world that is empirically the reverse of what was anticipated in 1986—the rates of foreign tax now paid by U.S. companies are on average lower than the U.S. rate. Where the overall rate of foreign tax paid by a company is lower than the U.S. rate, multiple foreign tax credit limitations may actually have the reverse of the intended effect; by artificially creating excess credits even when the overall foreign tax rate is below the U.S. rate, separate foreign tax credit baskets may encourage U.S. taxpayers to move investments into low-tax foreign jurisdictions (even if those investments are less efficient than alternative U.S. or foreign investments) so as to obtain full foreign tax credit utilization.

This scenario, in which the U.S. international tax rules were designed to address the reverse of the empirical reality that now exists, and are probably having the opposite of their intended effect, provides an apt illustration of why it is time to review and modernize those rules.

2. Fairness

Another policy criterion that has been prominently mentioned by Treasury is “fairness,” which is sometimes expressed in terms of preserving the U.S. tax base. While no one could quarrel with the notion of fairness in tax policy, what fairness means in practice is somewhat less clear. Our understanding is that Treasury is concerned that it would be unfair if U.S.-based multinationals could eliminate or significantly reduce their U.S. tax burden by investing abroad. This analysis presumably requires that a distinction be drawn between those cases in which it is “fair” to defer the U.S. taxation of foreign affiliates’ income, or to grant a foreign tax credit, and those in which it is not. The distinction might alternatively be expressed in terms of whether or not the U.S. tax base was inappropriately reduced.

a. Subpart F

In the subpart F context, there should be general agreement about two cases in which accelerated U.S. taxation is appropriate: first, where passive income is shifted into an offshore incorporated pocketbook; and second, where income is inappropriately shifted offshore through abusive transfer pricing practices. The first case is well-addressed by the extensive subpart F rules

concerning foreign personal holding company (FPHC) income, while the second case is addressed by detailed transfer pricing and related penalty rules which give the IRS ample authority to curb transfer pricing abuses. Thus, little needs to be done to advance fairness in these regards.

Conversely, we take it as generally agreed that when a foreign subsidiary engages in genuine business activity in its foreign country, the deferral of U.S. taxation that arises from the application of the normal rules defining U.S. taxing jurisdiction is not unfair. Absent a radical shift in U.S. international tax policy, the normal rules that recognize a foreign corporation as a separate taxable entity, impose no U.S. tax on its foreign income and generally tax its shareholders when its earnings are repatriated should continue to be viewed as fair.

This leaves a relatively narrow band of potential controversy: whether there are certain types of income that should be taxed currently even though they are associated with active foreign business operations. Subpart F currently taxes several categories of such income, but the rationales that have been advanced for doing so generally relate to notions of capital export neutrality (*i.e.*, efficiency), not fairness. We have already stated the NFTC's view that U.S. international tax policy needs a firmer foundation than the economic theorizing that underlies capital export neutrality. But whatever the merits of capital export neutrality as economic theory, it certainly does not shed any light on the meaning of fairness in international tax policy. Accordingly, we do not believe that a coherent "fairness" rationale has been advanced for the current taxation of active foreign business income. For additional analysis of these issues, see the discussion in II.B.1., below.

b. The Foreign Tax Credit

Fairness is central to the very existence of a foreign tax credit. It is generally accepted that legitimate bases for a government's exercise of taxing authority include both sovereign power over the person earning the income (residence-based taxing jurisdiction), and sovereign power over the income itself (source-based taxing jurisdiction). As a result, two or more countries are often able to assert jurisdiction to tax a single item of international income. Although both such claims may be legitimate, a longstanding international consensus has sought to avoid double taxation of international income.

The importance of preventing international double taxation is so widely accepted that it is generally taken as a given, without much analysis of why it matters. We suggest that the underlying reason for this unquestioned policy consensus is that avoiding double taxation is a matter of fundamental fairness. Certainly, efficiency and competitiveness considerations are also

at work: double taxation of international commerce would likely discourage cross-border trade and investment that otherwise represented the most efficient use of capital, and a country's businesses would be ill-positioned to compete in international markets if their international income suffered endemic double taxation. Nevertheless, the NFTC Foreign Tax Credit Report shows that, as a historical matter, the 1918 enactment of the foreign tax credit was viewed as a surrender of taxing rights that was justified primarily by equitable considerations. Treasury pursued enactment of the foreign tax credit because "it touched the equitable chord of sense, and because double taxation under the heavy war rates might not only cause injustice but the actual bankruptcy of the taxpayer."⁸ These equitable considerations included not only the fundamental unfairness of a confiscatory level of overall taxation, but also considerations of horizontal equity:

...if one taxpayer is being taxed twice while the majority of men similarly situated are being taxed only once, by the same tax, something wrong or inequitable is being done which, other things being equal, the legislator should correct if he can.⁹

It is also notable that the granting of the foreign tax credit was justified based on the primacy of source-based taxing jurisdiction.¹⁰ This may be justified by the fact that the source jurisdiction provides most of the government services that enable the income to be earned, and thus constitutes a better claim to tax than the mere residence of the person earning the income, because the residence jurisdiction would ordinarily provide few, if any, services enabling its residents to earn foreign income. Thus, the United States decided that if only one tax was to be collected, it ought by rights to be the tax imposed by the source country, with the United States as the residence country limiting itself to any "residual" tax that might remain after granting a credit for the foreign tax paid.

While much in the world has changed since 1918, justice and equity have not; confiscatory levels of taxation remain fundamentally unfair, as does imposing a heavier tax burden on taxpayers with international income than on taxpayers with purely domestic income. Thus, it should be clear that preventing double taxation through the foreign tax credit continues to be consistent with, and is indeed required by, Treasury's concern for fairness

⁸ T. S. Adams, *International and Interstate Aspects of Double Taxation*, NAT'L TAX ASS'N PROC. 193, 198 (1929). T. S. Adams was Treasury's international tax expert and the official most responsible for the enactment of the credit.

⁹ *Id.*, 198.

¹⁰ *Id.*, 197-198.

in tax policy. By the same token, it is clear that the aspects of the foreign tax credit that now tend to permit double taxation in many common situations are fundamentally unfair and require reformation.¹¹

c. Conclusion

We conclude by noting that, as a practical matter, Treasury's concerns for fairness of the U.S. tax system, and the preservation of the corporate tax base, should not be exaggerated in the context of the relatively modest reforms that we advocate. The NFTC does not believe that the rationalizations of subpart F and the foreign tax credit proposed in this project will alter historical patterns of offshore investment, although they will improve U.S. companies' ability to compete. Accordingly, while the distributional equity of the U.S. tax system is really not at stake here, the fairness of the system will be meaningfully improved by rationalizing and modernizing the taxation of U.S. companies that compete in the global marketplace.

3. Competitiveness

Accelerating the U.S. taxation of a U.S. company's overseas operations while granting a foreign tax credit means that a U.S.-based company will pay tax at the higher of the U.S. or foreign tax rate. If the local tax rate in the country of operation is less than the U.S. rate, locally-based competitors will be more lightly taxed than their U.S.-based competition. Companies based in other countries will also enjoy a lighter tax burden, unless their home countries impose a regime that is as broad as subpart F. Moreover, if U.S. foreign tax credit relief for the foreign taxes paid is incomplete, the resulting double taxation can further increase the overall tax burden on a U.S. company.

While the competitive impact of a heavier corporate tax burden is difficult to quantify, it should be clear that a company that pays higher taxes suffers a disadvantage vis-à-vis its more lightly taxed competitors. That disadvantage may ultimately take the form of a decreased ability to engage in price competition, or to invest funds in the research and capital investment needed to build future profitability, or in the ability to raise capital by offering an attractive after-tax rate of return on investment. Whatever its ultimate form, however, it cannot be seriously questioned that a heavier corporate tax burden will harm a company's ability to compete.

¹¹ These aspects of the credit include the interest allocation rules, the asymmetrical treatment of domestic and foreign losses, and the 90 percent limitation on the foreign tax credit for alternative minimum tax purposes. See discussion in IV. of this Part Three of the Foreign Income Project. We define international double taxation to occur when multinational income effectively is taxed at a rate in excess of the greater of the residence or source country income tax rates. This definition covers double taxation caused by defects both in U.S. and foreign law, but our focus here is solely on the U.S. statutory rules; thus, we do not suggest that the U.S. rules can hope to prevent double taxation caused by defects in foreign law (such as, for example, foreign law's failure to allow certain expenses to be deducted from taxable income).

Competitiveness concerns were therefore central to the debate when subpart F was enacted in 1962, even at a time when U.S.-based companies dominated the international marketplace. In that year, 18 of the 20 largest companies in the world (ranked by sales) were headquartered in the United States, but this apparent dominance did not convince Congress that the competitive position of U.S. companies in international markets could be ignored. Thus, although the Administration originally proposed the acceleration of U.S. taxation of most foreign-affiliate income, that proposal was firmly rejected by Congress based largely on concerns about its competitive impact.¹²

If international competitiveness was a concern 40 years ago, there are compelling reasons to treat it as a far more serious concern today. Four major developments, in particular, have changed the policy landscape in a manner that has brought competitiveness to the center of the debate on the future of subpart F and the foreign tax credit:

- With the completion of the post-World War II economic recovery in Europe and Japan, and the growth of an industrial economy in many countries in Asia and elsewhere, U.S. dominance of international markets is only a memory. Of the 20 largest industrial companies, the U.S.-based number has dwindled from 18 to eight. Thus, competition from foreign-based companies in international markets is far more intense today than it was in 1962.¹³
- While competition in international markets has become more intense, those markets have simultaneously become more important to the prosperity of U.S.-based companies, as foreign income has grown to be a much larger percentage of U.S. corporate earnings.
- In the nearly 40 years since subpart F was enacted, the governments of the United States' major trading partners have generally declined to follow the U.S. lead in accelerating tax on the active business income of their companies' foreign affiliates. They have certainly enacted controlled foreign corporation (CFC) tax rules that resemble subpart F, particularly as they relate to passive income, but in taxing genuine foreign business activity no other country has adopted rules with the broad sweep of subpart F, nor have other countries enacted foreign tax credit

¹² See NFTC Subpart F Report, *supra* note 1, Chapter 2.

¹³ Some have suggested that the loss of U.S. dominance is simply a function of the rest of the world "catching up" after the devastation of World War II. This may well be true, but it is also irrelevant: whatever the reasons for the loss of U.S. dominance, the point is that the competitive landscape is completely different today, so that it is important to reconsider the competitive impact of legislative provisions enacted when the world was a very different place.

regimes as restrictive as the U.S. regime.¹⁴ As a result, the foreign-based multinationals that are now the United States' toughest competitors have consistently enjoyed lighter home-country taxation than U.S.-based companies.

- Finally, while the competitive position of U.S.-based multinationals was steadily eroding for the above reasons, a constant expansion of subpart F and a tightening of the foreign tax credit hastened that erosion. In the decades after 1962, several major exceptions were narrowed or repealed, numerous categories of subpart F income were created or broadened, and in 1986 significant new restrictions were placed on the availability of foreign tax credits.

Although it is difficult to compare the overall impact of countries' income tax systems on the cost of cross-border investment, the data and analyses reviewed in the NFTC Subpart F and Foreign Tax Credit Reports suggest that, from a tax perspective, the United States is a relatively undesirable location for a multinational company's legal domicile. Recent trends indicate that the vast majority of cross-border mergers and acquisitions have been structured as foreign acquisitions of U.S. companies, and that the proportion of *inward* investment that is direct (rather than portfolio) has increased in the 1990s, while the share of *outward* investment in direct form has decreased.¹⁵ If these trends continue, over time we would expect to see a larger portion of U.S. and foreign economic activity carried out by companies domiciled outside the United States.

In conclusion, a significant modernization of the U.S. rules is necessary to restore competitive balance in the vastly changed circumstances of the global economy of the 21st century.

4. Compatibility with International Norms

As noted above, compatibility with international norms is important from a competitiveness perspective, but it bears further emphasis here that the United States' principal trading partners have consistently adopted rules that are less burdensome than the U.S. subpart F and foreign tax credit rules. We do not dispute the fact that subpart F established a model for the taxation of

¹⁴ See NFTC Subpart F Report, *supra* note 1, Chapter 4 and NFTC Foreign Tax Credit Report, Chapter 5.

¹⁵ Indeed, in the case of shipping income, U.S. control of active shipping businesses has been practically eliminated over a period coterminous with the imposition of current tax under subpart F in 1986. See NFTC Subpart F Report, *supra* note 1, Chapter 6, Case Study 2. The potential impact of subpart F inclusion on U.S. ownership of shipping was recognized explicitly in the 1962 enactment of subpart F. In the enactment, shipping income was excluded explicitly from subpart F treatment to foster, for defense reasons, U.S. ownership of shipping capacity.

offshore affiliates that has been imitated to a greater or lesser degree in the CFC legislation of many countries. But looking beyond the superficial observation that other countries have also enacted CFC rules, the detailed analysis in the NFTC Subpart F Report showed that in virtually every scenario relating to the taxation of active offshore operations, the United States imposes the most burdensome regime. Looking at any given category of income, it is sometimes possible to point to one or two countries the rules of which approach the U.S. regime, but the overall trend is overwhelmingly clear: U.S.-based multinationals with active foreign business operations suffer much greater home-country tax burdens than their foreign-based competitors. A similar analysis in the NFTC Foreign Tax Credit Report showed that the regimes for the prevention of international double taxation employed by the United States' major trading partners are substantially less restrictive than the U.S. foreign tax credit rules.

The observation that the U.S. rules are out of step with international norms, as reflected in the consistent practices of the United States' major trading partners, supports the conclusion that U.S.-based companies suffer a competitive detriment vis-à-vis their multinational competitors based in such countries as Germany and the United Kingdom.

Some commentators have suggested that the competitive imbalance created by dissimilar international tax rules should be redressed not through any relaxation of the U.S. rules, but rather through a tightening of foreign tax regimes.¹⁶ Purely as a matter of logic, the point is valid—a seesaw can be balanced either by pushing down the high end or pulling up the low end. However, the suggestion is completely impractical. Conformity and competitive balance are far more likely to be achieved through a modernization of the U.S. rules. Since the U.S. rules are out of step with the majority, from the standpoint of legislative logistics alone it would be far easier to achieve conforming legislation in the United States alone. More fundamentally, there is no particular reason to believe that numerous foreign sovereigns, having previously declined to adopt subpart F's broad taxation of active foreign businesses, or U.S.-style foreign tax credit limitation rules, will now suddenly have a change of heart and decide to follow the U.S. models.

Recent OECD initiatives relating to “harmful tax competition” do not increase the likelihood of foreign conformity with subpart F's treatment of active foreign businesses. The OECD project seeks to limit the availability and use of “tax haven” countries and regimes, but it does so in the relatively limited context of financial and other service activities that are viewed as

¹⁶ See, e.g., Reuven Avi-Yonah, *Tax Competition and Multinational Competitiveness: the New Balance of Subpart F – Review of the NFTC Foreign Income Project*, 18 TAX NOTES INT'L 1575 (April 19, 1999).

being particularly mobile.¹⁷ To combat the use of tax havens, the OECD has recommended that countries without CFC regimes “consider” enacting them. However, given the limited scope of the project, the OECD has not sought to address the issues that concern us here, relating to the impact of CFC rules on active foreign business operations.¹⁸ Thus, the current work of the OECD offers little reason to expect any reduction in the discrepancy between the U.S. subpart F rules and the rules of the United States’ major trading partners with respect to real foreign businesses.

In conclusion, the U.S. international tax rules are well outside the international mainstream, and should be conformed more closely to the practices of the United States’ principal trading partners. The NFTC advocates only that the U.S. rules be brought back to the international norm so as to achieve competitive parity—not that they be relaxed further in an effort to confer competitive advantage.

5. Administrability and Simplicity

The subpart F and foreign tax credit rules are some of the most complex provisions in the Internal Revenue Code, and they impose administrative burdens that, in many cases, appear to be disproportionate to the amount of revenue at stake. There are several sources of complexity within the rules, including the following:

- The original design and drafting of the rules was complex;
- That initial complexity has been exacerbated over the years by numerous amendments, which have created an increasingly arcane web of rules, exceptions, exceptions to exceptions, etc.; and
- The subpart F and foreign tax credit rules require coordination with each other, and with other regimes that are themselves forbiddingly complex (such as the passive foreign investment company rules).

The complexity of the rules long ago reached the point that the ability of taxpayers to comply with them, and the ability of the IRS to verify compliance, were both placed in serious jeopardy. The NFTC believes that administrability concerns alone would be a sufficient reason to undertake the modernization of subpart F and the foreign tax credit, even in the absence of competitiveness and other concerns. In particular, the drafters of the Code and regulations would do well to focus not only on the legal

¹⁷ OECD, HARMFUL TAX COMPETITION: AN EMERGING GLOBAL ISSUE (1998).

¹⁸ Although CFC regimes may target income in low tax countries, most do not target active income earned in those countries. OECD, CONTROLLED FOREIGN COMPANY LEGISLATION 46, 69–70 (1996).

operation of the rules, but also their practical implementation in terms of record keeping requirements, computational complexity and number and complexity of tax forms. In addition, we urge that fuller consideration be given to the interaction of multiple complex regimes. For example, it may be possible to read section 904(d) and its implementing regulations and conclude that the provision is understandable, and it may likewise be possible to read section 954 and its implementing regulations and conclude that that provision is also understandable, but when the two sets of rules must be read and implemented together, we submit that the limits of normal human understanding are rapidly exceeded.

B. Other Tax Policy Considerations

1. The Policy Study

In December 2000, the Treasury Department released a policy study, *The Deferral of Income Earned Through U.S. Controlled Foreign Corporations* (the “Policy Study”).¹⁹ The Policy Study addresses many of the same factors considered in the NFTC Subpart F Report, with a particular emphasis on capital export neutrality, but arrives at some markedly different conclusions. Based on the analysis that follows, however, the NFTC believes that the Policy Study fails to address, or addresses only superficially, some of the principal considerations supporting the conclusions in the NFTC Subpart F Report. As a result, the NFTC does not believe that the Policy Study makes a persuasive case for a number of its conclusions.

a. The Issue as Defined by the Policy Study

The Policy Study begins with the view that “deferral”²⁰ is problematic based on the interaction of the following core U.S. tax principles:

- As a basic jurisdictional matter, the United States does not tax the foreign income of foreign persons (including foreign corporations);
- The U.S. tax system recognizes a corporation as a separate taxpayer;²¹ and

¹⁹ See Policy Study, *supra* note 2.

²⁰ As discussed in the NFTC Subpart F Report (see *supra* note 1), the term “deferral” itself inaccurately suggests that the current system somehow departs from normative rules that would otherwise apply; as explained above, the absence of current U.S. tax on the foreign income of a foreign corporation in fact reflects the normative limits of U.S. taxing jurisdiction, and it is the acceleration of U.S. tax through such mechanisms as subpart F that represents the departure. We nevertheless defer to Treasury’s use of the term for purposes of this discussion.

²¹ *Moline Properties, Inc. v. Commissioner*, 319 U.S. 436 (1943) (a corporation engaged in business activities is taxed as an entity separate from its shareholders).

- It is the policy of the United States to tax U.S. persons on their worldwide income.

The Policy Study argues that the application of the first two principles in the context of a U.S.-owned foreign corporation produces a “tension” with the third principle, that of worldwide taxation.

We believe that the Policy Study overstates the significance of this tension. It seems to us that in a tax system that seeks to tax worldwide income only in the case of a U.S. taxpayer, that recognizes a foreign corporation as a taxpayer separate from its U.S. shareholders, and that does not tax the foreign income of foreign persons, all three principles are fully satisfied when U.S. taxation of the foreign company’s active business earnings is deferred until a dividend is paid, so that there is no fundamental tension among the three principles. We fail to see how the deferral of shareholder-level tax with respect to active corporate earnings over which the United States has no taxing jurisdiction does any more violence to legitimate U.S. taxing interests than the deferral of shareholder tax on corporate earnings that *are* subject to U.S. tax; in either case the issue is the timing of *shareholder*-level taxation, as to which the presence or absence of U.S. taxing jurisdiction over the underlying *corporate* earnings should be irrelevant as a matter of principle.

On the other hand, it is undeniable that recognition of a corporation as a taxpayer separate from its shareholders can put pressure on the system, because the resulting deferral of shareholder-level taxation of corporate earnings until the time of distribution creates an incentive to abuse the corporate form for tax purposes (particularly during periods when corporate tax rates are lower than individual rates). Such abuses of the corporate form have long been addressed by the Code in the form of such provisions as the accumulated earnings tax and the personal holding company tax, which limit opportunities to use the corporate form for the purpose of avoiding shareholder-level taxation. The proper tax interest of the United States in the CFC context is thus very similar to its interest in the corporate deferral context generally—that is, to identify the circumstances in which the corporate form is being misused to shelter income from shareholder level taxation, and to provide appropriate anti-abuse rules. Accordingly, it does not appear to us that the fact that the United States lacks taxing jurisdiction over the foreign earnings of a foreign corporation should fundamentally alter the system’s willingness to respect that corporation as a separate entity, and as a general rule to impose tax on its U.S. shareholders only when a distribution makes its earnings part of the worldwide income of those shareholders.

The Policy Study’s focus on a tension between the worldwide taxation of U.S. persons and the lack of U.S. taxing jurisdiction over the foreign

income of foreign corporations appears to have been intended to imply that the latter principle should be abandoned (as the Study in fact suggested in its options for reform). But if deferral should be repealed because it conflicts with worldwide taxation, then the same logic would suggest that *Moline Properties* should likewise be repealed because it is “in tension” with the taxation of economic income. We believe that both suggestions are equally radical and equally unjustified, that the real issue in both respects should be the identification of the cases in which these generally sound principles are subject to abuse, and that the active business earnings of foreign corporations do not represent such an abuse. Accordingly, when the tension discussed by the Policy Study is placed in proper perspective, the issue it raises is not whether the bedrock principle of deferral should be jettisoned because it conflicts with worldwide taxation of U.S. shareholders, but simply whether subpart F’s limitations on abuse of the foreign corporate form are functioning properly. Our view is that those limitations currently sweep too broadly in their application to active business income, and that the tension in the rules does not suggest otherwise.

b. Differential Taxation of U.S. and Foreign Earnings

The Policy Study argues more broadly that taxing the U.S. owners of foreign corporations only on the repatriation of profits produces an unequal tax burden vis-à-vis owners of domestic companies; the time value of the deferral is said to result in a lower effective tax rate than that on domestic investments. As a threshold matter, the available evidence suggests that U.S. companies operating abroad bear tax at a rate at least as high as, if not higher than, purely domestic companies.²² We respectfully suggest that the Policy Study’s premise that foreign-source income is lightly taxed compared to domestic income is factually incorrect, and cannot be used to justify tightening the subpart F rules.

Even taking the Policy Study’s premise at face value, however, the Policy Study does not make a persuasive case for eliminating the differential taxation of foreign and domestic earnings. The Policy Study suggests two reasons for concern—fairness and efficiency; however, as discussed below, we do not believe these principles justify sweeping more income into the U.S. anti-deferral regime.

i. Fairness

The fairness argument proposes that, as a matter of equity, taxpayers should bear the same tax burden regardless of where their income-producing

²² While the Policy Study, *supra* note 2, stated that U.S.-owned overseas operations are more lightly taxed than similar domestic investment, the NFTC Foreign Tax Credit Report, *supra* note 1, Chapter 6 shows that this claim is not clearly supported by the Policy Study’s own statistics and is flatly contradicted by independent academic research.

activities are located; based on its implicit definition of fairness as horizontal equity, the Policy Study suggests that companies “sophisticated enough” to operate abroad should not have a tax advantage over companies that operate purely domestically.

There are a number of difficulties with attempting to draw any conclusions concerning the proper scope of subpart F based on fairness, and particularly based on the truncated analysis presented in the Policy Study. As a threshold matter it is not clear that tax fairness can coherently be assessed at the level of corporations, given that the economic burdens of a tax system are ultimately borne by people, not companies. Many believe that a far more fundamental unfairness than that identified by the Policy Study is presented by the imposition of two levels of income tax on corporate earnings (once when they are earned by the corporation and again when they are distributed to shareholders).²³ While a detailed consideration of the issues relating to corporate tax integration is also beyond the scope of this report, we nevertheless suggest that it is difficult to justify major policy decisions on fairness grounds when this factor is not considered at all.

Further, even if horizontal equity among corporations can be coherently analyzed independently of the tax burden borne by individuals, it is far from clear why the Policy Study’s implicit definition of horizontal equity is the proper one to adopt. The Study suggests that horizontal equity should be measured by comparing the tax burden borne by companies with purely domestic operations with that borne by companies that have foreign operations. However, it is not self-evident that this is a more appropriate measure of horizontal equity than a comparison of the tax burdens borne by companies operating in a particular country. In other words, why is it more important that the United States concern itself with the relative tax burdens borne by a company operating in the United States and one operating abroad, than with the relative burdens borne by a U.S.-owned company operating abroad and a foreign-owned company operating in the same country? Just as it is impossible to achieve simultaneous capital export neutrality and capital import neutrality (in a world where national tax rates differ), it is equally impossible to achieve horizontal equity in both cases. The Policy Study, however, fails even to consider the second view of horizontal equity, so it provides no basis for assessing the relative importance of the two views.

²³ Indeed, in a study on corporate tax integration Treasury itself has argued that fairness requires eliminating the double taxation of corporate earnings and recommended a dividend exclusion as a way to implement that policy.

Finally, we suggest that in weighing the two views of horizontal equity sketched above, it would be appropriate as a policy matter to take into account the competitiveness impact of the choice between them. Moreover, horizontal equity (however defined) is not an absolute and is frequently weighed against other important policies reflected in the Code. Thus, even if we were to accept the Policy Study's view of fairness (which for the reasons stated above we do not believe to be justified), it would still be necessary to weigh that factor against such countervailing considerations as the competitive position of U.S.-based companies.²⁴

Accordingly, we do not believe that the Policy Study's fairness analysis justifies the broad acceleration of U.S. taxation of active business income under subpart F.

ii. Efficiency

The second consideration advanced by Treasury to support the view that domestic and foreign income should bear an equal tax burden is that investment decisions based on economic rather than tax considerations will produce the greatest economic efficiency, and thus maximize economic welfare, both globally and nationally. Thus, a substantial portion of the Policy Study, which was written by Treasury economists, discusses whether equal taxation of domestic and foreign income (*i.e.*, capital export neutrality) results in the most efficient global allocation of investment.

While the Policy Study acknowledges that the economic literature does not "prove" that capital export neutrality best achieves global efficiency, it nevertheless concludes that "[w]hen the goal is to maximize global economic welfare, capital export neutrality is probably the best policy."²⁵ The Study then turns to an interesting analysis of whether certain aspects of subpart F are themselves consistent with capital export neutrality principles, given that:

- Where subpart F affects the decision whether to invest at home or in a low-tax foreign country, it is consistent with capital export neutrality;

²⁴ Other considerations may also be relevant to an analysis of the fairness of subpart F, including for example the idea that there should be some rough congruence between a sovereign's taxing claims and the extent of the services or benefits provided by that sovereign to the earner of the income. This "benefits" principle of taxation may underlie the historic primacy of source-based taxing jurisdiction, and raises questions about the fairness of extending U.S. taxing claims over the earnings of active foreign businesses that rely primarily on the infrastructure, services, and legal systems maintained by foreign sovereigns. The idea that tax should generally be imposed only on income that has been realized by the taxpayer may also be relevant. While it has been suggested that controlling U.S. shareholders may have the ability to force a dividend, thus realizing the income on which they are taxed under subpart F, the fact remains that subpart F contravenes this "realization" principle. The Policy Study did not address these matters.

²⁵ Policy Study, *supra* note 2, 36.

- Where subpart F affects the decision whether to invest in a high or low-tax foreign country, it is not consistent with capital export neutrality; and
- Where subpart F affects both decisions, its effect is ambiguous.

The Policy Study thus takes an ambivalent view of the current “foreign-to-foreign related party rules” (*i.e.*, the foreign base company sales and services rules and the treatment of dividends and interest received from related persons as FPHC income under subpart F), concluding that these rules “have an uncertain effect on economic welfare,” that they “have ambiguous effects on the allocation of capital” and that they “may not in every case be the most effective way to increase global and U.S. economic welfare.” The application of these rules has ambiguous effects regarding the efficiency of capital allocation, according to the Policy Study, because the foreign-to-foreign related party rules of subpart F tend to raise overall tax burdens by more for investments in high-tax countries than for investments in lower-tax foreign countries.²⁶

The Policy Study’s intellectual honesty is to be applauded; its acknowledgement that the principal policy rationale for major portions of the subpart F rules does not unambiguously support the continued operation of those rules is a significant step in the direction of a much-needed reevaluation of the rules. Our suggestion in the NFTC Subpart F Report that the policy balance reflected in subpart F needs to be reevaluated in light of the development of a global economy would appear to be significantly strengthened by Treasury’s acknowledgement that the policies once believed to have favored certain aspects of the rules are in fact ambiguous in their effect. We suggest that when the putative benefits of capital export neutrality are deemed to be theoretically ambiguous, it is time to reconsider the dominant role of capital export neutrality in the formation of international tax policy.

In the absence of a clear economic policy justification for the foreign-to-foreign related party rules, the Policy Study does express a more purely revenue-based concern: if U.S. taxpayers had an unrestricted ability to reduce local taxes through foreign-to-foreign transactions (such that operations in any country could potentially be low-taxed), they would have an incentive to move capital abroad, potentially eroding the U.S. tax base. But there are several problems with this analysis. First, it would appear to be inconsistent with Treasury’s own conclusion that for the U.S. economy as a

²⁶ This analysis seems consistent with the intuitive view of many taxpayers that it is counterproductive for the United States to insist on full payment of tax in high-tax countries, because the result is that a U.S.-owned company will either pay more foreign tax than is borne by competitors based elsewhere, or invest in a less efficient but lower-taxed location.

whole, tax policy has little effect on net capital flows in or out of the country.²⁷ Second, this objection is inconsistent with the fact that subpart F does not currently apply to most active business operations in low-taxed countries. There would appear to be no logical basis for treating low-taxed operating income differently depending on whether it arose from local tax reduction with respect to operations in a high-tax country, or instead arose from operations in a country that had a low tax rate to begin with. In other words, penalizing only those taxpayers that operate in high-tax areas (presumably for business-efficiency reasons) makes no sense. Third, eliminating the foreign-to-foreign related party rules would encourage U.S. taxpayers to reduce their foreign tax liability, ultimately reducing the amount of foreign tax credits claimed against U.S. tax liability.

c. Competitiveness and International Norms

The Policy Study devotes a chapter to the issue of competitiveness. However, the chapter consists of less than seven pages (out of the Policy Study's 213 pages) and makes no serious effort to analyze the issue. The Study offers conclusory observations to the effect that competitiveness is affected by many factors, not just taxation, so that analyzing the effect of tax laws on competitiveness is extremely difficult; that, in the years since 1962, roughly half of the OECD countries have enacted some form of anti-deferral rule (including some that were recently tightened); and that the United States is still in a strong competitive position generally.²⁸

The NFTC does not deny that competitiveness is affected by many factors, and that assessing the issue is difficult. However, the NFTC also believes that the Policy Study's failure to address this issue on anything other than the most superficial level is its single greatest failure, and seriously undermines its credibility. Perhaps most surprising is the Policy Study's refusal to engage in any serious analysis of the similarities and differences between the U.S. and foreign anti-deferral regimes. As pointed out in the NFTC Subpart F Report, it simply is not enough to assert generally that various countries have enacted some form of anti-deferral regime. The NFTC has not suggested that subpart F should be repealed; instead, the NFTC has demonstrated that in virtually any scenario one

²⁷ Policy Study, *supra* note 2, 187.

²⁸ In support of the latter point the Policy Study, *supra* note 2, cites a study that has virtually nothing to do with taxes, is designed to measure countries that are attractive for inbound investment and says nothing about the attractiveness of the United States as a headquarters for companies with outward investment. While relying on the generalizations in this inapposite study, the Policy Study dismisses the significance of real data such as the fact that the proportion of U.S. outward investment that is direct investment vs. portfolio investment has declined from 86 percent in the 1960s to 35 percent in the 1990s, at the same time as the proportion of inward investment that is direct investment has increased, and does not comment on the high proportion of cross-border mergers and acquisitions in recent years (measured by deal value) where foreigners are the acquirers and U.S. companies are the targets.

might choose to analyze, the U.S. rules operate more harshly than the rules that apply to the United States' foreign competitors. The Policy Study ignores this entire debate by truncating its analysis at the point where it simply notes the existence of anti-deferral rules in other countries. This obviously provides no response at all to the NFTC's finding that the U.S. rules are out of step with those of the United States' trading partners, and should be reformed not by repealing them but simply by bringing them into line with the majority view, particularly as applied to active business income.

It is difficult to escape the implication that the Policy Study failed to respond to this aspect of the NFTC's report because it simply had no response to give. The U.S. rules are in fact harsher than those of the United States' major trading partners, and they do impose higher tax burdens on U.S.-based multinationals than are imposed on their foreign competitors in similar situations. While it may not be possible to delineate with precision the competitive impact this has, or to describe the myriad other factors that may also affect the competitive positions of these companies, neither of those facts justifies the Policy Study's failure to take the issue seriously enough to address it in detail.

Accordingly, the NFTC does not believe that its call for a reevaluation of the policy balance reflected in subpart F, and in particular the balance between competitiveness and efficiency, has been met by the Policy Study.

2. Relationship Between Subpart F and Foreign Tax Credit Issues

As noted above, a foreign tax credit becomes necessary only when a country decides to tax the foreign-source income of its residents. While credit and deferral issues are thus interrelated, we believe that the importance of that relationship has at times been exaggerated, particularly in the context of the relatively modest reforms proposed here. Were we advocating a more radical change to the U.S. international tax regime, such as the adoption of a territorial tax system, the relationship between credit issues and the scope of U.S. taxing jurisdiction would be central to the debate. But in the context of the incremental reforms proposed here, we believe that the interrelationship between the two issues is of more limited relevance, and indeed that the principal need at this point is to address some of the more exaggerated arguments that have been advanced concerning that relationship. We address two in particular: the first would view the imperfections of the foreign tax credit as being neutralized by the tax benefit of deferral; the second would more specifically argue that

the over-allocation of interest expense against foreign-source income is justified by the existence of deferral.

a. Problems with the Foreign Tax Credit Are Not Neutralized by Deferral

Some have suggested that the imperfections in the existing U.S. foreign tax credit rules should not be viewed as a serious problem because they are neutralized by the ability of a U.S.-based company to defer U.S. taxation of its foreign-source income. Under this view, a company's decision not to repatriate its foreign earnings can provide an economic benefit that offsets the detriment that will arise when it suffers double taxation on the eventual repatriation of those earnings. There are, however, significant flaws to this line of reasoning.

The two-wrongs-make-a-right nature of the argument misconceives the role of deferral in the U.S. international tax system. The argument essentially views deferral as a benefit that can appropriately be set off against some unrelated detriment; this ignores the essentially normative nature of the U.S. decision to tax foreign affiliate income only on repatriation. The deferral of U.S. tax on active foreign affiliate earnings has been a fundamental jurisdictional limitation in the U.S. tax system since the inception of the income tax, and cannot properly be viewed as a "benefit" that should be paid for by accepting foreign tax credit provisions that lead to chronic double taxation.

In attempting to view deferral as a benefit, rather than a normative feature of the U.S. tax system, the Policy Study argued that there is a fundamental inconsistency between the decision to tax the worldwide income of U.S. residents and the decision not to tax the active foreign income of foreign corporations (even when U.S.-owned). However, as discussed above, we believe that the Policy Study overstates the degree of tension between those two positions; the first relates to the scope of the residence-based taxing jurisdiction asserted by the United States; the second relates to the jurisdictional limitations on a sovereign's ability to tax nonresidents. The interaction of the two simply means that the United States will tax U.S. residents on income wherever earned, but as a general rule only when that income is in fact received by a U.S. resident.

Moreover, the fact that a U.S. resident may own an entity over which the United States lacks residence-based taxing jurisdiction reflects the limits of residence-based jurisdiction in a legal system that respects the existence of legal entities. A tax system could presumably be designed on a basis that disregarded the existence of any legal entity and sought instead to determine the economic income of each individual taxpayer. Such an approach would obviously represent a radical departure from any known tax system, and it is not clear on what basis such a system would even be advocated, since it

would depart not only from tax precedent but also from the operation of the U.S. legal system generally, in which the existence of corporate entities is generally respected as a legal reality.

Accordingly, short of such a radical proposal, the existence of foreign corporations as separate legal entities is simply a basic feature of the legal system that defines the limits of residence-based taxing jurisdiction. Subpart F (and similar provisions) represent specific exceptions to that jurisdictional scheme, designed to forestall efforts by U.S. taxpayers to take inappropriate advantage of those limits. But the existence of anti-abuse regimes that limit potential abuses of deferral cannot be viewed as contradicting the basic normative limit: the United States does not generally assert taxing jurisdiction over the foreign income of foreign persons. Therefore, the argument that the deferral of U.S. tax on the active business income of CFCs is a benefit that can properly be offset by known flaws in the U.S. foreign tax credit rules that permit double taxation misconceives the foundations of the U.S. international tax regime, and is completely without merit. Further, even if one were to accept that deferral was a tax benefit, it is not appropriately addressed by the foreign tax credit's insufficient relief of double taxation.

b. Interest Allocation Problems Are Not Neutralized by Deferral

Some have suggested that the over-allocation of interest expense against foreign-source income under current law is justified by the benefit of deferral. The point of this argument seems to be that it is inappropriate to take foreign interest expense into account for purposes of interest allocation when the foreign income associated with this interest is deferred. However, the argument is flawed because reforming current law would not permit any foreign interest expense to be allocated against U.S.-source income; thus, a global approach to interest allocation would have no effect on U.S. tax liability unless and until foreign income is repatriated. More broadly, determining whether foreign operations are funded by U.S. shareholder borrowings or by direct foreign borrowings has nothing to do with whether foreign income is taxed currently or deferred; it is thus difficult to find any justification for linking reform of the interest allocation rules to the scope of deferral.

C. Mobility

It has been suggested that subpart F reflects a Congressional concern about the "mobility" of income that should be taken into account in assessing any potential revision of the statute. However, the mere moveability of income is not the relevant issue; after all, any income is in some sense mobile, since any income may be moved by moving the functions that earn the income. Rather, subpart F has generally targeted income mobility only as a proxy for

some other underlying tax policy concern. Accordingly, we address the issue of income mobility in three relevant contexts; as it relates to passive income, as it relates to the foreign-to-foreign related party rules, and as it relates to active income that is perceived to be geographically mobile.

Passive Income

First, the issue of income mobility is implicated by subpart F's basic distinction between passive income (generally subject to accelerated U.S. tax) and active income (generally deferred). Underlying this distinction is the recognition that no meaningful activity by the taxpayer is required to earn passive income. Thus, when a U.S. company provides capital that a CFC invests passively, the only thing that has occurred is that the U.S. company has shifted its passive income to the CFC. By contrast, when a U.S. company moves income-earning activities into a CFC, that is not the type of income-shifting that subpart F has generally targeted. Thus, the underlying concern that triggers immediate U.S. taxation of passive income is not the mobility of the income per se, but rather the improper shifting of that income from a U.S. taxpayer to a foreign affiliate that did nothing to earn it. We therefore think that present law properly and effectively prevents the improper shifting of passive income from a U.S. taxpayer to a foreign affiliate, and have thus recommended no changes relating to the basic operation of the foreign personal holding company income rules of subpart F.²⁹

Active Income—Foreign-to-Foreign Rules

Turning from the category of passive income, we find that income mobility also arises as an issue in the context of some categories of active income. In particular, the foreign-to-foreign related party rules also implicate income mobility, but their underlying policy concerns are completely different from the case of passive income. Here, although the rules focus on the “deflection” of income between foreign affiliates, the fact that the United States has taxing jurisdiction over neither relevant affiliate makes it clear that mere income shifting is not the concern. Rather, the principal rationale for the foreign-to-foreign related party rules is capital export neutrality. We have set forth above the basis for our conclusion that capital export neutrality is not a persuasive justification for rules that penalize the use of centralized sales and services companies or inter-affiliate debt financing.³⁰

Further, we emphasize the differences in the underlying policy concerns regarding passive and active income; in the case of passive income, subpart F

²⁹ For the reasons discussed elsewhere in this report, however, we believe that certain payments from active affiliates should themselves be treated as active income on a look-through basis.

³⁰ Indeed, Treasury's own Policy Study has acknowledged that the current foreign-to-foreign related party rules (even if fully effective) have an uncertain effect on economic welfare.

prevents the improper shifting of income to a foreign affiliate that did not earn it, while the foreign-to-foreign related party rules apply regardless of whether or not the relevant affiliate in fact earned the income that it reports (by carrying out the relevant functions).

Another proffered rationale for the foreign-to-foreign rules has been that they serve to “backstop” the U.S. transfer pricing regime, which generally seeks to prevent the improper shifting of income from a U.S. taxpayer to a foreign affiliate that did not earn it. However, the transfer pricing rationale is in fact meaningless in the context of the foreign-to-foreign rules, given that (i) the United States generally has no direct tax interest³¹ in which of two foreign affiliates reports a particular item of income, and (ii) the foreign base company rules only apply to sales and services between a U.S. parent and a foreign affiliate if some of the income was deflected to another CFC. In other words, the base company rules never sought to police the transfer pricing of sales or services between a U.S. parent and a CFC that was actually carrying out sales or services activities in its country of incorporation.³²

Active Income—Activities Perceived to Be Mobile

While transfer pricing concerns thus do not support the current foreign-to-foreign rules, the final issue we consider is whether transfer pricing concerns would justify a broader focus on income mobility than is currently reflected in subpart F. The business activities that relate to producing some types of income may be relatively mobile, in the sense that they can be carried out by a foreign affiliate without significant capital investments in plant and equipment—for example certain forms of electronic commerce. The question addressed here is whether that type of income mobility enables U.S.-based companies to shift income to foreign affiliates improperly, causing those affiliates to report more income than is justified by the functions they exercise and the risks they bear.

We emphasize that the issue is not whether U.S. companies may properly shift the business activities themselves (*i.e.*, functions and risks) to a foreign affiliate. To suggest that the United States would have a tax policy objection to U.S. companies carrying out active business activities through their foreign affiliates would represent a radical departure from the current structure of the rules, and one for which no cogent rationale

³¹ To the extent permitted by transfer pricing rules, both the taxpayer and the U.S. Treasury benefit to the extent income is reported by foreign affiliates in low-tax jurisdictions. The taxpayer reduces its foreign income tax liability and the Treasury grants fewer foreign tax credits when the income is repatriated.

³² These observations confirm both that the transfer pricing aspect of the current foreign-to-foreign rules is really a backstop to capital export neutrality, rather than an independent basis for concern about income mobility, and that those rules never addressed the mobility of income between U.S. and foreign affiliates, but only among foreign affiliates.

has been articulated.³³ Rather, the question is whether the mere ability to locate such business activities in a foreign affiliate promotes the shifting of income to the foreign affiliate, particularly in connection with income that is perceived to be more mobile than traditional manufacturing income, and whether subpart F should thus be amended to impose current tax on such income that is perceived to be mobile.

We think that no such change to subpart F would be justified, for several reasons. First, it would be a solution in search of a problem; as discussed above in connection with the base company rules, transfer pricing as a discipline has matured, both in the United States and around the world, to the point that abusive transfer pricing practices are a risk that companies cannot afford to take.³⁴

Second, as a matter of principle, the proper response to any transfer pricing issues that may be presented by new kinds of businesses is to develop workable rules based on the fundamental principle that income should be attributed to the place where the activities giving rise to the income occur. Recent experience suggests that it is in fact possible to develop workable rules that properly attribute even very mobile types of income to the persons that economically earn it. For example, the OECD is making good progress in applying traditional income-attribution concepts to electronic commerce. Accelerating U.S. taxation of active CFC income solely on the grounds of mobility is not justified by current experience.

Indeed, an overreaction to the perceived fiscal dangers posed by electronic commerce would aptly illustrate the third and most practical problem that would face any attempt to accelerate U.S. taxation based on the perceived mobility of certain types of income earned by CFCs: that is the problem of setting and applying the standards by which income will be deemed to be “too mobile” and therefore subject to current U.S. tax. It is far from clear in the first place what standards would be applied in determining that some types of income are too mobile while other types of income are not. Second, even if such standards could be articulated, who will do the fact finding to make sure the standards are fairly applied across industry lines? It would seem an odd task for Congress to assign itself, or even to delegate

³³ Once the fundamental structural decision is made to respect the separateness of corporations for tax purposes, a taxpayer's decision to shift genuine economic activity to a corporation should likewise be respected—even when that corporation is one that operates outside of U.S. taxing jurisdiction, because the United States does not tax the foreign income of foreign persons.

³⁴ Further, although a transfer of intangibles might once have been used to shift income to a foreign affiliate, U.S. tax rules already ensure that an income stream attributable to U.S.-developed intangibles cannot be shifted tax-free to a CFC. See section 367(d) and regulations thereunder.

to Treasury, since this type of line-drawing would seem to call for a detailed understanding of the ever-changing operations of many different industries. Yet accelerating U.S. taxation of certain categories of CFC income based on anything less would amount to taxing on the basis of reputation or opinion rather than fact.

We conclude by emphasizing that although income mobility *per se* should not trigger the application of subpart F, it may nevertheless continue to be relevant as a proxy for other policies. For example, as noted above, passive income continues to be properly targeted when it is shifted to a CFC. In this connection, section 954(h) deserves special comment, since it specifically takes income mobility into account in defining the active business income of a financial services business. The relevant considerations there relate to the need adequately to define the scope of active financial services activities in the first instance, and then to determine whether a particular item of income that, like interest income, falls within or without the scope of subpart F by reference to the context in which it is earned, has a sufficiently close nexus to that active business.³⁵ Once these (admittedly difficult) issues are resolved, we believe that financial services businesses generally do not raise any additional conceptual or policy issues relating to income mobility not present in other industries.³⁶

Accordingly, based on the practical considerations as well as the matters of principle discussed above, we believe that a broad new focus on income mobility as the basis for accelerating U.S. tax under subpart F would represent a radical expansion of subpart F for which no persuasive justification has been offered.

D. Conclusion as to Policy Considerations

The NFTC believes that the tax policy criteria of competitiveness, administrability, fairness and international conformity all support a significant modernization of subpart F and the foreign tax credit at this time. Further, even if Congress and the Administration are persuaded to give continued weight to the policy of capital export neutrality as a general matter (which we do not believe to be justified), it must be recognized that important aspects of current law, such as the foreign-to-foreign related party rules of subpart F, cannot be justified on the basis of that policy. Moreover, even if continued

³⁵ See discussion in III.B.1 of this part of the Foreign Income Project.

³⁶ We have not sought to identify here other specific circumstances in which the mobility of income might helpfully be taken into account in setting the scope of subpart F; our point is that while mobility may continue to serve as a proxy for other relevant considerations (such as the nexus between other-wise-passive income and an active financial business), it does not offer an independent basis for accelerating U.S. taxation.

weight is given to capital export neutrality, the countervailing considerations identified in the NFTC's Foreign Income Project are sufficiently powerful to justify the reforms advocated below, which would do little more than restore the type of policy balance that Congress sought to achieve in 1962, and that has gone seriously awry in the intervening decades.

The legislative recommendations set out in III., below recognize that subpart F must continue to play a significant role in U.S. international tax policy, but seek to narrow the circumstances in which it accelerates the U.S. taxation of active foreign business income. Similarly, the NFTC's foreign tax credit recommendations recognize that significant limitations must continue to be placed on the availability of the credit, but seek to narrow the circumstances in which such limitations produce double taxation of foreign income.

III. Subpart F Legislative Recommendations

A. Rules of General Application

1. Look-Through Treatment of Payments by Active Foreign Affiliates

Under current law, an active CFC's payment of dividends, interest, rents or royalties to another CFC will generally trigger current U.S. taxation under subpart F. Thus, a U.S.-based multinational that is solely engaged in active foreign business operations through multiple CFCs can incur significant subpart F taxation simply by redeploying its active foreign assets among its foreign businesses. This inhibits the ability of U.S.-based companies to respond to market opportunities by imposing a U.S. tax cost on business decisions.

Further, the rules prevent U.S.-based companies from using common intercompany transactions (such as loans) to reduce foreign taxes in high-tax countries. Such intercompany transactions are widely used by foreign competitors to reduce local taxation, and their use is generally regarded as perfectly legitimate by foreign taxing authorities (subject to satisfying thin capitalization rules and the arm's length standard).

Finally, it seems irrational to insist on radically different U.S. tax results based on minor differences in the foreign corporate structure. If a taxpayer does business in multiple jurisdictions using a single foreign corporation, the movement of funds among the branches of that entity will not generate subpart F inclusions—rather, the subpart F treatment of the company will

depend on the nature of the income earned in its business operations. We see no reason to insist on a completely different analysis if it happens that other considerations (e.g., regulatory constraints or liability considerations) require the use of multiple foreign corporations.³⁷

It should be noted in this regard that in 1996 Treasury itself moved significantly in the direction of liberalizing U.S. multinationals' ability to re-deploy their active foreign business assets, by issuing the check-the-box entity-classification rules. One of the principal reactions from tax practitioners concerning those rules was to note that they would permit U.S. multinationals to convert CFCs into branches for U.S. tax purposes, without giving up the limited liability and other benefits of corporate status under foreign law. In the case of a single CFC with multiple branches, interbranch payments of interest, dividends, etc. would not be recognized for U.S. tax purposes, effectively achieving the same subpart F result as is proposed here. Treasury subsequently attempted to reverse the course set by the check-the-box rules, by issuing Notice 98-11 and subsequent pronouncements that sought to create a regulatory "branch rule" within the context of FPHC income. Treasury seems to have been responding primarily to the specter of U.S. multinationals using these structures to reduce local taxes in high-tax countries like Germany. As discussed above, efforts to prevent U.S. taxpayers from reducing foreign taxes are one of the counterintuitive results that flow from the adoption of capital export neutrality theories. Thus, Notice 98-11 was apparently based on a pure capital export neutrality rationale, which, for the reasons noted above, should no longer be given significant weight in the formulation of U.S. international tax rules.³⁸

Accordingly, we recommend that an exception from subpart F be provided for inter-affiliate payments out of active foreign earnings. Under this exception, a payment between related CFCs would be excepted from subpart F to the extent it was attributable to active income of the payor. "Look-through" principles that are already well developed under section 904(d) of the Code would be used to determine the portion of any payment attributable to active income. The exception would apply to payments of

³⁷ We acknowledge that deferral itself is based on the formal distinction between U.S. and foreign incorporation, but that is a formal distinction with numerous tax (and non-tax) consequences. Our point here is that once that line is crossed by a taxpayer that chooses to operate in foreign corporate form, the difference between one foreign corporation and two seems an odd basis on which to hinge significant U.S. tax consequences.

³⁸ Because we believe that the capital export neutrality policy basis of Notice 98-11 was misguided, we do not address whether the Notice's attempt to subject certain interbranch payments to the FPHC rules lacked statutory authority. In any event, since we are proposing that certain inter-affiliate payments be excepted from subpart F by the same token interbranch payments (whether or not deductible locally) should likewise not give rise to subpart F inclusions.

dividends, interest, rents and royalties. Payments between unrelated CFCs would continue to give rise to subpart F income, as under current law.

In addition, look-through treatment should also apply to gains realized by a CFC on the disposition of affiliated entities, including both corporations and partnerships. Under current law, such gains are automatically classified as passive income, even if the underlying business activities of the entity are entirely active; extending look-through treatment would eliminate this anomaly.

The NFTC considered two possible restrictions on the scope of this rule, but concluded that neither would be justified. One would have limited the exception to payments that were not deductible to the payor. However, the NFTC could identify no rational basis for treating a payment differently for U.S. tax purposes simply because it has the effect of reducing foreign taxation. The only possible reason that we could identify for making such a distinction would be based on capital export neutrality theory: by imposing U.S. tax on payments that reduce local taxation, subpart F would prevent taxpayers from enjoying deferral in the case of low-taxed foreign earnings (even in the case of an active business), with the goal of ensuring that investment decisions were not influenced by the prospect of such reduced taxation. However, this rationale, if accepted, would seem to require that U.S. taxation of all low-taxed foreign earnings be accelerated, to ensure that such a reduced foreign tax rate does not influence investment decisions—a radical departure from existing law that was soundly rejected in 1962 and has not been seriously proposed since then.

Once it is accepted that active foreign business earnings should be subject to U.S. tax only on repatriation (regardless of local tax rate), we can see no rational basis for distinguishing between an active foreign business that operates in a low-tax jurisdiction and one that operates in a higher-tax jurisdiction but makes a deductible payment to an affiliate. In both cases, the active foreign earnings bear a relatively low rate of tax, and both cases should be viewed as unobjectionable by the U.S. tax system, given the genuine foreign economic activity producing the income. Indeed, as discussed above, it would be ludicrous to argue that an active business in a high-tax jurisdiction is somehow harming the U.S. tax system when it seeks to reduce its local taxes by making legitimate payments to an affiliate.

The second restriction on the proposed look-through approach that was considered but rejected by the NFTC would have required that the recipient CFC itself be engaged in the conduct of an active foreign business. Under such an approach, interest or dividends paid to a CFC that functioned purely as a holding company would continue to generate subpart F income, but

we saw no rational basis for adopting such an approach. The critical factor is whether the taxpayer is engaged in active foreign business operations; if it is, the particular legal structure through which the operations are carried on should be irrelevant. For example, assume that a taxpayer has active business operations throughout Europe. If those operations are carried on by a single legal entity, under current law the movement of funds between the branches of the entity will generally have no subpart F implications.³⁹ If those operations are placed in separate legal entities that are in turn owned by a Dutch holding company, we believe that the subpart F results should be the same, and see no relevance in whether the holding company happens to be engaged in an active business of its own. Accordingly, we believe that the look-through exception should be available when payments are made to any related CFC.

Finally, we note that a look-through approach to the characterization of foreign income has been broadly accepted as being appropriate for foreign tax credit purposes, since it looks to the real nature of the underlying income. We submit that the same logic should apply for purposes of characterizing income under subpart F. Moreover, a consistent application of look-through principles would bring greater conformity between the subpart F and foreign tax credit rules, simplifying their interaction.

2. Repeal of Base Company Sales and Services Rules

Under current law, subpart F income includes “base company sales” and “base company services” income that is earned outside a CFC’s country of incorporation in connection with certain related party dealings. Although, from a business perspective, it is often sensible to have centralized sales or services entities, the base company sales and services rules effectively impose a tax cost on the use of such entities by accelerating U.S. taxation. Further, the base company sales and services rules interfere with legitimate foreign tax reduction efforts. For example, assume that a U.S. company establishes a manufacturing subsidiary in Germany to produce widgets for the European market. Given the high rate of tax in Germany, it would be rational for the company to seek to limit German tax by all legitimate means. One such means would be to move some functions and risks out of Germany, and locate them in a lower-tax jurisdiction. The arm’s length profits from those functions and risks would thus give rise to taxable income in the other jurisdiction, rather than Germany. Thus, for example, it might make sense to locate a sales and distribution entity somewhere other than Germany, to purchase the widgets from the German manufacturer and

³⁹ Subject, of course, to the final resolution of the Notice 98-11 controversy discussed above.

market them to customers throughout Europe. Unfortunately, the base company sales rules would largely defeat the point of the exercise by imposing current U.S. taxation on the distributor's earnings from all sales outside its country of incorporation.

Two rationales have been offered for the current structure of the rules. The first is transfer pricing; absent the base company rules, companies might seek to engage in abusive transfer pricing to maximize profits in low-tax jurisdictions. This rationale may have made a certain amount of sense in 1962, when transfer pricing enforcement was in its infancy. However, two major developments since that time have largely deprived it of its force. First, U.S. transfer pricing law and practice have undergone profound changes in the intervening years. Most importantly, based on legislative changes in the 1986 and 1993 tax acts, Treasury has issued detailed regulations that have drastically altered the transfer pricing enforcement landscape. These regulations implement a structure of reporting and penalty rules that are generally acknowledged to have had a significant impact on taxpayer behavior. Further, although audit experience with the new rules is still limited, the widespread availability of contemporaneous transfer pricing documentation is expected to enhance the IRS' ability to perform effective transfer pricing examinations.

The second major development that has changed the transfer pricing landscape is the globalization of transfer pricing enforcement; partly in response to U.S. initiatives, and partly because of their own compliance concerns, many of the United States' major trading partners have recently stepped up their own transfer pricing enforcement efforts, enhancing reporting and penalty regimes and increasing audit activity.

Thus, the ability of U.S. taxpayers to shift income into a low-taxed sales company by manipulating the pricing of transactions is far more limited today than it was when transfer pricing as a discipline was in its infancy. This basic change in the landscape suggests that transfer pricing enforcement no longer provides much of a justification for the base company sales and services rules.

The strength of the transfer pricing rationale as a justification for the current scope of the rules is further weakened when it is recognized that the rules are far broader than necessary to address U.S. transfer pricing concerns. This is because the base company rules apply to large categories of transactions that have no U.S. nexus at all and, therefore, present no U.S. transfer pricing concerns to begin with. In the example considered above, the only transfer pricing issue that could arise would be between the German manufacturer and the low-tax distributor, which would presumably be of no concern to the U.S. tax system.

The fact that the base company rules are fully applicable to transactions that have no U.S. transfer pricing nexus suggests that the transfer pricing rationale was at most a secondary consideration in the design of the base company rules. This brings us to the other proffered rationale for these rules, which is once again the theory of capital export neutrality and its obsession with ensuring that U.S. taxpayers pay the maximum possible amount of foreign tax.⁴⁰ As discussed above, the NFTC does not believe that the theoretical benefits offered by subpart F's haphazard pursuit of capital export neutrality theory even remotely justify the adverse fiscal and competitive impact of preventing U.S. taxpayers from reducing the foreign taxes on their international operations. Thus, we find that neither transfer pricing concerns nor capital export neutrality theories provide a convincing rationale for the base company sales and services rules.

When the weakness of these proffered rationales is compared with the costs imposed by these rules, the only possible conclusion is that they must be repealed. We refer not only to the costs that are borne in the form of higher foreign or U.S. taxes, but also to the rules' constant interference with rational business decision making. As companies struggle to adopt the globally integrated business models demanded by the global marketplace, these rules force them to consider sub-optimal business structures simply to avoid the harshest impact of the base company provisions.

The NFTC recognizes that the repeal of the base company sales and services rules may be seen as a radical proposal, since it would remove two of the principal categories of base company income that were first enacted in 1962. However, we have searched in vain for any rationale that would justify the retention of these rules, which, even if they may have made sense in 1962, are a dead weight on U.S. competitiveness today. We have also considered halfway measures that would substantially restrict the scope of the base company rules while providing the superficial reassurance of retaining the traditional structure of subpart F, but concluded that no such measures made any real sense. We therefore recommend that the base company sales and services rules be repealed in their entirety.

3. Symmetrical Treatment of Losses

Under current law, the treatment of subpart F income and the treatment of losses generated by subpart F-type activities are not symmetrical, creating

⁴⁰ As discussed above, the theory is that, by accelerating U.S. taxation when a U.S. company manages to reduce its foreign taxes, subpart F can ensure that taxpayers will be less tempted to make tax-motivated foreign investments (i.e., based on their ability to reduce foreign taxes while deferring U.S. taxes until repatriation).

many “heads-I-win-tails-you-lose” scenarios that are difficult to justify on a principled basis. The restrictive treatment of losses under subpart F includes the following features:

- Basic structural asymmetry: income from subpart F activities is always recognized currently on the U.S. tax return, but if those activities should instead generate losses they are generally given no current U.S. tax effect.
- Carryover restrictions: although the U.S. tax system uses an annual accounting period to calculate income, it also permits losses to be carried between taxable years so as to prevent the overtaxation of income in a multi-year period. Any activities carried on by a U.S. corporation will benefit from this ability to carry over losses. By contrast, current-year subpart F income is generally subject to current tax, without regard to the fact that the CFC may have had significant losses in another year, which could easily lead to the taxation of an amount greater than the CFC’s economic income in a multi-year period.⁴¹
- No consolidation of affiliate losses: a group of affiliated U.S. corporations may file a consolidated tax return, allowing the losses of one affiliate to offset the income of another, and ensuring that the group is not taxed on an amount that exceeds its economic income. By contrast, in the case of a group of affiliated CFCs, there is only a very limited ability to offset one CFC’s subpart F income with another CFC’s subpart F losses.⁴² Thus, a group of CFCs may easily be taxed on an amount of subpart F income that exceeds its economic income from subpart F activities.
- Offsetting of losses among subpart F income categories: the ability to offset losses among the various categories of subpart F income is severely restricted under the regulations, which generally treat the current-year earnings and profits limitation as the sole means of reducing a subpart F inclusion based on a CFC’s own current year losses. Thus, for example, the U.S. shareholder of a CFC with significant active earnings and profits will recognize subpart F income based on the CFC’s receipt of interest income, even if it has a net loss from commodities transactions that exceeds the interest income.

⁴¹ No loss carrybacks are permitted, and a loss carryforward is permitted only within certain foreign base company income categories (and in the case of FPHC income, limited to CFCs predominantly engaged in certain financial businesses). I.R.C. § 952(c)(1)(B).

⁴² No brother-sister losses may be taken into account, and a loss of a restrictively-defined “chain member” may be taken into account only within the same foreign base company income categories that apply to loss carryforwards. I.R.C. § 952(c)(1)(C).

This is particularly troublesome when it prevents taxpayers from being able to net the results of a business transaction with the offsetting effect of a related hedging transaction.

As a threshold matter, we cannot resist noting that this restrictive treatment of losses realized by CFCs, as compared with the treatment of losses realized by domestic affiliates, is a distinct departure from capital export neutrality principles, since it creates a genuine tax disincentive to carry on certain activities abroad. If the activities targeted by subpart F are carried on by a foreign corporation, subpart F will accelerate any income but defer any losses. If those activities were instead placed in a U.S. corporation, both income and losses would be recognized for U.S. tax purposes. Since the likelihood of any given activity's producing losses rather than income is not generally known at the outset, the system creates a structural bias in favor of U.S. investment, rather than anything approaching neutrality. However, as we noted at the outset, U.S. allegiance to capital export neutrality as a tax policy principle has been haphazard at best.

Turning now to why the subpart F rules treat losses as restrictively as they do, we found that most discussions of subpart F have devoted little attention to the issue, so that there is relatively limited material that sheds light on the reasons for the various restrictions noted above. Part of the problem is structural, of course, in the sense that the general nonrecognition of CFC losses for U.S. tax purposes is simply a function of the general jurisdictional limits that treat the income (and therefore the losses) of a foreign corporation as not being subject to U.S. taxation. In a regime in which U.S. taxation of foreign affiliate income is deferred, it is of course perfectly appropriate to likewise defer the recognition of foreign affiliate losses.

However, once the system is modified so as to accelerate the U.S. taxation of a foreign affiliate, the fundamental character of an income-based tax system should require a parallel acceleration of the recognition of foreign affiliate losses. The basic problem with subpart F today is that it makes no effort to provide such parallel treatment, and indeed goes out of its way to create asymmetries that accelerate income while deferring losses, particularly in the aftermath of the 1986 Act. The reasons for this asymmetry have never been satisfactorily articulated or examined.

The legislative history to the 1986 Act restrictions on the use of CFC losses cites Congressional concern about taxpayers' ability to offset subpart F income with a loss that "might have been in a non-subpart F income category or borne little or no relation to the income it offset."⁴³ The first scenario

⁴³ STAFF OF THE JOINT COMMITTEE ON TAXATION, GENERAL EXPLANATION OF THE TAX REFORM ACT OF 1986, 99TH CONG., 2D SESS. 972 (1987) [hereinafter "1986 Bluebook"].

(non-subpart F loss) does raise a cogent concern; the unrestricted ability to offset active business losses against subpart F income might encourage taxpayers to shift passive income into a loss-making CFC so as to “soak up” the loss against what would otherwise be taxable income.⁴⁴

On the other hand, the current rules sweep far more broadly than necessary if the only concern is to prevent active losses from offsetting passive income. The current restrictions also prevent subpart F losses from being carried forward or back, from offsetting other categories of subpart F income and from offsetting subpart F income of related CFCs. No overall rationale seems to justify these restrictions for subpart F purposes, when the use of losses for other purposes of the Code is not generally limited to “related” income categories.⁴⁵ After all, permitting losses to offset income is generally required to conform taxable income to economic income, consistent with the fundamental purpose and character of an “income” tax. In this regard, we emphasize that the earnings and profits limitation of section 952(c), which limits subpart F taxation to a particular CFC’s annual earnings and profits, does not limit taxation to economic income; as discussed above, it does not generally take into account losses in other taxable years, or losses of affiliates. Moreover, even looking at one company in one taxable year, section 952(c) does not limit subpart F taxation to economic subpart F income—that is, net income from subpart F activities. The Congressional expression of concern with permitting non-subpart F losses to offset subpart F income does nothing to explain why purely subpart F-related losses are so severely restricted as to distort the calculation of economic income from subpart F activities.⁴⁶

In evaluating subpart F’s treatment of losses, it is also important to recognize that business losses are an important fact of business life; at the outset of any particular business or investment, the participants obviously hope to generate profits, but the record shows that the best laid plans often generate losses. Further, the likelihood of any particular venture producing losses

⁴⁴ It might be questioned, however, whether U.S.-based multinationals would in reality have the luxury of investing significant portions of their capital in passive assets simply to offset active business losses for tax purposes—they are more likely to be using their capital to fund the investments needed to turn loss-making businesses into profitable businesses.

⁴⁵ Although there are limited exceptions such as those relating to passive activity losses under I.R.C. § 469, the Code generally requires no relationship between a loss item and an income item to permit the two to be netted for purposes of determining taxable income.

⁴⁶ Restrictions on the use of losses that arise in the implementing regulations seem to be based in large measure on regulatory literalism—for example, the regulations prevent a loss in one FPHC category from offsetting income in another based on several definitions that look to the “excess of gains over losses;” the regulations thus take an excess of losses over gains to be definitionally excluded from that definition. Whether or not this is the best or only available reading of the statute, it does not amount to a rationale for how losses should be taken into account in computing subpart F income.

rather than income is not generally known at the outset. Recognition of these business realities is a further refutation of the relevance of capital export neutrality theory to the structure of subpart F, because the genuine possibility of making losses should weaken the influence that tax rate differentials are likely to have on capital investment decisions.⁴⁷ Those decisions will instead have to be made on the basis of other business criteria.⁴⁸

Turning finally to the redesign of subpart F's treatment of losses, we believe that the fundamental principle should be that subpart F's acceleration of foreign affiliate income requires a parallel, symmetrical acceleration of foreign affiliate losses. This means that losses generated by any activities that would generate subpart F income should be available to offset any subpart F income of affiliated CFCs, and to be carried over as part of a consolidated "subpart F net operating loss" to other taxable years. The availability of such subpart F losses to offset subpart F income should not be affected by whether the relevant activities are in the same or different subpart F income categories. On the other hand, the principle of symmetry would continue to prevent the use of non-subpart F losses against subpart F income (or vice versa), subject to the basic economic-income threshold represented by the earnings and profits limit.

4. Restoration of a Meaningful *De Minimis* Rule

When it was originally enacted, subpart F recognized that a corporation engaged in the conduct of active foreign business operations would potentially generate income in connection with those operations that would fall into one of the subpart F income categories. The classic example of such income is interest on working capital, but many other instances can also arise, for example amounts relating to limited intra-group services, income from treasury operations, exchange gains on payables and receivables, etc. Rather than subjecting such active business operations to the full panoply of the subpart F rules with all their intricate exceptions and their attendant administrative complexity, the 1962 Act provided a substantial *de minimis* rule that excluded from subpart F amounts equal to up to 30 percent of a CFC's gross income.

⁴⁷ If a particular investment may produce a gain or a loss (as is the normal case in a real business), the decision as to where to locate that investment will not likely be driven by tax rates, since placing a losing venture in a low-tax jurisdiction (and thus using up the losses in a low-tax environment) is about as unattractive from a tax planning standpoint as locating a profitable venture in a high-tax jurisdiction (and thus paying high taxes on the profits), and neither outcome can be predicted.

⁴⁸ Further, if a venture is believed to have a virtual guarantee of profitability, this is likely to be attributable to the presence of valuable intangibles, the export of which for tax purposes is effectively policed by I.R.C. § 367(d).

This was significantly reduced in 1975, to 10 percent of gross income, and effectively repealed in 1986 by limiting it to the lesser of 5 percent of gross income or \$1 million. For the large operating subsidiaries of a U.S.-based multinational, the \$1 million threshold is rapidly exceeded by even the most limited financial operations required by such businesses.

The reason advanced by Congress in 1986 for its virtual repeal of the *de minimis* concept is simple: “Congress was concerned that the 10-percent *de minimis* rule allowed taxpayers to earn substantial amounts of tax haven income (such as interest) free of current tax under subpart F.”⁴⁹ However, labeling an amount of interest on working capital (for example) as “substantial” does not really offer a rationale for why the subpart F regime should apply. If subpart F is intended to prevent U.S. taxpayers from making tax-motivated investments abroad, the original approach of the 1962 Act seems a far more sensible implementation of that policy than today’s rules, because it recognized that active foreign business operations (presumptively non-tax motivated) would in the ordinary course of business generate collateral income that is described in subpart F but not within the scope of its intent.

The only other point made by the legislative history in 1986 was that a *de minimis* test based on a percentage of gross income could be a large amount “in absolute dollar terms,” which was “inconsistent with the *de minimis* concept in Congress’ view.”⁵⁰ Again, however, the proffered rationale is conclusory at best, and fails to address the conceptual basis for the *de minimis* rule. The rule, as originally enacted, recognized that active businesses inevitably earn some amount of interest, exchange gains, etc.; that being the case, the larger the size of the actual business, the larger the amounts of such collateral income it is likely to generate, since it will have larger working capital balances, larger receivables and payables on which it may realize exchange gains, etc. Thus, the focus of the original rule on a percentage of gross income is fully consistent with the basic concept of the *de minimis* rule, while it is the 1986 Act modification that departs from the logic of the rule.

Accordingly, we recommend that a meaningful *de minimis* rule be restored to subpart F by returning to the pre-1986 Act version of the rule, excepting from subpart F amounts that do not exceed 10 percent of a CFC’s gross income.⁵¹

⁴⁹ 1986 Bluebook, *supra* note 43, 990.

⁵⁰ *Id.*, 990-991.

⁵¹ In connection with other provisions of the 1986 Act, Congress expressed concern about the potential manipulability of tests based on gross income. While such concerns should be attenuated in a setting in which the gross income must be from an active business, if necessary an anti-abuse rule could be provided to forestall an artificial inflation of gross income intended to balloon a CFC’s income threshold under the *de minimis* rule.

B. Industry-Specific Rules

1. *Permanent Active Financial Services Rule*

The temporary subpart F rules applicable to active financial services income should be made permanent. Because our principal trading partners permit deferral (or exemption) of this type of income, U.S.-based financial services companies would be placed at a competitive disadvantage if the current, temporary provision were to expire. Further, the impermanence of the provision makes it difficult for U.S. companies to price long-term contracts on a competitive basis. Moreover, the recent revisions of the rule have successfully addressed the policy issues identified in previous years; if anything, long-term consideration should be given to reviewing some of the current restrictions, once the provision has been made permanent.

Subpart F, as enacted in 1962, did not generally subject *active* business income to current taxation (with the exception of sales and services income that had been “deflected” to a low-taxed base company). Consistent with the general policy, dividends, interest and certain gains derived in the active conduct of a banking, financing or securities business, or derived by an insurance company on certain investments relating to non-U.S. risks, were specifically excluded from current taxation. In 1986, Congress generally eliminated the active financial services rules from subpart F, thereby exposing, for example, interest and dividend income earned by a CFC engaged in a banking business to current U.S. tax.⁵² Congress expressed the view that the prior rules provided excessive opportunities for taxpayers to “route” income through low-tax countries for the purpose of reducing U.S. tax.

Beginning at roughly the same time, the international operations of financial services firms entered a period of exponential growth. The factors that contributed to this surge of international activity include: (i) the global movement to deregulate financial services businesses (e.g., the United Kingdom’s “Big Bang”); (ii) the related relaxation of regulatory restrictions on foreign financial services firms dealing with local customers; (iii) the concurrent rise of modern financial mathematics and information technologies that in turn led both to a wide array of new financial products and services (and financial risk management techniques), and to new cost structures for traditional financial services; and (iv) the rise in global portfolio asset and risk allocation philosophies among institutional customers. In addition,

⁵² Even after the 1986 Act, certain limited categories of financial services income were eligible for continued deferral. They included an expanded version of the calculation of tax-deferred underwriting income from the insurance of risks in the CFC’s country of incorporation (which in effect included some investment income), gains from trading in securities held in inventory by a dealer, and income of dealers in notional principal contracts.

access to foreign markets for U.S.-based financial services companies has been improved by such agreements as the World Trade Organization (WTO) services agreement, the North American Free Trade Agreement (NAFTA) and China Permanent Normal Trade Relations (PNTR).

The revolution in global financial markets and its impact on the activities of U.S.-based financial services firms cannot be overstated. Fifteen years ago, many of the United States' largest financial services firms earned less than 10 percent of their income from international operations. Today, many of those same firms earn 50 percent or more of their revenues outside the United States, and employ thousands of individuals both abroad and at home to support those efforts.

In response to the rapid globalization of both financial markets and financial institutions, Congress, in 1997, restored an active financial services rule to subpart F, but added new provisions to address the concerns that motivated the rule's repeal in 1986. Relying in large measure on the view that *active* financial services income was likely to be relatively *immobile* (and thus less subject to being "routed" to low-tax jurisdictions for tax reasons), the Taxpayer Relief Act of 1997 sought to identify *bona fide* active financial services firms by requiring minimum standards of *activity* with *customers* before income would be treated as eligible for deferral. Thus, for example, under the 1997 Act, banks and securities firms needed to satisfy three related tests: first, they had to be subject to *bona fide* local licensing and regulatory supervision; second, they were required actively to conduct their business through, in effect, their own employees; and third, only income from *bona fide* transactions with *customers* qualified for relief.

Recognizing that certain issues, including potential income mobility, would "require further study," in 1997, Congress enacted the active financial services provision for only one year. President Clinton vetoed the 1997 provision under his line-item veto authority, but the provision was reinstated when the Supreme Court declared the line-item veto unconstitutional in June 1998.

Following the line-item veto of the 1997 Act's active financial services income rules, the issue of how to identify *bona fide* international financial services firms was the subject of extensive consultations involving Treasury, Congress and the private sector. As a result of that effort, in 1998, Congress extended the active financial services provision for another year (1999, for calendar year taxpayers). In doing so, Congress responded, in particular, to concerns expressed by Treasury and others regarding the 1997 Act, by tightening still further the requirements that a taxpayer must satisfy before its income can qualify for relief from subpart F under the active financial

services income rules. In 1999, this provision was extended for an additional two years (2000 and 2001, for calendar year taxpayers).

The subpart F rules applicable today to financial services firms are in several respects stricter than the rules applicable to manufacturers:

- First, the rules impose a ‘superactivity’ requirement, under which a qualifying CFC in effect must directly conduct a vertically integrated and complete financial services business.
- Second, the law imposes ‘superbranch’ limitations that exceed current law’s foreign base company sales income rules relevant to manufacturers, by effectively requiring that each branch of a financial services firm satisfy a ‘superactivity’ test.
- Third, the 1998 rewrite of the statute for the first time ties the availability of an exception to subpart F to a requirement that income be derived only from customers outside the United States.
- Fourth, the 1998 Act imposes a requirement not otherwise present in subpart F that qualifying financial services income be subject to tax in the jurisdiction in which the ‘superactivity’ takes place.

The subpart F rules for active financial services income are intended to place the foreign activities of the entire U.S. financial services sector—insurance, banking, securities, leasing and finance companies—on equal footing with the foreign activities of U.S. manufacturing firms and non-U.S. financial services firms. As summarized above, to qualify for active financial services income relief from subpart F, a financial services business must be truly *active* and *immobile*. (Indeed, under current law, the subpart F restrictions imposed on a new foreign operation of a U.S.-owned financial services firm are arguably more onerous than the restrictions imposed on a “greenfields” industrial facility.) In short, in their current formulation, the active financial services income rules ensure that the international income of a financial services firm will not be deflected to low-tax or no-tax jurisdictions where no meaningful activities take place.

The existing subpart F provision expires at the end of 2001. The instability created by the temporary nature of these rules already has placed U.S.-based firms at a competitive disadvantage in an increasingly global financial services marketplace. In the absence of a permanent provision, the United States will remain out of step with the overwhelming majority of industrialized countries, which generally recognize such income as active trade or business income. U.S. financial services firms today lack the tax certainty and predictability that is integral to such strategic planning decisions as the allocation of capital, the deployment of human resources, and the structuring

of operations. Most importantly, it is impossible to price long-term financial transactions competitively when the applicable tax rate is unknown.

To create a stable and predictable tax environment for the international operations of U.S.-based financial services firms, to create some semblance of tax parity between U.S.-based financial services firms and their foreign-based competitors and to apply the tax policies underlying subpart F in a more evenhanded manner to all sectors of the U.S. economy, the NFTC recommends that current law's subpart F active financial services rules be made permanent.

In addition, once the current provision for active financial services income is made permanent (or at a minimum extended for a significant period), the NFTC recommends that the provision's detailed requirements be reviewed. Based on our analysis of the foreign base company rules, for example, it may no longer make sense to impose the current provision's 'superbranch' restrictions, or its limitations on doing business with unrelated U.S. customers, as long as reasonable activity tests are satisfied. Moreover, if the existing rules produce current taxation of certain types of active financial services income when a company otherwise meets the active business requirements and is entering the transactions to reduce foreign taxes, then such rules should also be examined in a fashion similar to that which we have recommended for foreign base company sales transactions.

2. Repeal of Foreign Base Company Oil-Related Income Rules

In 1982, Congress expanded subpart F income to include certain types of oil-related income, such as income from operating an oil or gas pipeline outside the country in which the oil or gas was extracted or sold. Congress acted based on concern that petroleum companies had been paying too little U.S. tax on their foreign subsidiaries' operations relative to their high revenue. Specifically, Congress thought that U.S. tax could be avoided on the downstream activities of a foreign subsidiary because the income of the subsidiary was not subject to U.S. tax until that income was paid to its shareholders. Congress believed that the fungible nature of oil, and the complex structures involved, meant that oil income was particularly suited to tax haven type operations.

It is difficult to square the 1982 Act's inclusion of oil-related income with subpart F's primary rationales, which seek to accelerate U.S. taxation of passive and other easily movable income. Pipeline income, of course, is neither passive nor easily movable. Moreover, no other major industrial country has special rules that sweep pipeline income into its anti-deferral

regime. Consequently, U.S. companies find it difficult to compete with foreign-based multinationals for pipeline projects that would generate income subject to subpart F. Therefore, we recommend that subpart F be amended to exclude any income derived from the pipeline transportation of oil or gas within a foreign country.

3. Repeal of Special Provisions Relating to Foreign Base Company Shipping Income

Recognizing the highly competitive nature of the shipping industry and the national security interest in U.S. ownership of shipping capacity, the subpart F provisions, as originally enacted in 1962, exempted all shipping income in foreign commerce from treatment as subpart F income.⁵³ Thus, shipping income that otherwise might have been passive or base company income was not treated as subpart F income under the originally enacted provisions. In 1975, shipping income whether active, passive, or otherwise subject to foreign base company income treatment became a separate class of subpart F income. However, shipping income was not included in subpart F income to the extent the income (again without regard to whether the income was passive or active) was reinvested in shipping assets. Finally, in 1986, the reinvestment exception was eliminated, reversing completely the status of shipping income.

While the United States was subjecting shipping income of CFCs to taxation, the rest of the world refrained from doing so.⁵⁴ Rather than aggressively taxing shipping income, many OECD nations have done the opposite, and adjusted their tax systems to encourage the local shipping activities of resident (and nonresident) companies.⁵⁵ U.S.-controlled

⁵³ See S. REP. NO. 1881, 87th Cong., 2d Sess. 85 (1962). U.S. maritime military strategy has always relied most heavily on U.S.-flagged ships for emergency sealift capacity. However, the shortfall in the number of U.S.-flagged ships needed for a maritime emergency has historically been made up by U.S.-owned foreign-flagged ships. NATIONAL DEFENSE TRANSPORTATION ASSOCIATION, MARITIME POLICY INITIATIVES 2000, REPORT OF THE NDTA MILITARY SEALIFT COMMITTEE WORKING GROUP OF MARITIME POLICY (Washington, D.C. 2000) [hereinafter "Maritime Policy"]. The highly competitive nature of this industry was also acknowledged in the legislative history of the Tax Equity and Fiscal Responsibility Act of 1982. See S. REP. NO. 97-494, 97th Cong., 2d Sess., Vol. 1, 150 (1982); JT. COMM. ON TAX, GENERAL EXPLANATION OF THE TAX EQUITY AND FISCAL RESPONSIBILITY ACT OF 1982, JCS-38-82,72 (1982).

⁵⁴ We are aware of no other country that has singled out active foreign shipping income for current taxation under a subpart F-like regime. No such provision was identified in the OECD's report on CFC legislation. See OECD, CONTROLLED FOREIGN COMPANY LEGISLATION (1996).

⁵⁵ "A significant amount of ship-owning in traditional maritime countries has relocated, closed down or lost market shares in response to growth of the close-to-zero-tax norm [of low-tax, largely non-OECD countries]." ECON CENTRE FOR ECONOMIC ANALYSIS, ANALYSIS OF SELECTED MARITIME SUPPORT MEASURES 19 (December 2000) (an unpublished internal report commissioned by the OECD). OECD nations have responded to the challenge from non-OECD shipping by reducing corporate taxes (and reducing manning costs) for shipping companies. *Id.*

foreign-flagged ships have suffered greatly as a result, as described in the NFTC Subpart F Report.⁵⁶

The NFTC believes generally that income from U.S.-owned active businesses should not be subjected to inclusion in income under subpart F solely because the income may not otherwise be subject to current taxation in other jurisdictions. Moreover, in the case of active shipping, the failure of other jurisdictions to tax the income is not a consequence of their having an inadequate basis for taxing the income. An active shipping business must make calls at ports and thereby is subject to tax wherever it does business.⁵⁷ However, in the interest of promoting international commerce, most countries do not tax ships calling at their ports. Indeed, under section 883 of the Code, the United States does not tax shipping profits of a foreign company the ships of which call at U.S. ports if the foreign corporation is organized in, and owned by residents of, a foreign country that grants to U.S. corporations an equivalent exemption. Currently more than 85 foreign countries, including such prominent open-registry countries as the Bahamas, Liberia, Malta and Panama, have entered into qualifying reciprocal arrangements with the United States.⁵⁸ Thus, the United States itself engages in a practice that leaves shipping income untaxed at its source—not because the United States does not have adequate nexus to tax the income, but because the United States seeks to facilitate international commerce.⁵⁹ In this regard, the U.S. tax rules further tilt the playing field against U.S.-controlled shipping by ceding the United States' right to tax foreign company shipping income sourced to the United States while at the same time asserting residence-based taxation of U.S. residents.

Accordingly, the NFTC recommends that the provisions that treat active shipping income as base company income be repealed.

⁵⁶ See NFTC Subpart F Report, *supra* note 1, Chapter 6, Case Study 2. The Price Waterhouse analysis, described in Case Study 2, shows that the U.S.-controlled share of the active shipping business in open registry countries, which had been approximately 25.8 percent before shipping income was brought under subpart F in 1975, had been practically eliminated by 1996, having fallen to a 4.9 percent share of the open-registry fleet. Since 1996, three major shipping companies have been sold by U.S. owners to foreign purchasers whose countries do not impose subpart F treatment upon their shipping profits. Maritime Policy, *supra* note 53, 20.

⁵⁷ The United States, for example, imposes a 4 percent tax on the U.S.-source gross transportation income earned by foreign corporations for a taxable year. See I.R.C. § 887(a). As indicated in the text, this tax is not imposed where a qualified reciprocal exemption arrangement, as defined in I.R.C. § 883, exists.

⁵⁸ See Rev. Rul. 97-31, 1997-2 C.B. 77.

⁵⁹ S. REP. 99-313, 99th Cong. 2d Sess. Vol. 2, 340-341 (1986).

4. Additional Reforms

a. Use of Generally Accepted Accounting Principles for Earnings and Profits Calculations

The determination of earnings and profits is relevant to the measurement of a CFC's subpart F income as well as for certain other purposes (such as section 1248). Under current law, the earnings and profits of a CFC are computed under rules substantially similar to those applicable to domestic corporations. As a practical matter, however, a foreign corporation is frequently unable to compute earnings and profits in the same manner as a domestic corporation. Although a domestic corporation generally calculates earnings and profits by making adjustments to U.S. taxable income, a foreign corporation necessarily uses *foreign* book income as its starting point.

Although foreign corporations do not compute U.S. taxable income, they frequently do adjust foreign book income to conform with U.S. generally accepted accounting principles for financial reporting purposes. There are numerous differences between generally accepted accounting principles and earnings and profits, but most relate to timing differences and have at most a transitory and nominal effect on a company's U.S. tax liability, particularly in light of the post-1986 rules requiring the computation of deemed paid foreign tax credits on a "pooled" basis.

Permitting foreign corporations to use U.S. generally accepted accounting principles for purposes of computing earnings and profits would reduce a significant administrative burden without materially affecting U.S. tax liability. We understand that the IRS and Treasury have previously considered implementing such a rule, but have expressed doubts concerning their regulatory authority in this regard. Accordingly, we recommend enactment of a provision clarifying that such a rule may be implemented by administrative action.

b. Further Recommendations

The NFTC also recommends:

- Providing a section 956 exception when CFC stock is pledged to support a U.S. parent borrowing that is immediately invested abroad. (Lenders often prefer to lend to parents rather than directly to CFCs, even if the funds are borrowed for CFC use.)
- Extending the subpart F high tax kick-out to inclusions under section 956 of the Code.

IV. Foreign Tax Credit Legislative Recommendations

A. Elimination of Structural Flaws

The current U.S. foreign tax credit rules fail to achieve their stated objective of preventing the double taxation of international income. The NFTC's legislative recommendations would bring the rules closer to their goal by focusing on four major problems within the structure of the rules:

- *Per se* double taxation under the alternative minimum tax foreign tax credit limitation;
- The structural over-allocation of interest expense against foreign-source income;
- The asymmetrical treatment of foreign and domestic losses; and
- The unjustifiable complexity of the rules, which renders them virtually inadministrable.

1. *Repeal of Alternative Minimum Tax Foreign Tax Credit Limitation*

The 1986 Act provided a new regime for computing the alternative minimum tax. As part of this regime, the 1986 Act provided that the foreign tax credit cannot offset more than 90 percent of the pre-credit alternative minimum tax. Though not a foreign tax credit limitation *per se*, the 90-percent rule causes a U.S. corporation with mostly or only foreign-source income to pay alternative minimum tax even if the corporation is subject to an effective foreign tax rate in excess of the U.S. alternative minimum tax rate. In such situations, the 90-percent rule by definition produces double taxation of foreign-source income contrary to the foreign tax credit's purpose. Congress rationalized the 90-percent rule on the ground that it prevented taxpayers with substantial economic income from avoiding all U.S. tax by using credits and losses.⁶⁰

This rationale is, of course, entirely inconsistent with the fundamental policy decision to grant a foreign tax credit to prevent international double taxation. Moreover, this approach effectively lumps foreign tax credits in with other "preference" items that are viewed as justifying the imposition of an alternative minimum tax because they suggest that taxable income has been permitted to depart too substantially from economic income. The fact,

⁶⁰ 1986 Bluebook, *supra* note 43, 436.

of course, is that a foreign tax payment is a true economic cost, and not in any sense an artificial result of the tax system. We submit that the 90 percent alternative minimum tax foreign tax credit limitation is unjustified by any sound tax principle and accordingly recommend that it be repealed.⁶¹

2. Allocation of Interest Expense

To limit the credit for foreign income taxes to the applicable U.S. tax on *foreign* income, it is necessary to have rules that divide gross income and associated expenses between U.S. and foreign sources.⁶² The U.S. rules for allocating and apportioning income and expense between U.S. and foreign sources exacerbate the departure from capital export neutrality caused by the foreign tax credit limitation. The most important example of how the source rules increase the non-neutrality of the U.S. system for taxing multinational companies is the treatment of interest expense.

Under the Tax Reform Act of 1986, domestic interest expense generally is apportioned between domestic and foreign-source income based on gross assets. As foreign governments do not recognize any part of U.S. interest expense as a deductible expense against foreign income, the result of apportioning U.S. interest expense to foreign-source income is to reduce the U.S. foreign tax credit limitation with no corresponding reduction in foreign income tax liability. Thus, as a result of U.S. source rules, a U.S. company facing equal investment choices and tax rates at home and abroad will confront a tax disincentive to invest abroad or to borrow at home. By contrast, a foreign-headquartered multinational typically does not face these tax disincentives under U.S. rules. The interest allocation rules have the anomalous effect of allowing a U.S. subsidiary of a foreign multinational to borrow in the United States at a lower after-tax cost than a U.S. multinational.

Among other things, the interest allocation rule can result in a U.S. multinational reporting positive taxable income to foreign tax authorities at the same time that its foreign tax credit limitation is zero because, under U.S. rules, its foreign operations produce a loss after the allocation of interest expense. This situation is common for a number of capital-intensive U.S. industries that increasingly are investing abroad, such as the public utility industry. Not only do companies with overall foreign losses (OFLs) lose any ability to credit foreign income taxes, but even when these companies subsequently show a foreign profit (as measured under U.S. tax rules) they

⁶¹ The Taxpayer Refund and Relief Act of 1999 passed by Congress, but vetoed by President Clinton, would have repealed the 90-percent limitation. Conf. Rep. No. 289, 106th Cong., 1st Sess. 247 (1999).

⁶² Foreign tax credit limitation systems with multiple categories of income, such as the current one, also require foreign income to be divided among the various income categories.

frequently are unable to utilize “excess” foreign tax credits generated in prior years. Although unused foreign tax credits may be carried forward for up to five years, they can be difficult to use because companies are required to “recapture” OFIs by recharacterizing foreign income as U.S.-source income to the extent OFIs reduced U.S.-source income in prior years. Thus, the loss recapture rules can operate to exacerbate the distortions to investment and financing decisions caused by the interest allocation rules.

The NFTC, therefore, recommends mitigating the distortions created by the interest allocation rules through the adoption of a “worldwide fungibility” approach, such as that contained in the Senate-passed version of the Tax Reform Act of 1986 and the Taxpayer Refund and Relief Act of 1999 (H.R. 2448—the large tax cut bill vetoed by President Clinton). Under this approach, U.S. interest expense would be apportioned against foreign-source income only if the debt-to-asset ratio was higher for U.S. than foreign investments. The principal reason the worldwide fungibility approach was not included in the 1986 Act, as enacted, was its revenue cost.

3. Symmetrical Treatment of Foreign and Domestic Losses

U.S. multinationals with foreign-source income and domestic losses suffer a reduction of their foreign tax credit limitation. The foreign tax credit limitation for these companies generally is equal to their U.S. tax on worldwide income, and their worldwide income is less than their foreign income to the extent of their domestic losses. As a result, U.S. multinationals with domestic losses may be unable to credit foreign taxes paid with respect to foreign income, resulting in double taxation of foreign-source income. Because the reduction in foreign-source income attributable to domestic losses is not restored when the company subsequently generates domestic profits, the utilization of excess foreign tax credits arising from domestic losses is deferred (or lost if credits cannot be used within the carryover period). U.S. tax law is asymmetrical in this regard because foreign losses are recaptured (which reduces foreign-source income), but domestic losses are *not* recaptured (which would increase foreign-source income).

The NFTC, therefore, recommends addressing this asymmetry by allowing domestic losses to be recaptured, so that foreign-source income would be increased to the extent that domestic losses reduce foreign-source income in prior years. This approach to the treatment of domestic losses was contained in the vetoed Taxpayer Refund and Relief Act of 1999 (H.R. 2448) and in many previous bills dating back to the late 1970s. There is little disagreement that the symmetry obtained by providing domestic loss recapture is appropriate from a tax policy perspective. The 1987 American Law Institute

Study on international tax reform,⁶³ for instance, has endorsed domestic loss recapture. The primary obstacle to the enactment of domestic loss recapture rules has been the revenue cost.

B. Simplification

1. Background

The foreign tax credit rules have grown progressively more complex over time, and at an accelerating pace over the last 20 years. The foreign tax credit limitation rules, whether consciously or not, strike a balance between pursuit of various tax and non-tax policy goals, on the one hand, and administrability and certainty of result, on the other. We believe that recent modifications to the Code and regulations have generally tilted too far toward pursuit of tax and non-tax policy goals and have not adequately considered compliance, administrative and uncertainty costs.

In particular, the 1986 Act foreign tax credit amendments, along with the IRS guidance interpreting them, represented a quantum leap in terms of the foreign tax credit's complexity and uncertainty of application. The issue is not so much the number of different separate limitations introduced as the fact that each brings with it a detailed set of rules for determining whether income is subject or not subject to that particular limitation. Further, for the various separate limitations to work as intended, elaborate look-through and tax allocation rules are required that introduce their own complexities and uncertainties. However, the 1986 Committee Reports made scant mention of the compliance and administrative burdens the new limitations imposed. While Congress examined many theoretical and policy issues before enacting the 1986 changes, it apparently did not foresee the more prosaic administrative and compliance complexities involved in applying the new limitation rules.

The NFTC believes that a number of the complexities introduced by the 1986 Act and other recent legislation are not justified by a commensurate gain in the efficacy or fairness of the statute, and that a significant amount of simplification could thus be accomplished without impeding the proper operation of the foreign tax credit. While it is true that much of the complexity in the current rules arises from the level of detail in the statutory scheme and may thus be difficult to eliminate, it is also true that some of the complexity springs from other causes entirely. These include the simple historical accretion of overlapping rules and the enactment of some

⁶³ AMERICAN LAW INSTITUTE, FEDERAL INCOME TAX PROJECT, INTERNATIONAL ASPECTS OF UNITED STATES INCOME TAXATION (1987) [hereinafter "ALI Study"].

provisions based solely on revenue considerations rather than sound tax policy. Complexity arising from the latter causes can easily be remedied without doing any violence to the rules. Accordingly, we recommend the enactment of the simplification measures described in 2. to 6., below.⁶⁴ Each suggested simplification measure is individually justified, but in addition, taken in the aggregate they would support a more basic simplification of the basket system, as described in 7., below.

2. Repeal of High-Tax Kick-out from Separate Limitation for Passive Income

The 1986 Act provided a separate limitation for passive income that prevents taxpayers from using high foreign taxes paid on other income to reduce or eliminate the residual U.S. tax on foreign-source passive income. Passive income is defined for this purpose by cross-reference to subpart F and passive foreign investment company (PFIC) rules, so that applying the foreign tax provisions requires mastery of those rules as well. However, under the “high tax kick-out,” net foreign-source income that would otherwise qualify as passive income, with respect to which foreign income taxes were paid that exceed the U.S. tax on such income, is excluded from the passive income separate limitation and treated as overall limitation income.

The enactment of this provision appears to have been driven by theoretical concerns, rather than observed or even plausible taxpayer behavior. The 1986 Bluebook contains an example of a high-taxed foreign subsidiary engaging in a back-to-back loan transaction that has no local tax consequences, but that increases passive and reduces overall limitation income for U.S. tax purposes. The result in the example is that high foreign tax is shifted from the overall to the passive limitation where it shelters low-tax passive income from U.S. tax.⁶⁵ The example appears largely theoretical and, in any event, could have been addressed more simply with special expense allocation rules under Treasury’s specific authority to prescribe anti-abuse rules to prevent manipulation of the character of income the effect of which is to avoid the purposes of the separate limitations.⁶⁶ The regulations that implement the high tax kick-out group gross passive income into numerous “sublimitations” under a very difficult set of rules, allocate expenses

⁶⁴ The recommendations made here are to a significant extent based on the respected ALI study, as well as on other work by the reporter for that study, David Tillinghast. See ALI Study, *supra* note 63, 318; and D. Tillinghast, *International Tax Simplification*, 8 AMERICAN J. TAX POLICY 187 (1990).

⁶⁵ 1986 Bluebook, *supra* note 43, 879-880.

⁶⁶ See I.R.C. § 904(d)(5)(B); CONF. REP. NO. 841, 99th Cong., 2d Sess. Vol. II 567 (1986). This regulatory authority has never been exercised, presumably because extensive high-tax kick-out regulations have been issued. See Treas. Reg. §1.904-4(c).

among these groupings, assign taxes to the groupings and then apply the high-tax test to each grouping. Further, allocating taxes for these purposes presents a number of thorny issues.⁶⁷

Weighing the perceived problem the kick-out addresses and the possibility of less burdensome solutions to that problem against the compliance and administrative headaches the kick-out causes, the kick-out seems hard to justify; we therefore recommend its repeal.⁶⁸

3. Consolidation of Separate Limitations for Low-Taxed Income into Single Basket

Several of the existing separate limitations were enacted to serve the single purpose of segregating categories of low-taxed income so as to prevent cross-crediting with higher-taxed income amounts, thus ensuring the collection of residual U.S. tax. Setting to one side the issue of whether it is appropriate from a policy perspective to segregate income categories based solely on the rate of foreign tax they are expected to bear, we submit that the purpose of the various low-tax baskets would be equally served by combining them into a single low-tax limitation. This combined basket would include the current passive, domestic international sales company (DISC), foreign sales company (FSC) and shipping baskets.

4. Repeal of Separate Limitation for High Withholding Tax Interest

The separate basketing of interest that suffers a foreign withholding tax of 5 percent or more appears to have been based on the view that, in the case of a financial institution earning a small net spread between its borrowing and lending costs, the 5 percent foreign withholding tax may represent a very high effective rate of tax.⁶⁹ This rationale seems to break down on several grounds. First, for portfolio investors (as opposed to financial institutions) the 5 percent and higher withholding rates triggering the limitation's application do not appear to produce excess credits,

⁶⁷ See Treas. Reg. §§1.904-4(c)(6) and 6(a)(1)(iv) and preamble to final § 904 regulations published in December 2000 (discussing §1.904-6(a)(1)(iv)).

⁶⁸ In connection with reformation of the passive basket, we note that the subpart F revisions recommended in III. of this Part of the Foreign Income Project that would remove certain types of income from the category of foreign personal holding company income would also modify the classification of that income as passive for foreign tax credit purposes. Examples would include inter-affiliate payments and gains from dispositions of related entities.

⁶⁹ This was felt to be particularly abusive in certain sovereign debt transactions, in which the government borrower is indifferent to the rate of withholding tax (because the same government is also the recipient of the tax revenue). This particular concern could have been addressed through a much more narrowly crafted anti-abuse rule.

because portfolio investors do not typically invest borrowed funds. Second, it is not clear why the averaging of high and low tax rates by financial institutions is uniquely inappropriate since such averaging in other industries is permitted. Third, withholding taxes of 5 percent or higher are routinely imposed on other types of income that have not been singled out for a separate limitation. Accordingly, we recommend repeal of the separate limitation for high withholding tax interest.

5. Repeal of Section 907

Internal Revenue Code section 907 essentially was enacted to distinguish royalty payments from income taxes so that a foreign tax credit would be allowed only for the latter. However, as the culmination of an administrative guidance process the origins of which antedated the enactment of section 907, the “dual capacity taxpayer” regulations under section 901 now independently distinguish royalty payments from income taxes, making the less-refined provisions of the statute redundant.

One significant difference between the two provisions is that, if the general income tax rate in a foreign country on all activities, oil and gas activities included, is high, and all other requirements are met, the section 901 regulations treat the full amount of the levy as a tax rather than a royalty, though the foreign tax rate exceeds the highest U.S. tax rate.⁷⁰ Section 907(a), by contrast, disallows as credits any foreign taxes paid by an extraction company that are in excess of the highest U.S. rate. It seems inappropriate to disallow credits claimed by extraction companies in excess of the U.S. rate in such situations, given that companies in other industries paying the same high foreign tax rate face no such disallowance.

Because the concerns initially addressed by section 907 are now covered in more targeted fashion by the regulations under section 901, the redundant statutory provisions add needless complexity to the taxation of international oil companies and should, therefore, be repealed.⁷¹

⁷⁰ This reflects the sound judgment that, to the extent that all taxpayers, including those in industries not receiving a specific economic benefit from the levying country, pay a high tax, no portion of that tax is a royalty.

⁷¹ The Taxpayers Refund and Relief Act of 1999 passed by Congress, but vetoed by President Clinton, would have repealed I.R.C. § 907.

6. Acceleration and Extension of Look-Through Treatment for 10/50 Companies

Dividends from each noncontrolled section 902 corporation are subject to their own separate limitation. Generally, a noncontrolled section 902 corporation is any foreign corporation that is not controlled by U.S. persons and that has at least one 10-percent U.S. corporate shareholder. Thus, the “10/50” basket may actually consist of an unlimited number of separate limitations.

The 10/50 basket was heavily criticized following its adoption, in part because it was widely believed to have been devised primarily to meet revenue needs in connection with final passage of the 1986 Act. Criticism focused on the multiple limitations involved and the complexities when noncontrolled section 902 corporations convert to CFC status or change their U.S. shareholders.

The Taxpayer Relief Act of 1997 attempted to reduce some of these complexities and, in addition, after 2002, generally repeals this separate foreign tax credit limitation. The 1997 Act substitutes the look-through rules of section 904(d)(3) to characterize dividends from noncontrolled section 902 corporations paid out of post-2002 earnings.⁷² Dividends received from noncontrolled section 902 companies in taxable years beginning after 2002, but derived out of earnings accumulated before such years, by contrast, will generally be combined into a single separate limitation for all dividends from noncontrolled section 902 companies. Dividends received from noncontrolled section 902 companies in taxable years beginning before 2003 remain subject to the 1986 Act rules.

The repeal rules for the 10/50 basket, it will be noted, are themselves quite complex. We therefore recommend that the effective date of the repeal be accelerated to the 2001 year and that the transition be simplified by applying look-through to all distributions beginning with that same year, regardless of the year in which earnings were accumulated.⁷³

Once it is accepted that a 10/50 company can provide sufficient information to enable its minority U.S. stockholders to apply the look-through rules to dividends from the company, there would appear to be no logical basis for applying a different rule to interest, rents and royalties, which under current law receive look-through treatment only in the case of a CFC. Thus, we recommend that look-through treatment be extended to interest,

⁷² PL. 105-34, § 1105(a)(1).

⁷³ The Taxpayer Refund and Relief Act of 1999 passed by Congress, but vetoed by President Clinton, would have accelerated the effective date of the repeal and simplified the repeal rules in some respects. H.R. REP. No. 289, 106th Cong., 1st Sess. 163 (1999).

rents and royalties received from 10/50 companies, subject to the shareholder being provided with adequate information concerning the underlying income of the company.

7. Summary: A Three-Basket System

The various individual reforms to the basket system described in 2. to 6., above are each justified for the reasons explained. It is also worth noting, however, that, taken in the aggregate, they would produce a three-basket system: for active income, for financial services income and for “passive plus” income (which would also include DISC, FSC and shipping income, as indicated in 3., above).⁷⁴

8. Avoiding Creation of New Uncertainties by Confirming Technical Taxpayer Rule

Under the technical taxpayer rule set forth in the regulations under section 901, the party entitled to claim a foreign tax credit generally is the party legally liable under foreign law for the foreign tax at issue. This rule provides an objective and easily-administered standard for determining whether a U.S. taxpayer is entitled to claim a foreign tax credit, avoiding potentially endless inquiry into the economic incidence of foreign taxes. Notice 98-5 creates a major exception to the technical taxpayer rule that increases uncertainty regarding the availability of foreign tax credits in many ordinary course of business transactions.

Notice 98-5 announces the IRS's intention to issue regulations that will deny foreign tax credits in abusive arrangements in which the expected economic profit is “insubstantial” compared to the foreign tax credits generated. Notice 98-5 was prompted by foreign tax credit-generating ploys of dubious merit, and the IRS's attack on these abuses was understandable, but the methodology employed by the IRS in the Notice causes problems for taxpayers not engaged in abusive transactions. Significant areas of uncertainty will include acceptable ratios of expected economic profit to foreign tax credits and the scope of the “arrangement” to which this test will be applied. Further, the Notice's lack of a routine business transaction exception means that many taxpayers will have to test common transactions under the Notice's economic profit test.

The Notice also noted that the IRS would consider issuing guidance to attack other abuses in the foreign tax credit area, including new guidance on

⁷⁴ This does not take into account limited-purpose baskets such as those that apply on a per-country basis under I.R.C. § 904(g) and various U.S. tax treaties.

hybrid entity and other structures that create a significant mismatch between the timing of income inclusions and credits. The IRS thus appears to be considering the reinstatement of its litigating position in *Abbot Laboratories Int'l Co. v. United States*,⁷⁵ which was essentially abandoned in the final section 901 regulations, with their strict formulation of the technical taxpayer rule.

Thus, while issued in response to real abuses, Notice 98-5 unfortunately undermines the benefits of the technical taxpayer rule. The addition of an “economic substance” test for determining the creditability of foreign taxes will add additional layers of complexity and potential controversy to foreign tax credit rules that are already the most highly articulated in the world. Instead of adding a new layer of complexity to the foreign tax credit system, the IRS and Treasury should consider using established foreign tax credit tools to address the problems discussed in Notice 98-5. Short-term holdings of foreign income producing assets could be addressed, for example, by broadening the mechanical, minimum holding period requirements for credits now found in section 901(k) of the Code. For taxpayers outside the financial services industry, allocation of any “purchased” foreign tax credits to the passive (rather than overall) limitation would render these credits far less valuable. An allocation to the passive limitation could be accomplished in many cases simply by repealing the passive limitation high-tax kick-out, as recommended in 2., above. Finally, the perceived abuses in the Notice involving hybrid instruments and hybrid entities (Examples 4 and 5) might alternatively be addressed using targeted fixes, as have been used in the past with hybrid instruments and entities.⁷⁶

C. Additional Reforms

1. Reordering and Extension of Foreign Tax Credit Carryovers

Congress enacted the current carryover rule in 1958, when the foreign tax credit limitation was computed on a per-country basis. Under that regime, the limited carryover of the 1958 rules was relatively unlikely to result in permanent disallowance of credits. Congress has since replaced the per-country regime with an overall limitation, substantially increasing the possibility that credits will expire unused (because losses in one country will offset tax-bearing income in another country). Moreover, the proliferation of separate limitations, and the acknowledged structural flaws of the rules discussed above (interest allocation, loss recapture) have also substantially

⁷⁵ 160 F. Supp. 321 (N.D. Ill. 1958).

⁷⁶ See, e.g., I.R.C. §§ 385(c), 1504(a)(4), and 894(c); Prop. 301.7701-3(h).

increased the possibility that credits will expire unused. Finally, the volume of international business has grown dramatically, which also contributes to the problem because growing foreign tax payments by a growing foreign business will crowd out a taxpayer's ability to utilize a foreign tax credit carryforward.

Accordingly, because expiring foreign tax credits may increasingly subject U.S. companies to significant double taxation, it is time to modernize the carryover rules better to serve the purposes of the foreign tax credit. We therefore recommend that the utilization of foreign tax credit carryovers be reordered, so that the oldest credit carryovers are used first (*i.e.*, credits would be utilized on a first-in-first-out basis). This will decrease the likelihood that later tax payments will cause credit carryforwards to expire unused. We also recommend that the carryforward period be extended from five years to ten.

2. Reassessment of Eligibility for Indirect Credits under Section 902

A taxpayer's qualification for the deemed paid or indirect credit under section 902 is governed by highly mechanical ownership rules generally requiring the ownership of at least 10 percent of the voting stock of the foreign corporation. When a taxpayer in substance owns the requisite amount of a foreign corporation's stock, we do not believe that credits should be denied on the basis of mechanical foot-faults. Accordingly, we recommend that the operation of section 902 be improved in two respects:

- Make it clear that eligibility for indirect credits with respect to a foreign corporation owned through a partnership does not depend on the foreign versus domestic status of the partnership;⁷⁷ and
- Allow for qualification on a consolidated basis, reversing the result of the *First Chicago* case.⁷⁸

3. Simplify Calculation of Alternative Minimum Tax Foreign Tax Credit

The 1997 Act permitted a taxpayer to calculate the alternative minimum tax foreign tax credit limitation by using regular taxable income in the numerator of the limitation fraction. This election was intended to enable taxpayers to avoid having to carry out a second calculation of foreign-source income

⁷⁷ Cf. Rev. Rul. 71-141.

⁷⁸ *First Chicago NBD Corp. v. Commissioner*, 96 T.C. 421, aff'd 135 F3d 457 (7th Cir. 1998).

based on alternative minimum tax taxable income, with the attendant need to go through a full round of expense and loss allocations to all of the various credit baskets. However, the rule enacted in 1997 results in a distorted calculation, since it creates a fraction that mixes regular foreign-source taxable income with alternative minimum tax taxable income. Because alternative minimum tax taxable income in the denominator will generally be greater than regular taxable income, the calculation will tend to understate the foreign tax credit limitation. It would be more appropriate to preserve the proper relationship between foreign-source and worldwide income by using regular income in both the numerator and denominator of the foreign tax credit calculation, as applied for alternative minimum tax purposes.

