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# The Deferral of Income Earned Through U.S. Controlled Foreign Corporations

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A Policy Study



Office of Tax Policy  
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## INTRODUCTION:

### PURPOSE, STRUCTURE, BASIC CONCEPTS, AND DESCRIPTION OF SUBPART F

#### I. Statement of Purpose

On December 11, 1998, Assistant Secretary of the Treasury for Tax Policy, Donald C. Lubick, announced that the Treasury Department would study the U.S. anti-deferral rules contained in subpart F of the Internal Revenue Code. These rules restrict the deferral of tax on foreign income for certain U.S. owners of “controlled foreign corporations” (“CFCs”).

Subpart F was enacted in 1962 and, while amended often since then, has retained its basic structure. After nearly four decades, however, Treasury, practitioners, and the business community<sup>1</sup> believe it is time to reexamine whether subpart F is the most appropriate – or effective – way to tax foreign income. As Assistant Secretary Lubick noted, “It has been suggested that, at least in some respects, the current deferral rules have failed to adequately take into account significant developments since their enactment. . . . [W]e plan to study the extent to which changes in our anti-deferral rules are warranted.”<sup>2</sup>

Assistant Secretary Lubick outlined the fundamental international tax policy principles that would guide the Treasury in its evaluation of the options for reforming or replacing the current subpart F regime:

In preparation for this study, we have identified some of the principles that have long guided policymakers in determining the appropriate taxation of international income. We doubt that there is significant controversy over what policy principles are appropriate. Although there are differences over the

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<sup>1</sup> See, e.g., Robert J. Peroni, J. Clifton Fleming, Jr., Stephen E. Shay, Getting Serious about Curtailing Deferral of U.S. Tax on Foreign Source Income, 52 SMU L. Rev. 455, 458 (1999) (“The complex, incomplete, and anachronistic nature of . . . [the anti-deferral] rules has prompted us to reconsider the appropriate scope of the U.S. anti-deferral regimes.”); National Foreign Trade Council, The NFTC Foreign Income Project: International Tax Policy for the 21<sup>st</sup> Century, Part One: A Reconsideration of Subpart F, at viii (Washington, 1999) (“[R]e-evaluation of the balance of policies that underlie subpart F is long overdue.”); David R. Tillinghast, An Old-Timer’s Comment on Subpart F, 98 TNI 61-24 (Mar. 31, 1998) (“Subpart F is now over 35 years old and it may be time to reexamine its policy premises . . .”).

<sup>2</sup> Hon. Donald C. Lubick, Assistant Secretary (Tax Policy), U.S. Department of the Treasury, Address at the GWU/IRS Annual Institute on Current Issues in International Taxation (Dec. 11, 1998). Assistant Secretary Lubick also described Treasury’s goals in undertaking the study, noting, “We intend to conduct this study in a comprehensive manner, relying on evidence over anecdotes, analysis over agenda. We intend that we shall neither be bound to nor ignore the policies which have guided us for the past three decades. We expect to set forth whatever conclusions a fresh slate review of the evidence leads us to.”

application and relative weight to be given to some of these principles, five policy goals in the international tax area are generally recognized:

- Meet the revenue needs determined by Congress in an adequate and fair manner;
- Minimize compliance and administrative burdens;
- Minimize distortion of investment decisions through tax considerations;
- Conform with international norms, to the extent possible; and
- Avoid placing an undue burden on the competitive position of our nationals.<sup>3</sup>

This study is intended to reexamine the system for taxing U.S. controlled foreign corporations and to consider some of the options for reform. The Treasury intends for the study to contribute to a public debate on these issues and invites comments on the study.

## **II. Structure of the Study**

The study examines three basic questions. First, in designing a system pursuant to sound tax policy, to what extent should foreign income of U.S. taxpayers bear a tax burden similar to domestic income? Second, how effective is the subpart F anti-deferral regime in achieving sound tax policy goals? Third, what alternatives are there to subpart F?

To answer these questions, the study first places subpart F in its historical context and seeks to determine its legislative aims. The study then examines, from an economic perspective, various policies for taxing foreign income and considers the extent to which these policies promote economic welfare. The study then considers whether subpart F has significantly affected multinational competitiveness. Next, the study examines whether subpart F currently is achieving its policy goals. The study also examines certain developments that may challenge subpart F in the future. Finally, the study considers options for change.

## **III. Basic Concepts**

A number of basic terms such as “deferral” and “worldwide” taxation are used throughout this study and its appendices. However, people may have different understandings of the meanings of these terms. For purposes of this study, the following section clarifies the meaning of the term “deferral” and the distinction between what are often called “worldwide” and “territorial” tax regimes.

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<sup>3</sup> Id.

## A. What is Deferral?

In simple terms, “deferral” is the postponement of current taxation on the net income or gain economically accrued by a taxpayer. Under U.S. tax law, in some cases deferral is specifically legislated into existence (e.g., nonrecognition of income contributed to and earned in retirement plans such as 401(k) plans and IRAs,<sup>4</sup> and nonrecognition of gain in corporate reorganizations under subchapter C of the Internal Revenue Code), while in other cases it is specifically legislated out of existence (e.g., economic accrual of original issue discount<sup>5</sup> and realization of gain on “short-against-the-box” and similar transactions<sup>6</sup>). Deferral, however, also is a result of more basic structural features of the U.S. tax system (e.g., the general principle under section 1001 that the economic gain in property is only taxable when a realization event occurs).

This study focuses on one type of deferral that results from a basic structural feature of the U.S. tax system. The foreign income of a foreign corporation generally is not subject to U.S. tax, even if the foreign corporation is organized by a U.S. taxpayer who would be subject to full U.S. taxation on foreign income earned by it directly. Thus, by organizing a foreign corporation, a taxpayer can, absent special rules, defer U.S. taxation on foreign income until it is repatriated, for example, as a dividend. In this context, because of the “time value of money” advantage of postponing payments of tax that otherwise would be due currently, deferral allows the foreign income to be taxed at a lower effective rate<sup>7</sup> than domestic income.<sup>8</sup>

## B. What are Worldwide and Territorial Systems of Taxation?

Countries around the world generally use one of three systems for taxing – or not taxing – the foreign income of their residents and/or citizens. Under one model, a jurisdiction does not tax the foreign income of its residents (“pure territorial taxation”) or exempts from tax some, but not all, of the foreign income of its residents (“partial territorial taxation”).<sup>9</sup> Under a second model, a

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<sup>4</sup> See Internal Revenue Code (I.R.C.) § 408.

<sup>5</sup> See I.R.C. §§ 1271-1275.

<sup>6</sup> See I.R.C. § 1259.

<sup>7</sup> Deferral could potentially allow the foreign income to be taxed at a zero effective rate. However, U.S. taxpayers are able to benefit from deferral only to the extent the income is not taxed in a foreign country at a higher rate than the U.S. rate.

<sup>8</sup> The Kennedy Administration likened deferral to an interest-free loan from the U.S. Treasury. See *infra* Chapter 2, text accompanying note 19. For an alternative view that deferral is better analyzed as a “forced equity investment” by the U.S. Treasury, see Peroni, Fleming and Shay, *supra* note 1, at 464-68 (1999).

<sup>9</sup> Partial territorial taxation is commonly and somewhat misleadingly referred to simply as “territorial taxation.” Although pure territorial systems are uncommon among developed

jurisdiction imposes tax on its residents' foreign income when that income is later repatriated ("remittance taxation"). Under a third model, a jurisdiction imposes tax on its residents' foreign income when earned ("current taxation of worldwide income").

Current taxation of worldwide income that is earned directly by domestic persons is the international norm. It is used by the United States, virtually all of the United States' major trading partners, and the overwhelming majority of countries around the world.<sup>10</sup> The deferral achieved by operating abroad through a foreign subsidiary, however, can neutralize the effect of worldwide taxation. It does so by allowing taxpayers that choose to operate abroad through a certain type of entity to postpone home country taxation of their foreign income. In such cases, deferral makes worldwide taxation effectively the same as remittance taxation.<sup>11</sup> Moreover, in certain circumstances, deferral can effectively make what is nominally a worldwide system into a territorial system. If the tax on income is delayed for a long enough time, the taxpayer's investment return on the amount of the deferred taxes will be greater than the amount of the taxes themselves.<sup>12</sup> Accounting standards reflect this result by not requiring accounting for deferred U.S. tax on multinationals' foreign income that is expected to be permanently reinvested abroad.<sup>13</sup>

Further blurring the distinctions between worldwide and territorial systems, most jurisdictions with worldwide systems, including the United States, allow a credit against domestic tax for foreign taxes imposed on the income subject to domestic tax. Under a worldwide system with a foreign tax credit, an item of foreign income generally is not taxed domestically to the

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countries, several countries in Central America use a pure territorial system of taxation, as do a number of countries in South America, Africa and the Middle and Far East.

<sup>10</sup> South Africa, whose tax system is currently based on territorial principles, has recently proposed moving to a residence based (worldwide) system of taxation to "bring the tax system in line with generally accepted norms for taxing international transactions." Department of Finance, Republic of South Africa, Budget Review 2000 84 (Feb. 23, 2000), available at <<http://www.finance.gov.za>>. Israel, too, is currently proposing to move from a system based on territorial principles to a worldwide system of taxation. See Joel Lubell, Israeli Finance Minister Presents Second Revised Tax Reform Proposal, 2000 Tax Analysts Worldwide Tax Daily, Oct. 17, 2000, available in 2000 WTD 201-4 (noting that although Israel had dropped other measures from its proposed tax reform, it was continuing to proceed with its proposal to adopt worldwide taxation).

<sup>11</sup> In both cases, foreign income is not taxed until repatriated. However, under a worldwide system, foreign income must be earned in a controlled foreign entity to obtain the deferral benefit.

<sup>12</sup> The period over which the income (after tax) earned on the deferred taxes exceeds that deferred tax amount varies depending upon foreign tax rates, fluctuations in interest rates, etc. In certain cases, however, it may be as little as ten years.

<sup>13</sup> Statement of Financial Accounting Standards No. 109 ("Accounting for Income Taxes"); Accounting Principles Board Opinion No. 23 ("Accounting for Income Taxes--Special Areas").

extent it is taxed abroad.<sup>14</sup> To the extent that a tax system is territorial, an item of foreign income is not taxed domestically regardless of whether it is taxed abroad. Thus, the foreign tax credit system minimizes the differences between a worldwide system and a territorial system to the extent the foreign tax equals or exceeds the domestic tax (so that no further domestic tax is owed). In fact, the foreign tax credit system can make worldwide taxation preferable for some taxpayers.<sup>15</sup>

Because the deferral that may be achieved by operating through a foreign subsidiary often neutralizes the effect of worldwide taxation, a substantial and increasing number of our major trading partners have adopted anti-deferral rules similar to those of the United States.<sup>16</sup> In fact, because of the importance of the anti-deferral concept, even countries such as France, commonly thought of as having largely territorial systems, have adopted anti-deferral rules.<sup>17</sup>

Finally, it should be noted that very few countries employ pure versions of either worldwide or territorial taxation. Most have elements of both.<sup>18</sup>

#### **IV. Brief Description of the Subpart F Regime**

To understand the discussion of subpart F in this study, it is important to understand its basic framework as set forth in sections 951-964 of the Internal Revenue Code. This section briefly describes the major provisions of subpart F. A more detailed description of these provisions (together with legislative history) is contained in Appendix A.

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<sup>14</sup> The foreign tax credit reflects the fundamental tax policy decision made by most countries, in order to prevent double taxation, to give up the right to tax their residents to the extent that the country where the income is sourced imposes tax and to reserve the right to tax their residents to the extent that the source country does not impose tax.

<sup>15</sup> See *infra* Chapter 3, note 59 and accompanying text (residual U.S. tax on repatriated income is often less than if the United States had a territorial system of taxation because, under a territorial system, dividends would not bring with them foreign tax credits that can be used to offset the income on royalties and other payments received from foreign parties).

<sup>16</sup> See *infra* discussion in Chapter 4, section III.C (foreign CFC regimes).

<sup>17</sup> In a country that uses a territorial system, anti-deferral rules are more accurately referred to as “anti-exemption” rules, since the country does not defer foreign income from inclusion in the domestic tax base, but rather exempts foreign income from inclusion in the domestic tax base.

<sup>18</sup> For example, the United Kingdom adopts worldwide taxation for corporations and applies a remittance system for taxing investment income and capital gains of individuals that are resident but not domiciled in the United Kingdom. The United States also has elements of a territorial regime. For example, section 911 modifies U.S. worldwide taxation by allowing U.S. individuals working overseas to exclude from their U.S. income certain amounts of foreign earned income and housing costs. Similarly, section 114 excludes from gross income extraterritorial income of a taxpayer.

Subpart F applies to certain income of “controlled foreign corporations” (“CFCs”). A CFC is a foreign corporation more than 50% of which, by vote or value, is owned by U.S. persons owning a 10% or greater interest in the corporation by vote (“U.S. shareholders”).<sup>19</sup> “U.S. persons” includes U.S. citizens, residents, corporations, partnerships, trusts and estates.<sup>20</sup> If a CFC has subpart F income, each U.S. shareholder must currently include its pro rata share of that income in its gross income as a deemed dividend.<sup>21</sup>

The subpart F rules attempt to prevent (or negate the tax advantage from) deflection of income, either from the United States or from the foreign country in which earned, into another jurisdiction which is a tax haven or which has a preferential tax regime for certain types of income. Thus, subpart F generally targets passive income and income that is split off from the activities that produced the value in the goods or services generating the income. Conversely, subpart F generally does not require current taxation of active business income except when the income is of a type that is easily deflected to a tax haven, such as shipping income, or income earned in certain transactions between related parties. In related party transactions, deflection of income is much easier because a unified group of corporations can direct the flow of income between entities in different jurisdictions.

A major category of subpart F income is foreign personal holding company income (“FPHCI”).<sup>22</sup> This category includes interest, dividends and rents and royalties.<sup>23</sup> It also includes gains from the sale of property that produces passive income or that is held for investment, gains from commodities transactions, and gains from foreign currency transactions, as well as certain other income that is, in effect, the equivalent of interest or dividends. Because of its passive nature, such income often is highly mobile and can be easily deflected.

The FPHCI provisions contain special rules that apply to certain types of income received by a CFC from a related person.<sup>24</sup> One set of rules treats certain active income as FPHCI if

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<sup>19</sup> I.R.C. §§ 957, 951(b). Note that under these definitions it is possible for a foreign corporation to have majority U.S. ownership but not be a CFC if there are not the requisite number of 10% shareholders.

<sup>20</sup> I.R.C. §§ 957(c), 7701(a)(30).

<sup>21</sup> I.R.C. § 951(a).

<sup>22</sup> I.R.C. § 954(c).

<sup>23</sup> Certain types of passive income such as interest and other investment income received by a financial services company or an insurance company are currently subject to a temporary exception from subpart F. See I.R.C. § 954(h) and (i). This financial services exception is described in more detail in Chapter 6, section III, infra. Certain types of insurance income continue to be subject to subpart F, most particularly income that is deflected from the United States in respect of insurance of U.S. risks by U.S.-owned foreign insurers. See I.R.C. § 953.

<sup>24</sup> Section 954(d)(3) provides that a person is a related person with respect to a CFC if (a) such person is an individual, corporation, partnership, trust or estate which controls, or is controlled

earned in transactions with related persons. Generally, rents and royalties earned by a CFC in an active business are excluded from FPHCI.<sup>25</sup> This exception does not apply, however, if the CFC's rents or royalties are received from a related person. Accordingly, rents and royalties received from a related person are generally treated as FPHCI, without regard to the nature of the business activities of the CFC that give rise to the rents and royalties.

Yet another set of rules excludes certain passive income from FPHCI if earned in transactions with related persons. Under these rules (commonly referred to as the "same country exception"), if a CFC receives dividends or interest from a related corporation incorporated in the same country as the CFC and the related corporation has a substantial part of its assets used in a trade or business in that country, then the dividends or interest will not be classified as FPHCI.<sup>26</sup> Further, passive rents and royalties earned by a CFC are excluded from FPHCI if they are received from a related corporation and the leased or licensed property is used within the CFC's country of incorporation.<sup>27</sup>

Other provisions of subpart F deal with the potential for deflection of income that would otherwise be considered active. For instance, sales income is active income and subpart F generally does not apply to active income. However, certain sales income, referred to as foreign base company sales income ("FBCSI"), is subject to current inclusion under subpart F because, when the manufacturing function is separated from its sales function, the sales income can easily be deflected from the jurisdiction in which the major economic activity that produced the value in the goods occurred, often a high-tax jurisdiction, to a low-tax jurisdiction where the "sales" activities occur.<sup>28</sup> This is particularly true in the case of related party transactions. Thus, the FBCSI rules<sup>29</sup> require current inclusion of income of a CFC from the sale of property (a) that is purchased from, or on behalf of, or sold to, or on behalf of, a related person, and (b) that is manufactured and sold for use, consumption or disposition outside the jurisdiction where the CFC is incorporated.<sup>30</sup>

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by, the CFC or (b) such person is a corporation, partnership, trust or estate which is controlled by the same person or persons which control the CFC. For this purpose, control is generally defined as ownership, directly or indirectly, of more than 50 percent of the relevant entity (by vote or value).

<sup>25</sup> I.R.C. § 954(c)(2)(A).

<sup>26</sup> I.R.C. § 954(c)(3)(A)(i).

<sup>27</sup> I.R.C. § 954(c)(3)(A)(ii).

<sup>28</sup> See H.R. Rep. No. 1447, 87<sup>th</sup> Cong., 2d Sess. 62 (1962) (1962 House Report); S. Rep. No. 1881, 87<sup>th</sup> Cong., 2d Sess. 84 (1962) (1962 Senate Report).

<sup>29</sup> The foreign base company sales income rules prevent deflection of income both from the United States to a foreign country and from one foreign country to another. Thus, while these rules act as a back-up to the transfer pricing rules of section 482, they are also concerned with foreign-to-foreign deflection.

<sup>30</sup> I.R.C. § 954(d).

Income from the sale of goods manufactured by the selling CFC is excluded from the FBCSI rules.<sup>31</sup> This exception is provided because, when the CFC performs the manufacturing, generally, the sales function has not been separated from the manufacturing function. However, because branches established in a separate jurisdiction can facilitate the deflection of income, the FBCSI provisions contain a branch rule.<sup>32</sup> The branch rule treats income from the sale of goods manufactured by the CFC as FBCSI in certain cases when the selling and manufacturing operations have been separated into different tax jurisdictions to obtain a lower rate of tax for the sales income.

Foreign base company services income is another category of subpart F income that applies to active income that can be deflected to a low-tax jurisdiction through related party transactions, in this case, through the performance of services.<sup>33</sup> Foreign base company services income includes income from services performed outside the CFC's country of incorporation for, or on behalf of, a related person.<sup>34</sup> These rules generally were intended to address circumstances in which service activities are separated from the other business activities of a corporation into a separate subsidiary located in another jurisdiction to obtain a lower rate of tax for the services income.<sup>35</sup> This result can occur not only when the CFC performs the services for a related person but also when a related person assists the CFC to perform the services for an unrelated person.<sup>36</sup> Thus, the regulations contain a "substantial assistance" rule under which, if a related person provides the CFC with substantial assistance contributing to the performance of the services, the services will be treated as performed for or on behalf of a related person.<sup>37</sup>

The foreign base company shipping income rules<sup>38</sup> treat shipping income as subpart F income even if earned in an active business and from a transaction with an unrelated person. Congress enacted this provision because of its concern that shipping income is so mobile that it is likely to escape all tax worldwide. Congress therefore determined that this income should be

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<sup>31</sup> Treas. Reg. § 1.954-3(a)(4).

<sup>32</sup> See I.R.C. § 954(d)(2).

<sup>33</sup> As noted in Chapter 6, section III, *infra*, the recently-enacted financial services exception exempts financial services businesses (but no other businesses) from the application of these foreign base company services rules. See I.R.C. § 954(e)(2).

<sup>34</sup> I.R.C. § 954(e).

<sup>35</sup> 1962 Senate Report, *supra* note 28, at 84.

<sup>36</sup> In that case, while the entity performing the services will be compensated, for example, at cost plus, the entity that has nominally contracted to perform the services will receive the bulk of the profit. This latter entity would generally be formed in a low-tax jurisdiction.

<sup>37</sup> Treas. Reg. § 1.954-4(b)(1)(iv).

<sup>38</sup> I.R.C. § 954(f). The shipping income rules cover not only income derived from or in connection with the use (or hiring or leasing for use) of aircrafts and vessels in foreign commerce but also income from space and ocean activities (as defined in I.R.C. § 863(d)(2)).

subject to current taxation. The same concern underlies the foreign base company oil related income rules,<sup>39</sup> which treat most “downstream” oil-related income (e.g., refining income) as subpart F income despite the fact that such income may be earned in an active business and entirely from unrelated persons.<sup>40</sup>

Another provision of subpart F prevents the tax-free repatriation of foreign income through investments in U.S. property.<sup>41</sup> As noted above, income earned by a CFC (other than subpart F income) generally is subject to U.S. tax when the income is repatriated, for example as a dividend or a royalty. If the CFC invested the income in the United States, for example, by the purchase of property or a loan to the parent corporation, the income would be effectively repatriated in a manner that would escape current tax. Thus, generally, in the case of certain investments in U.S. property by a CFC, the U.S. shareholder must include in income an amount calculated by reference to the amount invested in the U.S. property.<sup>42</sup>

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<sup>39</sup> I.R.C. § 954(g).

<sup>40</sup> See S. Rep. No. 494, 97<sup>th</sup> Cong., 2d Sess. 149-50 (1982) (because of the fungible nature of oil and the complex structure of oil operations, such downstream activities easily could be shifted to a foreign subsidiary in a tax haven).

<sup>41</sup> See I.R.C. § 956.

<sup>42</sup> There are several other categories of subpart F income (such as income attributable to participation in an international boycott). However, these provisions were enacted to address wider foreign policy, rather than tax, concerns and accordingly are not further discussed in this study.

## CHAPTER 1

### WHY SUBPART F WAS ENACTED: DEVELOPMENTS IN THE LAW BEFORE 1962

#### I. General

The purpose of this chapter is to place subpart F, the anti-deferral regime for U.S. controlled foreign corporations,<sup>1</sup> in historical context by examining the events leading up to its introduction in 1962. The chapter notes that subpart F is only one of a number of regimes enacted to respond to the tax avoidance opportunities provided by a tension between the U.S. tax rules of worldwide taxation and the separate tax status of corporations. Since the enactment of the first income tax laws, taxpayers have used corporations to avoid the general U.S. tax rule that subjects the worldwide income of U.S. persons to current taxation. This chapter describes how Congress has repeatedly acted to restrict deferral when this tax avoidance has occurred. Finally, the chapter describes how certain tax avoidance techniques that developed in the late 1950s and early 1960s (together with the economic considerations discussed in the next chapter) provided the impetus for the enactment of subpart F.

#### II. The Underlying Need for Anti-Deferral Rules: Structural Tensions in the U.S. Tax System

Two fundamental but inconsistent features of the U.S. tax system operate to create tax avoidance potential and, thus, the potential need for anti-deferral rules. The first feature is the tax treatment of corporations as separate persons and the second is worldwide taxation. In addition, a third feature, the treatment of a corporation as domestic or foreign under U.S. tax law, operates together with these two fundamental features to create the tax benefit potential of the rules treating corporations as separate taxpayers.<sup>2</sup>

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<sup>1</sup> See supra Introduction, note 19 and accompanying text for the definition of “controlled foreign corporation” (or “CFC”).

<sup>2</sup> By making U.S. or foreign status of a corporation dependent upon the place of organization, this third feature allows a U.S. taxpayer to choose foreign status for a corporation that it controls simply by organizing the corporation outside the United States. In this way, the taxpayer can obtain deferral because only the U.S. source income or income effectively connected with the conduct of a U.S. trade or business of a foreign corporation is subject to U.S. tax. However, treatment of a corporation as domestic or foreign based on place of organization is not fundamental. Rather, it is a rule of operation to make the basic rules work. Changing this rule to a different test for determining whether a corporation is foreign or domestic, such as “management or control,” would not eliminate the tension between worldwide taxation and separate corporate status. Taxpayers would simply adapt their deferral techniques to the new definition.

The treatment of U.S. corporations as separate taxpayers with tax consequences independent from those of their owners is consistent with the general business law concept of the “corporate veil.”<sup>3</sup> U.S. tax law has generally respected this concept and, under the U.S. classical tax system, the earnings of a corporation generally are subject to tax in the first instance at the level of the corporation. The earnings are not taxed at the level of the shareholders until they are distributed by the corporation.

There is no overriding reason for U.S. tax law to adopt the position that a corporation is a separate taxpayer,<sup>4</sup> and, indeed, originally it did not.<sup>5</sup> As explained in Appendix A, temporary income tax laws enacted to raise revenue during the Civil War era required individual taxpayers that held an ownership interest in both incorporated and unincorporated businesses to include in income their share of the profits, whether or not distributed.<sup>6</sup> However, the Revenue Act of 1913 established separate taxing regimes for individuals and corporations.<sup>7</sup> The reasons it did so are not entirely clear, but early and influential proponents of the income tax strongly believed in separate business taxation, apparently mainly for administrative reasons.<sup>8</sup>

The second feature, the current taxation of U.S. citizens, residents and corporations on their worldwide income, also dates from the introduction of the modern income tax in 1913.<sup>9</sup> However, this worldwide taxing jurisdiction applies only to U.S. persons. Foreign persons, including foreign corporations, are taxable only on income from sources within the United States,

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<sup>3</sup> See, e.g., Moline Properties v. Commissioner, 319 U.S. 436 (1943).

<sup>4</sup> See, e.g., Department of the Treasury, Integration of the Individual and Corporate Tax Systems, Chapter 4 (1992) (“Treasury Integration Study”) (discussion of the Comprehensive Business Income Tax Prototype). See also Rosemarie Portner, German Government Embarks on Program for Safeguarding Employment, Economic Growth, 19 Tax Notes Int’l 794 (Aug. 30, 1999) (explaining proposal of German government to tax corporations and unincorporated businesses in the same way).

<sup>5</sup> See infra Appendix A, part 1, section I.B. (development of the treatment of a corporation as a separate taxpayer under U.S. tax law).

<sup>6</sup> See Act of June 30, 1864, ch. 173, § 117, 13 Stat. 223.

<sup>7</sup> See Revenue Act of 1913, ch. 16, § II.A (individuals), § II.G (corporations), 38 Stat. 114.

<sup>8</sup> See Michael J. Graetz & Michael M. O’Hear, The “Original Intent” of U.S. International Taxation, 46 Duke L.J. 1021, 1038 n.67 (Mar. 1997).

<sup>9</sup> Current taxation of worldwide income has become a fundamental feature of the U.S. tax system (although, as stated earlier, the U.S. tax system also includes elements of territoriality). With respect to its origins, however, certain commentators have noted that “[t]he decision in 1913 to tax the worldwide income of taxpayers may simply have followed the earlier decision to tax worldwide income in the 1909 federal excise tax on corporate income.” Id. at 1042 n.85. See also Appendix A, note 3 (discussing the evolution of the standard for imposing U.S. taxing jurisdiction in Civil War era tax laws).

or on income that is effectively connected with the conduct of a trade or business within the United States.<sup>10</sup>

These two features, which interact with one another to create opportunities to use corporations to avoid U.S. tax, create the need for anti-deferral rules. First, the generally applicable rule of current taxation of worldwide income leads taxpayers to search for deferral vehicles. Second, the treatment of corporations as taxpayers separate from their owners provides the structural framework for the deferral of U.S. tax, because a U.S. taxpayer may earn income through a foreign corporation that will not be subject to U.S. tax until the income is distributed by the foreign corporation to the U.S. taxpayer.

The tension between these features of U.S. law would disappear if the principle of worldwide taxation were abandoned, or if corporations were treated as passthrough entities. If the United States decided no longer to tax foreign income, the form in which business was conducted abroad would become irrelevant for U.S. tax purposes. Likewise, if the United States decided to tax corporations owned by U.S. citizens and residents as passthrough entities, worldwide taxation would be fully implemented.<sup>11</sup>

Taxing U.S. persons currently on their worldwide income is widely regarded as an important goal for a number of reasons. First, worldwide taxation furthers equity in the tax system by treating all income the same. As commentators have observed, “since the source of income has no bearing on its validity as a measure of ability to pay, the tax burden should be based on ‘worldwide income’.”<sup>12</sup> Second, worldwide taxation avoids a perception of unfairness that would occur if tax reduction were more readily available to those with the ability to invest offshore. Third, worldwide taxation also supports the principle of economic efficiency, which is examined at greater length in Chapter 3. If all income, domestic and foreign, is taxed currently and at the same rate, there is no tax-motivated reason for foreign rather than domestic investment.<sup>13</sup>

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<sup>10</sup> See I.R.C. §§ 881 and 882.

<sup>11</sup> Since 1945, there have been a number of legislative attempts to end deferral (i.e., in effect, to treat foreign corporations as passthroughs) of which the most recent was the Foreign Income Tax Rationalization and Simplification Act of 1992, H.R. 5270, 102d Cong., 2d Sess., introduced in May 1992 by Representatives Rostenkowski and Gradison. There also has been discussion, from time-to-time, about moving to a territorial system (i.e., abandoning worldwide taxation).

<sup>12</sup> See Hugh Ault and David Bradford, Taxing International Income: An Analysis of the U.S. System and its Economic Premises, in Taxation in the Global Economy 27 (Assaf Razin and Joel Slemrod eds., 1990).

<sup>13</sup> The current U.S. system of deferral for nonsubpart F income (generally, active business income) earned through a foreign corporation (as well as the territorial aspects of the U.S. system, e.g., section 114) prevents these advantages from being fully realized at present.

Treating corporations as separate taxpayers, however, is also widely regarded as important, particularly under the so-called “classical” system of taxation used by the United States. Under such a system, the two separate levels of taxation (on the corporation and shareholder) are generally considered to go hand-in-hand with the ability to defer the second level of taxation until distribution. If this second level of tax were not deferred, businesses could be deterred from operating in corporate form.<sup>14</sup> As a practical matter, in the near term, it is likely that corporations will continue to be treated as separate taxpayers.<sup>15</sup>

Accordingly, because of the incompatibility of worldwide taxation and the taxation of a corporation as a separate entity, the conduct of business in corporate form will continue to require policy determinations on the appropriate scope of the deferral benefit.

### **III. The Need for Restrictions on Deferral: Tax Avoidance and Response**

#### **A. 1913 to 1934**

##### **1. “Formed or Availed Of” Standard**

The Revenue Act of 1913 generally treated a corporation as separate from its shareholders. However, it created an exception in the case of corporations “created or organized, formed or fraudulently availed of for the purpose of preventing the imposition of” the graduated surtax on individuals. U.S. shareholders of such corporations were required to include in income their share of the corporation’s gains and profits, whether or not distributed.<sup>16</sup> This provision, a predecessor to the accumulated earnings tax and personal holding company provisions, limited the separate entity treatment of a corporation and its shareholders to prevent tax avoidance.

The Revenue Act of 1921<sup>17</sup> replaced this provision requiring current inclusion of the corporation’s undistributed earnings at the shareholder level with one that imposed an additional income tax directly on corporations formed or availed of to avoid the surtax.

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<sup>14</sup> A foreign corporation’s foreign source income that is not effectively connected with a U.S. trade or business will not be subject to two levels of U.S. tax (although there may be foreign tax at the corporate level).

<sup>15</sup> The merits of integration, which are beyond the scope of this study, are addressed in the Treasury Integration Study, *supra* note 4.

<sup>16</sup> Revenue Act of 1913, § II.A. Subdivision 2.

<sup>17</sup> Revenue Act of 1921, ch. 136, § 220, 42 Stat. 227. Under this provision, in lieu of the additional corporate level tax, shareholders could agree to be taxed on their share of the net income of the corporation.

## 2. Transfers of Property to Foreign Corporations (Predecessor to Section 367)

U.S. taxpayers were able to defer U.S. tax not only by earning income through a foreign corporation but also by transferring appreciated property to a foreign corporation in a tax-free exchange. If the foreign corporation was formed in a jurisdiction that did not impose a tax on the sale of capital assets, both U.S. and foreign tax would be avoided on the capital gain. The income could subsequently be repatriated in a tax-free exchange. To address this potential for tax avoidance, the Revenue Act of 1932<sup>18</sup> added section 112(k),<sup>19</sup> the predecessor to section 367, which required gain recognition on a transfer of property to a foreign corporation unless, prior to the exchange, it was established to the satisfaction of the Commissioner that the exchange was not in pursuance of a plan having as one of its principal purposes the avoidance of tax.

### B. Personal Holding Companies – 1934

The Revenue Act of 1934<sup>20</sup> contained provisions intended to prevent tax avoidance or postponement.<sup>21</sup> Although the tax avoidance practices Congress identified in 1934 were not new,<sup>22</sup> the 1921 provisions, which required a showing that the corporation was organized or availed of for the purpose of preventing the surtax on the shareholders, had proved ineffective in discouraging tax avoidance. Taxpayers often were able to show some need for the accumulation of profits in the corporation.<sup>23</sup> The 1934 House Report explained one of the specific tax avoidance schemes with which Congress was particularly concerned:

Perhaps the most prevalent form of tax avoidance practiced by individuals with large incomes is the scheme of the ‘incorporated pocketbook.’ That is, an individual forms a corporation and exchanges for its stock his personal holdings in stock, bonds, or other income-producing property. By this means the income from

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<sup>18</sup> Revenue Act of 1932, ch. 209, 47 Stat. 169.

<sup>19</sup> See H.R. Rep. No. 708, 72d Cong., 1<sup>st</sup> Sess. 20 (1932).

<sup>20</sup> Revenue Act of 1934, ch. 277, 84 Stat. 680.

<sup>21</sup> H.R. Rep. No. 704, 73d Cong., 2d Sess. 1 (1934) (1934 House Report) .

<sup>22</sup> See, e.g., a letter written in 1937, in which the Chairman of Joint Committee on Tax Evasion and Avoidance (transmitting his report to Congress) observed: “The problem of the personal holding company has been one requiring the continued attention of Congress beginning with the Revenue Act of 1913.” Report of the Joint Committee on Tax Evasion and Avoidance of the Congress of the United States, House Doc. No. 337, 75<sup>th</sup> Cong., 1<sup>st</sup> Sess. 7 (1937) (1937 Report of the Joint Committee on Tax Evasion).

<sup>23</sup> 1934 House Report, supra note 21, at 11.

the property pays corporation tax, but no surtax is paid by the individual if the income is not distributed.<sup>24</sup>

To address this problem, the Revenue Act of 1934 imposed the additional tax on the undistributed profits of a corporation that fell within the definition of a “personal holding company,” without regard to the purposes for which the corporation was formed.<sup>25</sup> A personal holding company was defined as a corporation 80 percent of whose gross income for the taxable year was derived from certain passive income and more than 50 percent of the stock of which was owned by not more than 5 individuals. The personal holding company regime was intended to remove the tax benefit available to an individual from earning passive income through a separate corporation.

### C. Foreign Personal Holding Companies – 1937

In 1937, Congress again sought to address the proliferation of tax avoidance schemes involving the use of corporations to lower the rate of tax on shareholders’ income. The Revenue Act of 1937<sup>26</sup> contained a series of provisions that were based on recommendations by the Joint Committee on Tax Evasion and Avoidance. This Joint Committee was formed pursuant to a resolution of Congress to investigate methods of tax evasion and avoidance detailed in a letter from President Franklin D. Roosevelt to Congress, dated June 1, 1937.<sup>27</sup> In his letter, the President explained:

We face a challenge to the power of the government to collect, uniformly, fairly, and without discrimination, taxes based on statutes adopted by Congress.

....

Methods of escape or intended escape from tax liability are many. . . .

....

. . . All are alike in that they represent a determined effort on the part of those who use them to dodge the payment of taxes which Congress based on the ability to pay. All are alike in that failure to pay results in shifting the tax load to the shoulders of others less able to pay and in mulcting the Treasury of the Government’s just due.<sup>28</sup>

In a letter accompanying the President’s letter to Congress, Henry Morgenthau, the Secretary of the Treasury, outlined the tax evasion devices that were leading to serious tax base erosion. Among those devices was the use of foreign personal holding companies established in

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<sup>24</sup> Id.

<sup>25</sup> Revenue Act of 1934, § 351.

<sup>26</sup> Revenue Act of 1937, ch. 815, 50 Stat. 813.

<sup>27</sup> Tax Evasion and Avoidance, Hearings before the Joint Committee on Tax Evasion and Avoidance, 75<sup>th</sup> Cong., 1<sup>st</sup> Sess. (Part1) 1 (1937) (1937 Hearings).

<sup>28</sup> 1937 Report of the Joint Committee on Tax Evasion, supra note 22, at 1.

tax havens to avoid tax.<sup>29</sup> During the summer of 1937, Roswell Magill, Under Secretary of the Treasury, testified before the Joint Committee on Tax Evasion and Avoidance that foreign personal holding companies were used “as a means of siphoning assets and income out of the United States into foreign countries where there are no income taxes, or where such taxes are low.”<sup>30</sup>

Based upon the evidence presented at these hearings, the Joint Committee on Tax Evasion and Avoidance determined that legislation directed at the device of the foreign personal holding company was “necessary to protect the revenue and prevent further use of one of the most glaring loopholes now existing.”<sup>31</sup> The Joint Committee noted that jurisdictional and tax collection problems prevented Congress from enacting a regime parallel to the personal holding company regime under which a surtax would be imposed directly on the foreign corporation. Thus, the Joint Committee proposed a method of taxation under which the undistributed income of the foreign personal holding company would be included in the gross income of shareholders that were U.S. citizens or residents whether or not this income was distributed to them.<sup>32</sup>

As enacted by the Revenue Act of 1937, a foreign personal holding company was defined as a foreign corporation that met two requirements: (1) more than 50 percent of its stock was owned by not more than five individuals who were citizens or residents of the United States; and (2) at least 60 percent of its gross income was derived from dividends, interest, annuities and other specified passive income. Pursuant to the recommendation of the Joint Committee, the U.S. shareholders were required to take into income, on a current basis, their pro rata share of the undistributed net income of the foreign personal holding company.

Although the Joint Committee generally was satisfied that the foreign personal holding company provisions would address the tax evasion problems raised at the hearings, they also recognized that this legislation might not be sufficient to address devices involving foreign corporations that could arise in the future. In its report, the Joint Committee stated that:

[The Committee] also recognizes the complex character of the problem and the difficulty of framing a tax law which is proof against all the varied and complicated devices involving the use of foreign entities which legal ingenuity may evolve in the future. The committee is therefore of the view that it should continue its study of this problem and should consider other and additional measures which may be feasible for preventing the use of spurious foreign entities to thwart the intent and purposes of the revenue laws.<sup>33</sup>

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<sup>29</sup> Id. at 1-2.

<sup>30</sup> 1937 Hearings, supra note 27, at 85.

<sup>31</sup> 1937 Report of the Joint Committee on Tax Evasion, supra note 22, at 17.

<sup>32</sup> Id.

<sup>33</sup> Id. at 22.

#### **D. Prelude to Subpart F: Tax Haven Operations in the 1950s and Early 1960s**

In the early years of the income tax, Congress thus focused its attention on attempts by individuals to obtain deferral benefits. After the Second World War, however, U.S. corporations made significant inroads into European and other world markets.<sup>34</sup> At the same time, domestic tax rates, which had risen from before the war, stayed at relatively the same levels.<sup>35</sup> The combination of increased foreign business, an incentive to avoid higher domestic tax rates, and the rise of classical tax havens,<sup>36</sup> led to increasing use of deferral by these U.S. corporations.

Although U.S. businesses previously had been able to benefit from deferral by operating through a foreign subsidiary in a low-tax country, their use of tax haven corporations to obtain a tax advantage for income otherwise earned in a high-tax foreign country was a new and rapidly growing phenomenon.<sup>37</sup> The Kennedy Administration's figures indicated that over one-third of the approximately 500 American-owned firms in Switzerland had been formed in 1960.<sup>38</sup> Of the 1,200 subsidiaries of U.S. corporations in Nassau, Bahamas, in 1962, less than 50 were operated by employees of the offshore company. The rest were operated for a fee by trust companies and attorneys. These corporations generally were sales subsidiaries with no foreign economic activities, which merely booked a sale and took a percentage of profit.<sup>39</sup>

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<sup>34</sup> For example, income earned by U.S. investors from their investments abroad as a fraction of total U.S. GNP increased by 150 percent between 1946 and 1962 (from about 0.4 percent in 1946 to 1.0 percent in 1962). See Economic Report of the President Transmitted to the Congress January 1964, together with the Annual Report of the Council of Economic Advisers 207 (1964) (GNP figures); Economic Report of the President Transmitted to the Congress February 2000, together with the Annual Report of the Council of Economic Advisers 422 (2000) (foreign investment figures).

<sup>35</sup> The top statutory corporate income tax rate was 24 percent in 1940, 31 percent in 1941, 40 percent from 1942-45, 38 percent from 1946-49, 42 percent in 1950, 51 percent in 1951, 52 percent from 1952-63, 50 percent in 1964, 48 percent from 1965-78, 46 percent from 1979-86, 40 percent in 1987, 34 percent from 1988-93, and 35 percent from 1994-present.

<sup>36</sup> For a recent definition of tax havens, see infra Chapter 2, note 12.

<sup>37</sup> See Message from the President of the United States Relative to our Federal Tax System, H.R. Doc. No. 140, 87<sup>th</sup> Cong., 1<sup>st</sup> Sess. 6, 26 (1961), reprinted in Committee on Ways and Means, 90<sup>th</sup> Cong., 1<sup>st</sup> Sess., Legislative History of H.R. 10650, 87<sup>th</sup> Cong., The Revenue Act of 1962 (Part 1) 146, 166 (1967) (President's Tax Message); President's 1961 Tax Recommendations, Hearings before the Committee on Ways and Means on the Tax Recommendations of the President Contained in his Message Transmitted to the Congress, April 20, 1961, 87<sup>th</sup> Cong., 1<sup>st</sup> Sess. (Vol. I) 303, 343 (1961) (1961 Hearings before the House).

<sup>38</sup> 1961 Hearings before the House, supra note 37, at 303, 343.

<sup>39</sup> Rothenberg & Yoder, 928-2nd Tax Management, Subpart F – Foreign Base Company Income A-3, n.47 (1997) (citing Wall St. J., March 29, 1962, at 1).

The Kennedy Administration identified a number of artificial or paper transactions through which profits could be diverted to a subsidiary organized in a tax haven, most of which required the tax haven subsidiary to act as a middleman.<sup>40</sup> For example, the tax haven subsidiary could acquire the right to license patents developed by the parent or sister corporation, provide the services of technicians of a corporate affiliate to customers located in another country, acquire the distribution rights with respect to products manufactured by its affiliates,<sup>41</sup> or reinsure the U.S. risks of its parent.<sup>42</sup> Further, dividend and interest payments could be used to move assets or earnings from a high-tax country to a tax haven (for example, by dividend or interest payments from a foreign subsidiary in a high-tax jurisdiction to a related party in a low-tax jurisdiction).<sup>43</sup>

To illustrate the tax savings available through the use of tax haven subsidiaries, the Kennedy Administration gave the example of an American company operating through a German subsidiary.<sup>44</sup> Although the tax rate in Germany was 51 percent, this tax rate could be artificially lowered by diverting half of the profits, through one of the arrangements cited above, to another subsidiary located in a “tax haven” country, like Switzerland (for example, by establishing a sales subsidiary in Switzerland and then allowing that sales subsidiary to earn “profit” by buying from the related German manufacturer and then selling to unrelated third parties, generally located outside of Switzerland). Assuming the Swiss tax was sufficiently low, the overall tax rate on the income could be reduced substantially.<sup>45</sup>

Thus, the main thrust of the tax avoidance techniques which led to the enactment of subpart F was the “deflection” of income to low-tax jurisdictions, not only from the United States, but also from foreign high-tax developed countries where the principal value-adding activity took place. The Kennedy Administration’s reasons for opposing this type of income deflection are discussed in Chapter 2.

### **E. Foreign Investment Companies – 1962**

In 1962, in conjunction with the enactment of subpart F, Congress also enacted certain provisions to address the tax deferral obtained by small investors in foreign investment companies. Domestic regulated investment companies (mutual funds) were taxed on their current earnings unless the company distributed at least 90% of those earnings (and certain other conditions were met). Thus, at least one level of current tax was imposed at ordinary income tax rates, either at

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<sup>40</sup> See Revenue Act of 1962, Hearings Before the Committee on Finance on H.R.10650, 87th Cong., 2d Sess. (Part I) 98 (1962) (1962 Hearings before the Senate).

<sup>41</sup> President’s Tax Message, supra note 37, at 25.

<sup>42</sup> 1962 Hearings before the Senate, supra note 40, at 98.

<sup>43</sup> President’s Tax Message, supra note 37, at 25.

<sup>44</sup> Id.

<sup>45</sup> Id.

the corporate or investor level. By contrast, foreign investment companies could avoid U.S. tax if they had no U.S. source income. U.S. investors in such companies generally were taxed only when they sold the stock. In that case, the gain from the stock sale was taxed at capital gains rates rather than ordinary income rates.

During the 1950s, Congress was aware that foreign investment companies were used for tax avoidance but determined that by the early 1960s, “the seriousness of the problem [had] increased substantially.”<sup>46</sup> In his 1961 tax message to Congress, President Kennedy noted that:

For some years now we have witnessed substantial outflows of capital from the United States into investment companies created abroad whose principal justification lies in the tax benefits which their method of operation produces.<sup>47</sup>

The Kennedy Administration recommended a regime for foreign investment companies similar to that which it recommended for U.S.-controlled foreign corporations, i.e., current inclusion of the income of the foreign corporation at the U.S. shareholders’ level.<sup>48</sup> Congress, however, rejected this approach. Instead, the foreign investment company provisions, sections 1246 and 1247, taxed the U.S. shareholders of the foreign investment company at ordinary income rates on their share of the post-1962 accumulated earnings and profits when they sold the stock of the company. To avoid the tax at ordinary income rates on post-1962 accumulated earnings and profits, the taxpayers could elect to have the foreign corporation distribute annually 90 percent of the taxable income (other than capital gains).<sup>49</sup> These provisions applied to a foreign corporation that was either registered as a management or unit investment trust or that was primarily engaged in investing or trading in securities, when more than 50 percent of the stock of the corporation was held by U.S. persons.<sup>50</sup> Because these provisions applied without regard to the ownership percentage of each U.S. person, small investors were subject to this regime.

#### **IV. Conclusion**

From 1913 to 1962, Congress enacted several provisions that responded to circumstances caused by tensions between worldwide taxation and separate tax status for corporations because it determined that this tension produced recurring opportunities for tax avoidance. When Congress was presented with evidence that taxpayers were using corporations to avoid current U.S. taxation on their worldwide income, it consistently decided that the principle of worldwide taxation should be reinforced and it acted to restrict some aspect of deferral. Subpart F, described

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<sup>46</sup> H.R. Rep. No. 1447, 87<sup>th</sup> Cong., 2d Sess. 72 (1962).

<sup>47</sup> *Id.*

<sup>48</sup> *Id.* at 72-73.

<sup>49</sup> Taxpayers electing this treatment were required currently to include in income their share of the capital gains of the foreign corporation whether or not distributed.

<sup>50</sup> I.R.C. § 1246(b).

more fully in the next chapter, was one such reaction in response to techniques for avoiding worldwide taxation (in this case, particularly involving tax havens) in the late 1950s and early 1960s.

## CHAPTER 2

### THE INTENT OF SUBPART F

#### I. Introduction

The previous chapter placed subpart F in a broad historical context. This chapter describes the specific policy reasons for the enactment of subpart F that were debated in depth when subpart F was enacted in 1962.<sup>1</sup> These policy reasons include both general tax policy, such as preventing tax avoidance (through tax haven techniques that reduced both U.S. and foreign tax), as well as more specific economic policy, such as promoting economic efficiency.<sup>2</sup>

#### II. Concerns Leading to Enactment of Subpart F

##### A. Preventing Tax Haven Abuse

In his message to Congress in 1961, President Kennedy had proposed to end “tax deferral privileges in developed countries” and to eliminate “tax haven deferral privileges” in all countries.<sup>3</sup> Subpart F, as enacted, contained the President’s proposal to eliminate tax haven deferral because Congress agreed that tax havens provided an inappropriate tax incentive for U.S. businesses to

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<sup>1</sup> Appendix A contains a more complete discussion of the policy reasons behind the enactment of subpart F, as well as a discussion of subsequent amendments to subpart F. To determine the intent behind subpart F, it is necessary to look both at the reasons put forward by the Kennedy Administration (particularly as those reasons relate to the Administration’s original tax haven proposals), and the legislative history contained in Committee Reports and Floor Debates. It has been argued that the Kennedy Administration’s reasons for proposing subpart F are not relevant to evaluate the regime because Congress did not enact what the Administration proposed. This argument is based on the premise that, in its evolution from the 1961 proposal to the 1962 statute, subpart F was altered to reduce the importance of the policy of capital export neutrality. However, the changes to the statute made during its passage through Congress did not, as a practical matter, greatly weaken the capital export neutrality impact of subpart F. See infra section II.D of this Chapter 2. Thus, to fully understand the intent behind the statute, it is appropriate to examine the arguments supporting the Kennedy Administration’s original proposal.

<sup>2</sup> One additional reason given for the enactment of subpart F in 1962 was the balance of payments deficit. This was a concern because the balance of payments deficit that existed at the time (caused by an outbound flow of dollars) placed the fixed exchange rate of the dollar under pressure. As exchange rates now float, however, this factor is not a concern today, and will not be considered further.

<sup>3</sup> Message from the President of the United States Relative to our Federal Tax System, H.R. Doc. No. 140, 87<sup>th</sup> Cong., 1st Sess. 7 (1961), reprinted in Committee on Ways and Means, 90<sup>th</sup> Cong., 1<sup>st</sup> Sess., Legislative History of H.R.10650, 87<sup>th</sup> Congress, The Revenue Act of 1962 (Part 1) 147 (1967) (President’s Tax Message).

move capital abroad and that their use should be curtailed.<sup>4</sup> It did not, however, include the proposal to eliminate tax deferral in developed countries.

Tax haven deferral could be distinguished from tax deferral in developed countries because this second type of tax deferral could have been obtained by taxpayers that were conducting business operations through non-tax motivated structures and transactions.<sup>5</sup> Such transactions generally occurred in high-tax jurisdictions with tax rates similar to those in the United States.<sup>6</sup> Commenting on his proposal to end tax deferral in developed countries, the President stressed that:

Many American investors properly made use of this deferral in the conduct of their foreign investment. Though changing conditions now make continuance of the privilege undesirable, such change of policy implies no criticism of the investors who utilize this privilege.<sup>7</sup>

Tax haven deferral, however, was deferral that was maintained for tax avoidance purposes. Referring to tax haven deferral in his tax message, President Kennedy noted that, “[t]he undesirability of continuing deferral is underscored where deferral has served as a shelter for tax escape through the unjustifiable use of tax havens such as Switzerland.”<sup>8</sup>

Significantly, tax haven deferral included deferral used to avoid either U.S. or foreign taxes. The type of transactions that the President’s proposal and Committee Reports identified as giving rise to tax haven deferral were “artificial arrangements” between related corporations that “exploit the multiplicity of foreign tax systems and international agreements in order to reduce sharply or eliminate completely their tax liabilities both at home and abroad.”<sup>9</sup> The Senate Finance Committee reported that:

In the case of foreign income, your committee has been primarily concerned with ending tax haven abuses; namely, devices to avoid either the United States or

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<sup>4</sup> See 108 Cong. Rec. 17752 (1962) (Remarks of Senator Kerr) (“[T]his bill is beneficial in that it will stop the drain on our investment which is artificially induced by the low tax rates it is possible to obtain through the use of tax haven subsidiaries.”).

<sup>5</sup> See the President’s Tax Message, supra note 3, at 6.

<sup>6</sup> Id. at 24-25.

<sup>7</sup> Id. at 6.

<sup>8</sup> Id.

<sup>9</sup> Id. This portion of the President’s Tax Message was quoted in both the House and Senate Reports. See H.R. Rep. No.1447, 87<sup>th</sup> Cong. 2d Sess. 57 (1962) (1962 House Report); S. Rep. No. 1881, 87<sup>th</sup> Cong., 2d Sess.78-79 (1962) (1962 Senate Report).

foreign taxes which could be expected to be imposed under normal business operating conditions.<sup>10</sup>

Although both the Administration and Congress described these transactions as involving “tax havens,” neither proposed to deal with the problem by targeting particular countries. Rather, tax haven deferral was identified by the way in which the deferred income was earned. President Kennedy’s proposal, and the final subpart F legislation, identify “forms of activities, such as trading, licensing, insurance, and others, that typically seek out tax haven methods of operation.”<sup>11</sup> The Kennedy Administration did not attempt to define the term “tax haven,” other than by examples such as Switzerland.<sup>12</sup>

## **B. Taxing Passive Income Currently**

Subpart F also was intended to ensure that all passive income earned by U.S.-owned foreign corporations<sup>13</sup> would be subject to current U.S. tax, whether or not such income was earned through tax haven operations.

Both the House and Senate Reports stated the reasons for taxing passive income as follows:

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<sup>10</sup> 1962 Senate Report, supra note 9, at 2. See also 108 Cong. Rec. 17750-51 (1962) (Senator Kerr describing tax haven abuses as “attempts to avoid U.S. or foreign taxes by the use of artificial corporate devices or selection of countries for incorporation for tax rather than business purposes.”).

<sup>11</sup> President’s Tax Message, supra note 3, at 7. See also 1962 House Report, supra note 9, at 57; 1962 Senate Report, supra note 9, at 79 (quoting from President’s Tax Message).

<sup>12</sup> See President’s Tax Message, supra note 3, at 6. This lack of specificity might be contrasted with the Organization for Economic Cooperation and Development’s (OECD’s) current project on harmful tax competition. The OECD specifies four major features of a tax haven: (1) no or nominal taxation of the relevant income; (2) rules that prevent the effective exchange of information with foreign tax authorities; (3) a lack of transparency in the operation of legislative, legal or administrative provisions; and (4) the absence of a requirement for substantial activity. See Organization for Economic Cooperation and Development, Harmful Tax Competition: An Emerging Global Issue, at 22-25 (1998) (“OECD HTC Report”). In general, to be classified as a tax haven, a country must meet the no or nominal tax criterion, and one of the other three criteria. The OECD HTC Report also discusses harmful preferential tax regimes that can exist in countries that would not be classified as tax havens. The similarity between the characteristics of a tax haven and a harmful preferential tax regime highlights the fact that a modern diversified economy’s preferential regime can be almost indistinguishable from a tax haven. As such, the undesirable effects of tax havens may be replicated by countries that are not tax havens but that adopt harmful preferential tax regimes.

<sup>13</sup> References in this study to U.S.-owned foreign corporations are references to entities that would be controlled foreign corporations under subpart F.

Your committee while recognizing the need to maintain active American business operations abroad on an equal competitive footing with other operating businesses in the same foreign countries, nevertheless sees no need to maintain deferral of U.S. tax where the investments are portfolio types of investments, or where the company is merely passively receiving investment income. In such cases there is no competitive problem justifying postponement of tax until the income is repatriated.<sup>14</sup>

### **C. Promoting Equity Among Taxpayers**

Another fundamental objective of subpart F was to promote equity among U.S. taxpayers. In his tax message, President Kennedy stressed the importance of equity to a sound federal tax system. He noted that deferral undermined equity among U.S. taxpayers because those that operated abroad, and thus obtained the benefits of deferral, gained a significant tax advantage over those that operated their businesses exclusively in the United States.<sup>15</sup> The Administration maintained that deferral was akin to a special subsidy to U.S. taxpayers that were sophisticated enough to conduct business abroad.<sup>16</sup> Thus, the President argued that his Administration's proposal to end deferral was necessary to achieve greater equity.<sup>17</sup>

The Administration took the position that to treat taxpayers equitably, the tax policy of the United States must be based on the concept of tax neutrality (or efficiency). This position was explained in a report prepared by the Treasury and submitted to the Senate in conjunction with the testimony of Treasury Secretary Douglas Dillon at April 1962 hearings before the Senate Finance Committee:

One of the most fundamental of the guiding principles in American income taxation is that there should be equality in tax treatment of similar groups of taxpayers. Applied to corporations, this principle must be interpreted to mean that the income of any branch or subsidiary of an American corporation operating overseas should as far as possible be subject to the same corporate income tax rates as the income of any branch or subsidiary operating at home.<sup>18</sup>

In a statement accompanying the President's Tax Message, Secretary Dillon noted that:

There exists, in addition, an important issue of equity which has a significant bearing on domestic employment and production . . . . With the present deferral

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<sup>14</sup> 1962 House Report, supra note 9, at 62; 1962 Senate Report, supra note 9, at 83..

<sup>15</sup> President's Tax Message, supra note 3, at 6, 33.

<sup>16</sup> Revenue Act of 1962, Hearings before the Committee on Finance on H.R. 10650, 87<sup>th</sup> Cong., 2d Sess. (Part 1) 103 (1962 Hearings before the Senate).

<sup>17</sup> President's Tax Message, supra note 3, at 1, 6.

<sup>18</sup> 1962 Hearings before the Senate, supra note 16, Exhibit III, at 177.

privilege, an American firm contemplating a new investment and finding cost and market conditions comparable at home and abroad is impelled toward the investment opportunity overseas. This is so because it would thereafter be able to finance expansion on the basis of an interest-free loan from the U.S. Treasury, repayable at the option of the borrower.

. . . .  
. . . I believe that reasons of tax equity as well as reasons of economic policy clearly dictate that in the case of investment in other industrialized countries we should give priority to tax neutrality in the choice between investment here and investment abroad.<sup>19</sup>

These equity arguments applied with even more force to U.S.-owned foreign corporations engaging in tax haven activities. In that case, such entities were not engaging in economic activity that was fortuitously subject to a lower rate of foreign tax. Rather, they were engaging in tax-motivated activity and gaining benefits not available to domestic corporations.<sup>20</sup>

#### **D. Promoting Economic Efficiency**

One of the Kennedy Administration's principal economic reasons for seeking to end deferral entirely was to encourage efficiency based on the concept of tax neutrality. This concept is closely related to the concept of equity discussed in the previous section. Indeed, in certain cases, the two terms appear to be used interchangeably. Nevertheless, there is some difference between the two.

The Treasury view on the role of tax neutrality in promoting economic efficiency was summed up in a paper presented in conjunction with hearings before the Senate Finance Committee in April 1962:

Neutrality is a fundamental principle of taxation in the United States. The purpose of neutrality is to promote equity and the most efficient possible allocation of existing resources. Ideally, corporate tax rates should everywhere be the same, assuming roughly equivalent government services. We cannot control foreign tax rates and the fact that they may contribute to inequities. But we can prevent the American tax structure from contributing to the artificial diversion of funds to low-tax areas, by taxing the income of our overseas subsidiaries at the same rates as are applicable to income earned at home. The burden of proof for not following the general principle of tax neutrality should be on those who wish to continue a departure from that neutrality.<sup>21</sup>

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<sup>19</sup> President's Tax Message, supra note 3, at 29-30.

<sup>20</sup> See id. at 6.

<sup>21</sup> 1962 Hearings before the Senate, supra note 16, Exhibit III, at 173. The Kennedy Administration recognized that, as long as tax rates differ between countries, two alternative types of tax neutrality were possible with respect to the foreign income of U.S. companies. Under the

The Secretary of the Treasury, Douglas Dillon, pointed out that the adverse effect on economic efficiency from the use of tax haven techniques was very significant, since use of those techniques produced some of the greatest disparities in tax rates:

The existence of these tax-haven operations constitutes a most serious breach in our principle of tax neutrality, one which is growing by leaps and bounds every year.<sup>22</sup>

In enacting subpart F, Congress agreed to a targeted approach, developed with the assistance of the Treasury Department, that restricted deferral to discourage certain tax avoidance techniques designed to lower both U.S. and foreign tax. The Committee reports explicitly endorse the goal of preventing deflection of income to low- or no-tax regimes. Moreover, a number of the floor speeches in both houses implicitly endorse the efficiency argument in explaining what the narrower tax haven provisions were intended to achieve. For example, in the House,<sup>23</sup> Representative Ullman, a member of the Ways and Means Committee, explained that:

[T]he foreign income provision of the bill are aimed at . . . the goal of equal tax treatment of income earned abroad and income earned here in the United States. This will be accomplished by eliminating the use of foreign tax havens and closing other loopholes which allow income earned abroad to escape taxation.

. . . .

These tax-haven companies are sometimes used as a device through which to sell -- on paper at least -- products manufactured in this country. This creates the opportunity for direct escape of U.S. taxes. Other tax-haven companies market goods produced by U.S.-owned subsidiaries in foreign countries whose taxes are roughly comparable to our own. In that case the availability of the tax haven serves directly to lure U.S. manufacturing operations overseas.<sup>24</sup>

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first type, capital export neutrality, the foreign income would be taxed at domestic rates, with a credit for foreign taxes paid. Because the domestic company would pay at least the domestic rate whether it invested at home or abroad, tax would be eliminated as an investment factor. Under the second type, capital import neutrality, the foreign income of the domestic company would be taxed only at foreign rates, thus allowing the domestic company to operate under the same tax burden as its foreign competitors. For reasons of tax equity and economic policy, the Kennedy Administration recommended giving priority to capital export neutrality. President's Tax Message, supra note 3, at 30.

<sup>22</sup> 1962 Hearings before the Senate, supra note 16, at 98.

<sup>23</sup> The House version of the bill, which itself fell short of what the Administration had requested, was subsequently cut back by the Senate. However, both the House and Senate measures were designed to end deferral on income from tax haven operations. See 1962 Senate Report, supra note 9, at 79.

<sup>24</sup> Vol. 108 Cong. Rec. 5320 (1962).

Similarly, in the Senate, Senator Kerr, the floor manager for the bill, explained:

[T]he President asked us to impose U.S. tax on the profits of all foreign subsidiaries of U.S. companies. Neither we nor the other body felt that this was necessary in order to achieve the President's major purposes. I am convinced that under this bill we do accomplish those major purposes . . . .

. . . .  
. . . . [T]his bill is beneficial in that it will stop the drain on our investment which is artificially induced by the low tax rates it is possible to obtain through the use of tax haven subsidiaries.<sup>25</sup>

The legislative history suggests that the Kennedy Administration believed that the compromise statute did not, to any significant extent, sacrifice its concerns about capital export neutrality<sup>26</sup> as compared with the Kennedy Administration's original proposal, but, instead, that it sacrificed the original proposal's relative simplicity.<sup>27</sup> Capital export neutrality is a concern only when taxpayers have an incentive to move income offshore because they can obtain a lower rate of tax on the income. The Kennedy Administration determined that this could happen in two situations. The first situation arose when taxpayers were conducting business operations in a foreign jurisdiction with tax rates that were lower than those in the United States.<sup>28</sup> The second situation arose when taxpayers were conducting business operations in a foreign jurisdiction with tax rates that were comparable to or greater than those in the United States but were able to

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<sup>25</sup> Vol. 108 Cong. Rec. 17752 (1962) (remarks of Senator Kerr).

<sup>26</sup> See supra note 21 (discussing and comparing capital import neutrality and capital export neutrality).

<sup>27</sup> This point is illustrated by the following exchange between Representative John Byrnes and Secretary Dillon during the 1961 House hearings on the President's proposal:

MR. BYRNES. What if we decided to just consider the tax haven problem then and forget about the rest. Would that take care of the situation?

SECRETARY DILLON. It would take care of the greater part of the problem if you could devise a series of laws that would cover all possibilities. With the situation in Europe, we find that the possibilities are pretty well myriad and we think you would have to develop a very complex body of law which would probably have to be changed rather frequently in light of experience to keep up with the legal ingenuity of those who wish to make use of these tax havens.

President's 1961 Tax Recommendations, Hearings before the Committee on Ways and Means on the Tax Recommendations of the President Contained in his Message Transmitted to the Congress, April 20, 1961, 87<sup>th</sup> Cong., 1<sup>st</sup> Sess. (Vol. 1) 345 (1961) (1961 Hearings before the House).

<sup>28</sup> President's Tax Message, supra note 3, at 6.

lower their foreign tax burden artificially through an arrangement involving a tax haven corporation.<sup>29</sup> Subpart F was designed to address the second situation. The Kennedy Administration did not consider the first situation to be a concern because, in 1962, tax rates in most developed countries that were not used for tax haven operations were substantially comparable to the U.S. tax rate,<sup>30</sup> and the Kennedy Administration specifically intended to encourage investment in lesser developed countries that were not used for tax haven operations.<sup>31</sup>

### **E. Competitiveness of U.S.-Owned Foreign Corporations**

Another issue relevant to the enactment of subpart F was the effect of anti-deferral rules on the competitiveness of U.S. multinationals. Congress accepted the arguments made during the hearings that the President's proposal to end deferral completely would discourage U.S. businesses from investing abroad, which investment was necessary to stimulate U.S. exports, and would place U.S.-owned businesses at a competitive disadvantage with foreign-owned businesses. Although both the House and the Senate favored a regime that focused on tax haven operations, the Senate carved out what it perceived to be legitimate foreign operations to respond to concerns about U.S. competitiveness abroad.<sup>32</sup> Thus, the legislation as enacted reflects an attempt to target arrangements that created tax incentives for capital to move outside the United States while being narrow in application to avoid unduly harming the competitiveness of U.S. business in the foreign market.

The Committee reports do not address the competitiveness argument in particular detail. Most often, the absence of competitiveness concerns are cited as a reason for restricting deferral in a particular case. Thus, for example, explaining the provision taxing passive income, both the

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<sup>29</sup> Id.

<sup>30</sup> Id. at 24 (comparing the tax rates of Belgium, Denmark, France, Germany, Italy, the Netherlands, Sweden, and the United Kingdom and noting that "tax deferral with respect to profits earned in these countries does not . . . have any material effect on U.S.-owned firms."). See also 1961 Hearings before the House, supra note 27, at 322 (statements of Secretary Dillon indicating that the Administration mainly intended to address tax haven deferral because it was primarily this type of deferral that allowed taxpayers to take advantage of significant disparities between the foreign and U.S. tax rate).

<sup>31</sup> See President's Tax Message, supra note 3, at 7.

<sup>32</sup> See Vol.108 Cong. Rec. 17751 (1962) (remarks of Senator Kerr) ("[T]he committee has carefully screened out of the House provisions those features which would have interfered with legitimate foreign operations of American controlled corporations."). Thus, for example, the Senate version of the bill carved out active rents and royalties received from unrelated persons and replaced the provision in the House bill requiring current inclusion of earnings not reinvested in the foreign corporation's business with a narrower provision that applied to earnings of the foreign corporation invested in U.S. property.

House and the Senate Reports<sup>33</sup> state that, although generally deferral was necessary to maintain the competitiveness of active U.S. business, earning passive income abroad did not give rise to the same concerns and, therefore, did not give rise to a need for deferral.

Senator Kerr also emphasized that, while the purpose of the bill was to remove artificial incentives to invest abroad through the use of tax haven devices, the legislation was not intended to affect legitimate overseas operations.<sup>34</sup>

There is nothing in the bill that interferes with investment abroad which is made for sound economic reasons. . . .

. . . .

. . . . [T]his bill does not interfere with sound business investments abroad which do not make use of tax haven subsidiaries.<sup>35</sup>

However, the legislative history of subpart F suggests that, in 1962, Congress did not intend to endorse the view that U.S.-owned foreign corporations should be able to reduce their foreign tax by any means available, such as shifting income from high-tax to low-tax foreign jurisdictions. This point is demonstrated by its decision to enact the anti-tax haven provisions (including the related party rules).<sup>36</sup> Congress reached its decision to enact the anti-tax haven

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<sup>33</sup> See supra portions of 1962 House and Senate Reports quoted at the text accompanying note 14.

<sup>34</sup> Vol.108 Cong. Rec 17751 (1962) (remarks of Senator Kerr).

<sup>35</sup> Vol.108 Cong. Rec.17752 (1962) (remarks of Senator Kerr).

<sup>36</sup> See, e.g., a floor debate between Senators Kerr and Javits. Senator Javits had proposed an amendment that would have treated the EEC as “one country” for purposes of some of the related party exceptions. Senator Kerr opposed it on the grounds that Switzerland might at some date join the EEC, which would then allow U.S. multinationals to operate tax free in the EEC while retaining U.S. deferral privileges. Thus, if Switzerland, Monaco or Liechtenstein joined the EEC:

[I]f a corporation were a resident of Switzerland or Monaco or Liechtenstein, it would have the privilege under the amendment of selling anything manufactured anywhere in the world in the European Economic Union, make its profit, and keep the profit from taxation under our laws or under the impending bill. . . .

. . . .

The . . . amendment would create an irresistible magnet for exportation of American capital, American business and American jobs, because insofar as the European Economic Union is concerned, their operations would be practically free so far as they continued to invest money.

Vol. 108 Cong. Rec.18596 (1962). Senator McCarthy, in support of Senator Javits, explicitly made the argument that using a Swiss sales corporation was justified to reduce high European taxes, and, in so doing, would increase U.S. tax when the income was repatriated. See Vol. 108

provisions (including the related party rules) despite extensive testimony from the business community about how foreign competitors were able to lower their taxes in similar ways.<sup>37</sup>

Further, the legislative history of subpart F indicates that Congress did not believe competitiveness concerns compelled it to permit deferral with respect to CFC operations in low-tax jurisdictions.<sup>38</sup> This legislative history indicates that Congress (and the Administration) assumed that U.S.-owned foreign corporations were conducting active businesses only in countries in which the tax rate was equivalent to that of the United States.<sup>39</sup> Congress was aware that in certain cases the United States' major trading partners had corporate tax rates slightly lower than those of the United States.<sup>40</sup> However, to avoid discouraging U.S. investment in active foreign business, Congress was prepared to allow some tax disparity and to forego the minimal marginal tax it would have collected if deferral had been ended.<sup>41</sup> Congress did not, however, endorse significant tax disparity, except in the specific case of free world developing countries.

A review of the legislative history of subpart F indicates that Congress did not want to encourage the earning of low-tax income, apart from the specific circumstances set out in the

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Cong. Rec. 18597 (1962). Senator Kerr, on the other hand, argued that the amendment provided a strong incentive to invest overseas. The amendment was defeated. See Vol. 108 Cong. Rec. 18598 (1962).

<sup>37</sup> The testimony concerning the foreign provisions of the President's original proposal are contained in 1961 Hearings before the House, supra note 27, Vol. IV. See, id. at 2939 for a specific example (statement of H.S. Geneen, President, International Telephone and Telegraph Corporation).

<sup>38</sup> Although Congress did include provisions within subpart F to promote investment in less developed countries, these provisions were not intended to address competitiveness concerns but to encourage development in these countries. See President's Tax Message, supra note 3, at 7.

<sup>39</sup> See, e.g., second paragraph of floor speech of Representative Ullman, quoted supra (text accompanying note 24), and Separate Views of the Republicans on H.R. 10650, H.R. Rep. No. 1447, 87th Cong. 2d Sess. B24-25 (1962) (Separate Views of Republicans). See also President's Tax Message, supra note 3, at 24-25.

<sup>40</sup> In only two cases, however, was the tax disparity greater than 12 percentage points: Belgium and Italy. In Germany, Canada and France it was within 2 percentage points. The U.K. had a higher corporate rate. 1962 Hearings before the Senate, supra note 16, Exhibit III, Table 2, at 179.

<sup>41</sup> It was also influenced by testimony from business leaders that many major trading partners raised revenue by relying heavily on turnover taxes and other taxes that were not creditable in the United States. See, e.g., 1961 Hearings before the House, supra note 27, Vol. IV, at 2735-36, 2817, 2850, 3019-20. Therefore, even with a slightly lower corporate rate, without deferral U.S.-owned foreign businesses might bear a heavier tax burden abroad than comparable U.S. businesses.

legislation. Thus, in 1962, Congress understood competitiveness to mean allowing U.S. persons to continue to invest in other developed countries in which they could profit by exploiting American know-how and ingenuity. Certainly, Congress decided that currently reporting income and paying U.S. tax might place the U.S.-owned foreign corporations at some disadvantage. But Congress does not appear to have understood competitiveness to mean allowing U.S.-owned foreign corporations in those countries to reduce their foreign tax by shifting income to a low-tax jurisdiction.<sup>42</sup>

### III. Conclusions on Intent of Subpart F

Preventing tax haven abuse, taxing passive income currently, promoting equity, promoting economic efficiency, and avoiding undue harm to the competitiveness of U.S. multinationals all played important roles in forming subpart F. Although Congress acknowledged the importance of equity and economic efficiency, as these goals were articulated by the Kennedy Administration, Congress was concerned that ending deferral completely would place U.S. companies at a competitive disadvantage in their foreign operations. Concerns about competitiveness thus prevented Congress from adopting the original 1961 Kennedy Administration proposal, which would have implemented capital export neutrality more fully by ending deferral on all income.

Congress also determined, however, that it did not want to permit U.S. multinationals to use tax haven devices to create a significant tax disparity between foreign and domestic effective tax rates. Thus, Congress sought to end deferral for income obtained through such devices, without regard to whether those devices were used to avoid foreign tax or U.S. tax. In particular, it intended to target devices that created artificial inducements to invest abroad by shifting income from high-tax jurisdictions (either the United States or high-tax foreign countries) to low-tax jurisdictions. In addition, because Congress concluded that subjecting passive foreign income to current tax would not jeopardize the competitive position of U.S. multinationals, Congress also ended deferral on passive foreign income.

The relative importance that Congress gave to equity, efficiency and competitiveness is unclear, however, because Congress may not have considered these criteria to have been in conflict. Congress heard testimony from the Administration that tax haven devices were the primary cause of significant disparities between foreign and domestic tax rates, and that addressing the “tax haven problem” would address most of the Administration’s concerns about equity and efficiency (albeit at the price of more complexity than the original Administration proposal). Congress may thus have believed that by ending deferral only in the tax haven context and with respect to passive income, it addressed the goals of equity and efficiency without unduly harming competitiveness.

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<sup>42</sup> That Congress viewed competitiveness in this narrower way is implicitly supported by the reaction of the bill’s opponents. Business leaders complained that the anti-tax haven provisions would have the effect of stifling foreign investment because it was those tax avoidance techniques that made U.S. corporations competitive since foreign-owned companies could use these tax avoidance techniques. See, e.g., 1961 Hearings before the House, *supra* note 27, Vol. IV, at 2697, 2856, 2916. This view was rejected by the Congress as a whole.

## CHAPTER 3

### ECONOMIC WELFARE AND THE TAXATION OF FOREIGN INCOME

#### I. Introduction and Overview

Chapters 1 and 2 described the history of subpart F and explained why it was enacted. A principal goal of subpart F was to prevent U.S. companies from avoiding tax by shifting income away from the United States or from foreign non-tax haven countries to foreign tax havens.<sup>1</sup> This chapter now considers whether subpart F improves global and U.S. economic welfare. To do this, the chapter first looks at the broad question of how to tax foreign investment to maximize economic welfare. It then looks at the narrower question of how the subpart F foreign-to-foreign related party rules<sup>2</sup> affect global and U.S. economic welfare and U.S. tax revenue.

With respect to the broader question of how to tax foreign investment to achieve economic policy goals, a careful review of the literature reveals that capital export neutrality is probably the best policy when the goal is to provide the greatest global economic output. Capital export neutrality requires structuring taxes so that they are neutral and do not cause investors to favor either domestic or foreign investment. Put another way, if taxes were structured based on capital export neutrality, investors would make their investment decisions as if there were no taxes. Similarly, with respect to national economic welfare, a careful review of the literature provides no convincing basis for rejecting the conclusions of the basic economic analysis that a country should tax income from outward foreign investment at a rate that is at least as high as the tax rate imposed on income from domestic investment.

Regarding the narrower question of how the subpart F foreign-to-foreign related party rules affect global economic welfare, this chapter concludes that the subpart F foreign-to-foreign related party rules do not necessarily improve global economic welfare even though these rules bring tax rates on some foreign investment closer to the rate on similar U.S. domestic investment. The effects of the rules may be uneven, causing tax rates on investments in different foreign countries to diverge and thereby pushing investment from high-tax to low-tax foreign countries. Thus, it is not clear whether, on balance, these rules make taxes more neutral with respect to the effect on investors' choices between investments in different countries.

This chapter further concludes that the effect of the subpart F foreign-to-foreign related party rules on U.S. economic welfare is also uncertain. In the short run, if these rules were tightened to prevent them from being avoided, real investment may be unaffected, but U.S.

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<sup>1</sup> Although the Kennedy Administration referred to this income shifting as “tax haven deferral,” the provisions of subpart F also target attempts to shift income to preferential tax regimes in countries that are not generally considered tax havens. Accordingly, references in this study to “tax haven deferral” should be understood to include income shifting to countries with preferential tax regimes.

<sup>2</sup> For a definition of the term “foreign-to-foreign related party rules,” see *infra* section IV.A.

companies may lose more revenue from the increased tax on foreign income than is gained in tax revenue by the U.S. Government. In the long run, however, tightening the rules may cause U.S. companies to choose U.S. investment rather than foreign investment, which, depending upon the extent of this substitution, could produce a net national gain in economic welfare coming both from greater productivity of U.S. labor and increased U.S. tax collections.

Regarding the question of how the subpart F foreign-to-foreign related party rules affect U.S. tax revenue, the chapter concludes that, in general, limiting deferral on income from foreign-to-foreign related party transactions would increase U.S. tax revenue by reducing the incentive for capital to leave the United States. Conversely, allowing taxpayers to defer income from foreign-to-foreign related party transactions would likely encourage capital to leave the United States in favor of lower-taxed foreign investment opportunities, reducing the U.S. tax base and U.S. tax revenue.

## **II. A Note on Economic Methodology**

A brief description of economic methodology might be helpful to understand the structure of this chapter. One of the primary objectives of economics is to understand how markets or other economic systems work and the effects of making changes in those systems. A principal way to accomplish this objective is to construct a “model” of the market or economic system in question.

In this case, the term “model” refers to a precisely defined logical construct, often expressed in mathematical and/or graphical form. To make a model manageable, the economist attempts to identify and represent only the most essential aspects of the economic system, sometimes in quite simplified terms. The model is then used to examine the effects of policy changes. To the extent that the model accurately characterizes the important elements of the real economic system under study, the results are helpful in understanding the operation of the economic system and the effects of potential policy options. This process is helpful because frequently the interactions between different components of a model are complex and cannot be understood without the use of formal means of reasoning, such as mathematical or graphical systems.

The development of economic understanding in a particular area generally proceeds as follows. One or two authors first publish articles which set out rather simple models of the markets or economic systems at issue and explore results within those models. Further progress is made as other economists (sometimes joined by the original authors in the field) publish articles that examine the effects of changing one or more of the key simplifying assumptions in the original model to provide a more accurate representation of the real world. These authors explore results within their revised models, sometimes confirming the results of the original authors, other times finding that the different assumptions yield different outcomes in some important dimension. Such results sometimes generate debates about which assumptions are most relevant or realistic and may give rise to further modeling and/or empirical research to attempt to ascertain which assumptions most closely portray reality.

This process goes on continuously. In areas of economic inquiry that are relatively new, the models may be relatively embryonic, and our understanding of how the markets or economic systems work may be rudimentary. Other markets or economic systems have been examined intensively for decades, and a great deal is known about them. Even in these cases, however, new insights are possible. Indeed, sometimes major changes in our understanding of markets or policies are brought about through this process. Additionally, changes in the economy may require revisions in even relatively mature economic models.

Section III of this chapter describes the development of the understanding of how tax policy, as it applies to foreign investment, affects economic welfare. The purpose of section III is to review what is known in general about the way to tax income from foreign direct investment to maximize economic welfare and to provide the conceptual framework for the economic analysis of the subpart F rules. The economic literature on this topic is fairly extensive and well developed. The articles by Peggy Musgrave were the seminal contributions, presenting the original economic models. The subsequent articles cited in this section explored the consequences of changing aspects of the Musgrave model, sometimes reaching different conclusions about what might constitute the best tax policy. The discussion evaluates these efforts and the state of knowledge in this area. It is found that Musgrave's results have stood the test of time and still appear to provide the best guide for determining appropriate tax policy. Section IV contains the economic analysis of the subpart F foreign-to-foreign related party rules. Section V contains conclusions about the optimal taxation of foreign investment income and about the economic effect of the subpart F foreign-to-foreign related party rules.

### **III. Optimal Taxation of International Investment Income**

#### **A. Introduction**

This section begins by reviewing studies that seek to determine the tax policies that maximize global economic welfare. It then reviews studies that seek to determine the tax policies that maximize U.S. economic welfare, possibly at a cost to other nations.<sup>3</sup> Policies that maximize global welfare are considered first, because maximizing global welfare is probably the best way to maximize U.S. economic welfare. All nations are likely to do best over the long term by establishing international tax policies that encourage private investors to make the best use of resources. Thus, it is probably not advisable to establish policies that promote national short-term interests at the expense of global economic welfare, because establishing such policies is likely to encourage other nations to seek to advance their own short-term national interests at the expense

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<sup>3</sup> To measure economic welfare, economists attempt to place an actual dollar value on the economic well being of individuals. To do this, they consider a number of things besides just the dollar value of output. For example, if policies are put in place to encourage greater output by encouraging greater work effort or greater saving, the gain in economic welfare would be smaller than the increase in output, because the greater saving or work effort would require some sacrifice by individuals. Global economic welfare refers to the economic well being of all individuals at home and abroad, whereas U.S. economic welfare refers to the economic well being of U.S. residents.

of global economic welfare. The need for a broad global view is particularly evident today in open economies, such as the United States, which have both substantial inbound and outbound investment. Further, the United States is often looked upon to provide global leadership in the policies it adopts.

It is also necessary, however, to determine how taxes on direct foreign investment income affect U.S. economic welfare. Although maximizing global economic welfare is probably the best policy for both capital-exporting and capital-importing countries, there may be more than one tax structure that achieves this goal, and individual countries will not necessarily be indifferent on the question of which structure should be adopted. For example, taxes on income from foreign direct investment can be structured so that for the same level of global output and total tax revenue, a capital-exporting country receives a bigger share or a smaller share of the revenue compared to a capital-importing country. The international distribution of tax revenue is thus not a matter of indifference to individual countries. Indeed, it is an important consideration when countries design their rules for taxing foreign investment. Therefore, this section also examines how taxes on foreign investment affect U.S. economic welfare.

## **B. Promoting Global Economic Welfare**

### **1. The “Standard Analysis”**

Studies by Peggy Musgrave<sup>4</sup> and Gary Hufbauer<sup>5</sup> were among the first to carefully examine ways to structure international tax policies to maximize global economic welfare. They each used a basic model in which they assumed that there is only one form of capital investment used to produce only one type of output,<sup>6</sup> that capital is freely mobile between countries, that the volume of saving is not affected by changes in the rate of return, that each country has its own tax rate that it applies to all income from investment earned within its borders, and that capital-importing countries do not change their tax policies in response to tax policy changes in the capital-exporting country. Analyzing this economic model, both Musgrave and Hufbauer found that a tax policy maximizes global economic welfare when it is consistent with the principle of capital export neutrality.<sup>7</sup> According to this principle, countries should structure their taxes so

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<sup>4</sup> See, e.g., Peggy Brewer Richman, Taxation of Foreign Investment Income, An Economic Analysis (1963); Peggy B. Musgrave, United States Taxation of Foreign Investment Income, Ch. 7 (1969).

<sup>5</sup> Gary C. Hufbauer, American Enterprise Institute, Hoover Institution Policy Study No.16 A Guide to Law and Policy, U.S. Taxation of American Business Abroad (1975).

<sup>6</sup> A later section explores how the analysis changes when there is more than one way to finance investment (for example, through equity or debt) and when there is more than one type of output.

<sup>7</sup> Other economists who derived the best policies within this standard model came to the same conclusions. See, e.g., Richard E. Caves, Multinational Enterprises and Economic Analysis 229-31 (1982); Joel Slemrod, Effect of Taxation With International Capital Mobility, in Uneasy Compromise: Problems of a Hybrid Income-Consumption Tax 115-48 (1988).

that investors in a capital-exporting country are indifferent, after taxes, between foreign and domestic investments that are expected to produce the same pretax rates of return.<sup>8</sup> In other words, international tax policies should be structured so that capital is allocated in the way it would be without taxes.<sup>9</sup>

The logic of their analysis (referred to hereafter as the “standard analysis”) is simple and compelling. First, consider a world without taxes. A fixed stock of privately-owned capital will be most productive if it is allocated in free, competitive markets by the owners, each independently seeking to gain the highest return from investment.<sup>10</sup> All investors will be satisfied by their choices only when they cannot expect to increase their returns further by moving investments from one country to another. In other words, the allocation of capital is optimal when global output cannot be increased by reallocating capital between countries.

Now, suppose that the income from capital is taxed. Even if the countries each impose different tax rates, the optimal allocation of capital will still be achieved if each investor faces the same tax rate regardless of where the investment is placed.<sup>11</sup> This will be true because the investors will be satisfied with their choices only when they can expect to receive the same after-tax return regardless of where they invest. However, because each investor would face the same tax rate regardless of where the investment is made, the expected pretax return from alternative

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<sup>8</sup> Throughout this section, an investor’s rate of return generally refers to the investor’s risk-adjusted rate of return. See, *infra*, note 10 for further explanation of this concept.

<sup>9</sup> As discussed in a later section, the conclusions from this analysis may also be relevant for a country that simultaneously imports and exports capital when there is more than one way to finance investment.

<sup>10</sup> Of course, this does not mean that the tax-free allocation of capital would yield the highest actual return on the capital. Instead, it is the investor’s expected returns, adjusted for risk, that are maximized. Rates of return must be adjusted for risk because the income an investment actually will generate is not known when the investment is undertaken. Investors generally are averse to risk, so they generally require a higher expected after-tax rate of return on more risky investment alternatives. The investor’s satisfaction is thus greatest when the risk-adjusted expected rates of return are the same among investment alternatives.

<sup>11</sup> This condition would be met, for example, if the capital exporting country taxed foreign source investment income as it accrued, but allowed a full foreign tax credit (i.e., a credit that was not limited based on the rate of tax imposed in the capital exporting country) for any investment income tax paid abroad.

It is sometimes argued that because capital-exporting countries limit the foreign tax credit on income from direct foreign investment to the tentative local tax due on the income, true capital-export neutrality cannot be achieved, so the attempt should be abandoned entirely. However, the fact that required pretax rates of return may be very high in high-tax capital-importing countries (resulting in too little investment in these countries) appears to offer little justification for abandoning capital export neutrality and favoring investment in lower tax countries, where pretax rates of return presumably are low (resulting in too much investment in these countries).

investments would also be the same. Thus, the investors will make the same choices they would have made without taxation. The result is an optimal tax structure that provides the best international allocation of capital and maximizes global output.

By contrast, if the investors face different tax rates depending on where they invest, they will still make investments in such a way that they can expect to receive equal after-tax rates of return from alternative investments in different countries. However, because they would face different tax rates depending on where they invest, the rates of return from those alternative investments would have to differ, before taxes, in order to be equal, after taxes. The investors' choices would not result in the best allocation of capital because output could be increased if capital were instead moved from the country where the investors face the lower tax rate (and the pretax return is lower) to the country where they face the higher tax rate (and the pretax return is higher).<sup>12</sup> This result is explained in more detail in figure 1 and the box below.

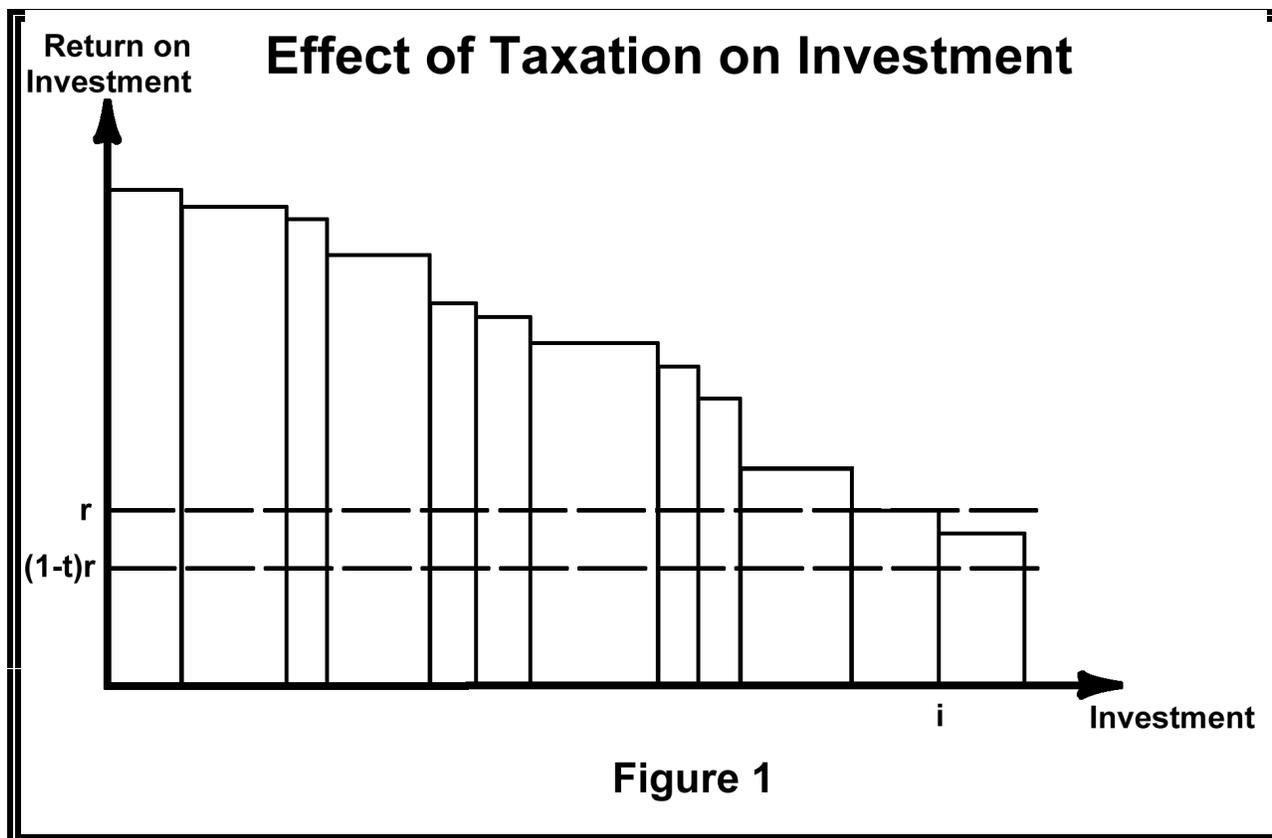
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<sup>12</sup> To optimize the allocation of capital either the low tax rate could be raised or the high tax rate could be reduced.

### ***The Relationship Between Taxes and the Productivity of Investment***

*Figure 1 shows why a higher tax rate on investment income in a country tends to be associated with a smaller amount of investment in the country, and with a higher rate of productivity per dollar of investment. Each bar represents an investment opportunity. The width of the bar represents the amount of the investment and the height of the bar represents the total income the investment produces per dollar of investment, per period. Thus, the area of each bar represents the income produced by the investment in each period. The investment opportunities are arranged in descending order, with the most productive opportunities on the left. Investors will undertake the most productive investments first. Thus, for example, if  $i$  is the total amount of capital invested in the country, the country's gross domestic product is given by the area of all the bars to the left of  $i$ .*

*If capital markets are competitive, then any investor can contribute funds to any investment opportunity, so competition among investors ensures that each receives the rate of return available on the least profitable investment, but no more than that. In the figure, this rate of return is  $r$ . The country taxes investment income at the rate  $t$ , so the after-tax rate of return received by investors is  $(1 - t)r$ . If capital is allowed to move freely among countries and if local investment stands at  $i$ , then this implies that investors are able to get  $(1 - t)r$  after taxes on their investments in other countries. To see how taxes affect local investment and the local rate of return to investment, consider what happens if the country raises the tax on local investment to  $t'$ , while tax rates on investments in all other countries are unchanged. The tax increase will cause investors to undertake fewer of the local investment opportunities, until the pretax rate of return on local investment rises by enough so that the rate of return after tax is again equal to that available from the offshore investments. For example, if investment that moved away from the country did little to affect rates of return offshore (a realistic approximation in most cases) then capital would continue to leave the country until the pretax rate of return rose to  $r'$ , such that  $(1 - t)r = (1 - t')r'$ .*



## 2. Criticisms of the Standard Analysis and Responses to Those Criticisms

### a. Adding the Role of Savings

This standard analysis has been criticized in a paper by Thomas Horst,<sup>13</sup> because it ignores the possible effect of taxes on saving.<sup>14</sup> Horst added savings behavior to the standard model and

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<sup>13</sup> Thomas Horst, A Note on the Optimal Taxation of International Investment Income, 94 Q.J. of Econ. 793-98 (June 1980).

<sup>14</sup> Saving clearly is influenced by the level of income. That is, the rate of saving increases as income levels increase. It is less clear how much saving responds to changes in the rate of taxation or other changes that would affect an investor's rate of return on investment. In principle, changes in an investor's rate of return will influence the investor's decision whether to spend money now or save that money to spend it in the future, and this decision will have an effect on global output. However, available evidence from an extensive body of empirical study provides little convincing evidence that the sensitivity of saving to the after-tax rate of return is large enough to matter in this context. See, e.g., Robert E. Hall, Intertemporal Substitution in Consumption, 96 J. of Pol. Econ. 339-57 (1988); Douglas Elmendorf, Board of Governors of the Federal Reserve System, Finance and Economic Discussion Series No. 96-27, The Effect of

asked how a capital-exporting country should structure its taxes to maximize global output.<sup>15</sup> He concluded that the capital-exporting country should not necessarily set taxes to be consistent with the principle of capital export neutrality. According to his analysis, the optimum tax rates depend on the responsiveness, or “elasticities,” of the supply and demand of capital with respect to changes in the rate of return. Horst found that if the capital demand and supply elasticities are similar at home and abroad, then taxes should be structured in the capital exporting country so that income from foreign investment is taxed at a rate between the tax rate imposed on income from domestic investment and the tax rate imposed by the foreign host country.

Horst’s analysis has been subject to several criticisms.<sup>16</sup> One is that the analysis ignores any effects of tax changes on tax revenue, and that the conclusions reached by Horst depended on ignoring these effects. Because countries are constrained in their tax policy by the need to raise revenue, this has been viewed as a weakness in Horst’s analysis. A second criticism is that the analysis assumes implicitly that the tax rate on income from domestic investment in the capital-exporting country is fixed, so that only the tax rate on foreign investment income can be changed. As demonstrated by later studies discussed below, these criticisms may not be critical if one is using the analysis only to determine whether the optimal tax on foreign investment income is higher or lower than the tax on domestic investment income and if the capital exporting country’s investment does not have a substantial effect on global rates of return. However, Horst’s analysis also ignores the role of other income taxes, in particular the taxes on labor income (i.e., taxes imposed on wages) and on pure economic profits.<sup>17</sup> Later studies (reviewed below) have shown that ignoring the role of other income taxes causes the analysis to yield invalid conclusions about the optimal relative rates of tax on domestic and foreign investment income.<sup>18</sup>

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Interest Rate Changes on Household Saving and Consumption: A Survey (1996). Changes in saving that can be fully explained by changes in income do not alter the conclusions from the standard analysis.

<sup>15</sup> Horst formalized arguments made earlier by Musgrave, supra note 4.

<sup>16</sup> See, e.g., Staff of the Joint Committee on Taxation, Factors Affecting the International Competitiveness of the United States, Scheduled for Hearings before the Committee on Ways and Means on June 4-6 and 18-20 and July 16-18, 1991 247-48 (1991).

<sup>17</sup> “Pure economic profits” or “economic rents” describes the return to the investor in excess of the return that the investor would require to undertake the investment (e.g., the return to a monopolist in excess of the return that would be available in a competitive market).

<sup>18</sup> One can view Horst’s analysis as supporting the view that the goal of capital import neutrality (the goal of ensuring that investment income earned in the same country faces the same tax rate regardless of the residence of the investor), rather than capital export neutrality, should be sought if all countries do not have the same tax rates for investment income. Capital import neutrality ensures economic efficiency in saving decisions by ensuring that all investors, regardless of where they reside, have the same incentive to save. Capital import neutrality does not ensure economic efficiency in the allocation of saving among various investment opportunities around the world, however. See Rosanne Altshuler, Recent Developments in the Debate on Deferral, 87 Tax Notes 255 (2000). Under the standard analysis, capital export neutrality yields the best result, even

### **b. Adding a Tax Revenue Constraint**

In a somewhat more general analysis, Christopher Findlay<sup>19</sup> considered a similar problem to that addressed by Horst, but Findlay assumed that tax authorities could vary the tax rates on investment income from both domestic and foreign investments and he recognized that the tax authorities had to meet a revenue need. Findlay examined, in particular, how countries should structure taxes on foreign investment income when there is a global revenue constraint and the capital-importing and capital-exporting country can share the revenue.

Although Findlay's analysis is broader than Horst's, he reaches similar conclusions. Like Horst's analysis, however, Findlay's analysis has been subject to criticism for ignoring the role of other income taxes.<sup>20</sup> For example, his analysis ignores the fact that an increase in the tax rate on investment income that discourages investment probably also would reduce revenue from the taxes on labor income (because the decrease in investment would also decrease the demand for labor).

### **c. More Recent Studies: Adding Other Income Taxes**

In later studies, using even more general analyses, Neil Bruce,<sup>21</sup> and Michael Keen and Hannu Piekola<sup>22</sup> demonstrate that it is important to account for taxes on labor income and on pure economic profits. In particular, they show that if tax rates on domestic income from labor and capital, including pure economic profits, are structured optimally in both the capital-exporting and capital-importing countries, then countries should choose an international tax policy that follows the principle of capital export neutrality. According to these studies, the tax structure that allocates capital most efficiently also allows the needed revenue to be raised with the lowest possible tax rate and therefore the smallest possible saving disincentive.

In their analysis, Keen and Piekola assume that both the capital-importing country and the capital-exporting country seek to maximize global welfare and cooperate to achieve that goal. In contrast, Razin and Sadka<sup>23</sup> ask what international tax policies countries will choose if they do

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when tax rates are different at home and abroad. It doesn't matter if savers in different countries face different rates of return, because the rate of return is assumed not to influence saving.

<sup>19</sup> Christopher C. Findlay, Optimal Taxation of International Income Flows, 62 Econ. Rec. 208-14 (1986).

<sup>20</sup> Neil Bruce, A Note on the Taxation of International Capital Income Flows, 68 Econ. Rec. 217-21 (1992).

<sup>21</sup> Id.

<sup>22</sup> Michael Keen and Hannu Piekola, Simple Rules for the Optimal Taxation of International Capital Income, 99 Scandinavian J. of Econ. 447-61 (1997).

<sup>23</sup> Assaf Razin and Efraim Sadka, International Tax Competition and Gains from Tax Harmonization, 37 Econ. Letters 69-76 (1991).

not cooperate, but instead each country seeks to maximize only its own national welfare. They found that if no country is large enough to influence global pretax rates of return,<sup>24</sup> then countries will adopt the system of residence taxation under which capital-importing countries would not tax inbound foreign investment income and capital-exporting countries would levy the same tax on income from domestic and foreign investment. The capital-exporting countries would thus adopt policies consistent with capital export neutrality.

James Mackie and Donald Rousslang<sup>25</sup> considered the slightly different problem faced by a capital-exporting country that wants to set its taxes to maximize global welfare, assuming that the capital-importing countries will not change their taxes. The authors find that, depending on the circumstances, the capital-exporting country would impose taxes on foreign investment income at a rate that is either higher or lower than the tax on domestic investment income. In particular, the best policy choice for the country will depend on whether it is able to impose optimal taxes on other types of income besides investment income and on whether its investments are large enough to influence global rates of return. The authors find that if the country is able to impose optimal taxes on the other types of income and is not large enough to influence global rates of return on investment, then it would maximize global welfare by choosing a tax policy that favors domestic investment over foreign investment. In the more realistic case, however, in which tax authorities are unable to impose optimal taxes on the other types of income or the country is sufficiently large that its taxes materially influence global pretax rates of return on investment, the authors found that there is little reason to believe that the best policy would involve favoring either domestic or foreign investment income.

#### **d. Adding Corporate and Non-corporate Sectors**

Another possible shortcoming of the standard analysis is that it assumes there is only a single form of capital investment, when in fact there are different forms of capital investment and they are often taxed at different rates, both at home and abroad. In particular, business income typically is taxed at the entity or owner level, depending on whether the business is organized as a corporation. Under a so-called classical system of corporate income taxation (such as the system used by the United States), corporate profits generally are effectively taxed twice, once when they are earned by the corporation and again when they are distributed as dividends to individual shareholders, or realized as capital gains. The analysis that follows assumes that the individual-level tax raises the cost of capital for corporations.<sup>26</sup>

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<sup>24</sup> A number of authors have assumed that this “small country” case is an acceptable approximation for the United States (i.e., the United States is not large enough to influence global pretax rates of return). See, e.g., Roy J. Ruffin and Farhad Rassekh, The Role of Direct Investment in U.S. Capital Outflows, 76 Am. Econ. Rev. 1126-30 (1986).

<sup>25</sup> James Mackie and Donald J. Rousslang, Office of Tax Analysis, U.S. Department of Treasury, The Optimal Taxation of Income From International Investment: A Geometric Analysis (1997) (mimeo).

<sup>26</sup> However, under the so-called “new view,” to the extent corporate investments are made from retained earnings, the individual-level tax on dividends does not affect the cost of capital.

When corporate income is taxed at a higher rate than income from non-corporate investment, this differential tax treatment tends to cause too much investment in the non-corporate sector and too little investment in the corporate sector.<sup>27</sup> That is, taxes distort the decision on whether to undertake investment using the corporate form in favor of using the non-corporate form. The higher corporate taxes can also distort corporate investment financing choices between equity and debt.

Another way that adding corporate and non-corporate sectors alters the standard analysis is to increase the importance of the effect tax changes may have on the supply of capital to the corporate sector. In Horst's model, this effect comes exclusively from the response of saving to changes in the after-tax rate of return, since his model contains only one kind of investment. If the standard analysis is used to prescribe the optimal way to tax income from corporate investment, however, it must be remembered that the supply of capital to the corporate sector can vary not only as a result of change in the overall saving, but also as a result of movements of capital between the corporate and non-corporate sectors. As the prior discussion in this chapter suggests, however, accounting for the response in the supply of capital to tax changes has no clear effect on the conclusion that capital export neutrality is the optimal policy for promoting global economic welfare.

To apply the principle of capital export neutrality to corporate investment, the capital-exporting country would set the domestic tax on income from corporate investment abroad such that the total tax on this income (the foreign and domestic taxes combined) is equal to the tax on income from domestic corporate investment. Under this scheme, a corporation organized in the capital-exporting country would require the same pretax rate of return for both domestic and foreign investment.<sup>28</sup>

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According to this view, only the individual tax on capital gains affects investment and that tax is small because of deferral and step-up in basis at death. See, e.g., Department of the Treasury, *Integration of the Individual and Corporate Tax Systems* 116-18 (January 1992).

<sup>27</sup> See, e.g., *id.* at 1-14.

<sup>28</sup> In practice, most capital-exporting countries defer the residence-based tax on income earned by corporate subsidiaries from active business pursuits abroad until the income is repatriated to the home country, or they exempt the income entirely from the local tax. When a residence-based tax is applied to the foreign investment income, a credit is usually available for foreign income taxes. The deferral feature of such systems violates the condition of capital export neutrality by providing a preference for foreign investments in low-tax countries. At the same time, the tax systems in most countries tend to discourage international investment in high-tax capital-importing countries. The credits allowed for foreign income taxes generally fail to restore capital export neutrality with respect to investment in high-tax countries, because the capital-exporting country generally limits the credits to the domestic tax due under the residence principle, although cross crediting (combining income and tax credits from different foreign investments) can sometimes restore it. Hence, according to the standard analysis, the current U.S. system, which provides deferral and limits foreign tax credits to the U.S. tax due on repatriated foreign investment income, generally violates the principle of capital export neutrality by simultaneously

It is possible to reduce the distortion that favors non-corporate investment over corporate investment by reducing the total tax on income from international corporate investment, by reducing the total tax on income from domestic corporate investment, or by reducing both taxes simultaneously. However, reducing only one of these tax rates, while it would reduce the distortion favoring non-corporate investment, would introduce a distortion in the choice between domestic and foreign corporate investments. For example, reducing only the tax on foreign investment income would cause domestic corporate investors to favor a foreign investment over a domestic alternative that has a higher pretax return. The tax bias against corporate investment, by itself, does not provide a compelling reason to favor foreign or domestic corporate investments if the overall goal is to minimize distortions in investment decisions.

**e. Adding Portfolio Investment Flows**

Daniel Frisch<sup>29</sup> has argued that the capital-exporting country should set a lower tax rate on foreign investment income of corporations if portfolio investment is highly mobile. He has argued that portfolio mobility allows investors in the capital-exporting country to avoid the local tax on corporate profits by investing directly in equities of foreign corporations that face a lower corporate tax rate in the capital-importing country, instead of investing abroad through domestic corporations that engage in foreign investment. In this case, the capital-exporting country's corporate income tax would cause less foreign investment by its domestic corporations, matched by greater portfolio investments in foreign companies by its domestic residents. If output of unaffiliated corporations in the capital-importing country and of capital-exporting country affiliates operating in the capital-importing country are perfect substitutes for each other, an attempt by the capital-exporting country to levy any tax on its corporation's foreign investment income in addition to the tax levied by the capital-importing country would merely cause the domestic corporations to lose foreign investment opportunities to foreign corporations, because domestic investors would invest directly in the shares of the foreign corporations.

Harry Grubert and John Mutti<sup>30</sup> question the conclusions reached by Frisch. In Grubert and Mutti's model, if taxes on income from U.S. investment abroad were reduced, the price of output from this U.S. investment abroad would fall relative to both other foreign output and U.S. domestic output. This would increase the quantity demanded of output from the U.S. foreign investment at the expense of both U.S. domestic output and other foreign output. The displaced U.S. domestic output would cause capital to move from the United States to U.S. foreign investment, whereas the displaced foreign output would cause capital to move from other foreign producers to U.S. foreign investment. The net effect on economic welfare is ambiguous. Grubert and Mutti conclude that even if portfolio capital were perfectly mobile, there is no

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encouraging too much investment in low-tax capital-importing countries and too little investment in high-tax capital-importing countries.

<sup>29</sup> Daniel Frisch, The Economics of International Tax Policy: Some Old and New Approaches, 47 Tax Notes 581-91 (1990).

<sup>30</sup> Harry Grubert and John Mutti, Taxing Multinationals in a World With Portfolio Flows and R&D: Is Capital Export Neutrality Obsolete?, 2 Int'l Tax and Pub. Fin. 439-57 (1995).

compelling reason to believe that global welfare would improve if the capital-exporting country taxes foreign investment income of its corporations at a rate lower than domestic investment income. In addition, they point out, contrary to Frisch's views on portfolio mobility, that investors do not appear to regard equities of foreign corporations as perfect substitutes for equities of domestic corporations. Indeed, they provide evidence that, in 1992, U.S. residents had less than four percent of their equity portfolios in foreign shares, and less than six percent of total U.S. corporate stock is owned by foreigners.<sup>31</sup>

### **3. Conclusion on Maximizing Global Welfare**

The literature on optimal taxation of foreign direct investment income suggests that, when the goal is to maximize global economic welfare, capital export neutrality is probably the best policy. The basic conclusions of the standard analysis, that the best policy is to impose equal taxes on domestic and foreign investment income, appear to provide the best guide for determining appropriate tax policy even when complicating factors introduced by later authors are considered. Thus, these conclusions still appear valid when the analysis is made more complicated by considering: (a) the possible effects of changes in the rate of return on the amount of saving; (b) the existence of different forms of capital investment, such as corporate and non-corporate investment, that are taxed at different rates; or (c) the ability to invest internationally through portfolio investments in foreign corporations as well as through foreign direct investment by domestic corporations.

#### **C. Promoting U.S. Economic Welfare**

##### **1. The Standard Analysis**

###### **a. General**

To maximize its national economic welfare, a country should set tax rates on income from foreign direct investment (inward or outward) to maximize the sum of the private benefit for local investors and tax revenue for the local government.<sup>32</sup> Using the simple framework of the standard analysis, Peggy Musgrave<sup>33</sup> has shown that, if the capital-exporting country's investments do not materially affect global rates of return, it would achieve this optimum if its tax rate on foreign investment income were set so that local investors were indifferent between investing at home or

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<sup>31</sup> Grubert and Mutti note that their findings are consistent with those of French and Poterba, who found that equity ownership is greatly undiversified on a worldwide basis. See id. at 448 (citing Kenneth French and James Poterba, NBER Working Paper No. 3609, Investor Diversification and International Equity Markets (1991)).

<sup>32</sup> As explained further in note 3, supra, and accompanying text, attempting to maximize national economic welfare (instead of global economic welfare) may not be in a country's long-term economic interests.

<sup>33</sup> Musgrave, supra note 4.

abroad when the total return<sup>34</sup> to the capital-exporting country is the same for each type of investment. This condition is referred to as national neutrality.<sup>35</sup> If this condition is met, a unit of capital invested abroad brings the same total return to the capital-exporting country as a unit of capital invested at home. In the standard analysis, the capital-exporting country can achieve national neutrality by taxing foreign investment income under the residence principle and allowing only a deduction (rather than a credit) for foreign income taxes. That is, the capital-exporting country denies deferral of its tax on foreign earnings and provides no foreign tax credit, but allows the company to deduct foreign income taxes as though they were ordinary business expenses.<sup>36</sup> The condition is not met if a credit is given for foreign taxes, or if the residence-based tax on foreign-source profits is deferred or forgiven. Similarly, James Mackie and Donald Rousslang<sup>37</sup> have concluded that the deduction for foreign income taxes (instead of a foreign tax credit) also maximizes the local welfare of the capital-exporting country if saving responds to the after-tax rate of return and if non-capital factor incomes are taxed optimally.

#### **b. Adding Market Power and Tax Policies in Other Countries**

Martin Feldstein and David Hartman<sup>38</sup> have observed that a large capital-exporting country may be able to take advantage of its market power to obtain a higher total return from its capital by imposing a higher tax rate on foreign investment than the rate on alternative domestic investments.<sup>39</sup>

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<sup>34</sup> As used throughout this section, the “total return” to the capital-exporting country is comprised of the after-tax return to the private investor plus the tax revenue collected by the capital-exporting country.

<sup>35</sup> Expressed mathematically, if DR is the pretax return on a domestic investment, FR is the pretax return on a competing foreign investment, and  $t_f$  is the tax imposed by the foreign country on the foreign investment, national neutrality exists if an investor is indifferent between the two investments when  $DR = FR(1 - t_f)$ . Under these circumstances, the total return to the capital-exporting country from the domestic investment (as defined in note 34, *supra*), will equal the total return to the capital-exporting country from the foreign investment (which is net of any foreign taxes paid).

<sup>36</sup> For example, assuming a 30 percent foreign tax rate and no credit for foreign taxes, an investor would be indifferent between a \$1000 foreign investment with an expected pretax return of \$100 and a competing \$1000 domestic investment with an expected pretax return of \$70. In this situation, if the capital-exporting country taxes the income from the foreign investment or the domestic investment currently and allows a \$30 deduction (but no foreign tax credit) for taxes paid to the foreign country, the investor’s taxable income from either investment will be \$70.

<sup>37</sup> Mackie and Rousslang, *supra* note 25.

<sup>38</sup> Martin S. Feldstein and David Hartman, The Optimal Taxation of Foreign Source Investment Income, 93 Q.J. of Econ. 613-29 (1979).

<sup>39</sup> The total return that the capital-exporting country receives from foreign investments of its residents is the return after foreign income and withholding taxes.

For a capital-importing country, the standard analysis implies that the optimal tax policy depends primarily on the responsiveness of inward investment to the local tax rate. This, however, depends in turn on the tax rules of the capital-exporting country, as well as the market power of the capital-importing country. For example, if the capital-exporting country allows a credit for foreign income taxes, the inflow of capital to the capital-importing country may be little affected by changes in the local tax rate, as long as it is less than the rate in the capital-exporting country. In this case, the capital-importing country has the incentive to tax the foreign investment income under the source principle at a rate that is no lower than that imposed by the capital-exporting country under the residence principle.<sup>40</sup>

If the capital-exporting country exempts or defers foreign-source profits of its domestic residents (or allows them to defer the residence-based tax on this income), or if it allows only a deduction for foreign income taxes, the optimal policy for the capital-importing country is a matter of balancing the lost revenue from lower taxes on inward investment income against the benefits of greater inward investment that can be obtained through lower tax rates. The optimum tax rate of the capital-importing country depends on the responsiveness of inward investment to the local tax rate. Several authors have shown that, under the following conditions, the optimum tax rate on inward investment income is zero: (a) the capital-importing country is too small to affect the rate of return to international investment, (b) capital is perfectly mobile internationally, and (c) the capital-exporting country does not provide a tax credit for income taxes paid to the capital-importing country.<sup>41</sup>

### **c. Adding Corporate and Non-corporate Sectors**

If corporate investment income is taxed at a higher rate than non-corporate investment income, the rules for maximizing the local benefit from international investment become more complicated.<sup>42</sup> Under the principle of national neutrality, the capital-exporting country would tax net foreign source corporate income (income earned abroad after deducting the foreign tax) at the same rate as it taxes domestic source corporate income. International capital flows would cause the total rate of return to corporate capital located in the home country (the private return plus

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<sup>40</sup> If the foreign investment income is taxed at a lower rate by the capital-importing country, an increase in the rate will increase tax revenue of the capital-importing country without discouraging any inward investment. An article by Roger H. Gordon discusses situations in which a “dominant” capital-exporting country effectively can support capital income taxation in small capital-importing countries. See Roger H. Gordon, Can Capital Income Taxes Survive in Open Economies?, 67 J. of Fin. 1159-80 (1992). If the capital-exporting country allows averaging of income and taxes on foreign source income from different countries, however, the optimum tax rate for the capital-importing country may differ from the tax rate in the capital-exporting country.

<sup>41</sup> See, e.g., Roger H. Gordon, Taxation of Investment and Saving in a World Economy, 76 Am. Econ. Rev. 1086-1102 (1986); Slemrod, supra note 7.

<sup>42</sup> See supra note 26 and accompanying text (discussing whether the U.S. corporate income tax actually causes new corporate investment to be taxed at a higher rate than non-corporate investment).

the domestic tax revenue) to be the same as the rate of return from foreign corporate investment after deducting the foreign tax. Because the corporate investment is taxed more heavily, however, there would be too much investment in the domestic non-corporate sector. Thus, the total return to the home country would rise if a dollar were taken from the domestic non-corporate sector and put into corporate investment at home or abroad.<sup>43</sup>

By itself, a distortion in favor of non-corporate over corporate investment provides no clear reason to favor foreign over domestic corporate investment. For example, eliminating the domestic tax on income from foreign corporate investment (leaving unchanged the tax rate on income from domestic corporate investment) would eliminate the difference between the total domestic returns from investment in the domestic non-corporate sector and corporate investment abroad, but it would cause domestic corporate investors to favor a foreign investment that yields a total return to the home country that is lower than the pretax return to the alternative domestic corporate investment. If the goal is to maximize the local benefit, these distortions (i.e., the distortions that favor investment that is both domestic and non-corporate) cannot be removed simultaneously as long as the domestic discrimination against corporate investment exists.

#### **d. Adding R&D**

Gary Hufbauer<sup>44</sup> has argued that U.S. tax policy should favor foreign investment with lower tax rates in order to encourage greater research and development in the United States, and it should not encourage corporations to move headquarters abroad. He points out that the United States would benefit from more headquarter service jobs and more jobs in research and development activities, all of which tend to be higher paying jobs. Grubert and Mutti<sup>45</sup> showed, however, that all of these benefits can be gained by cutting the tax on domestic corporate investment as well, because such tax cuts would also encourage more research and development and provide a tax incentive for companies to locate their headquarters in the United States. They also point out that there should be no presumption that a reduction in the tax on foreign investment would do more (and that it might well do less) to promote research and development in the United States than would a reduction in the tax on domestic investment income.<sup>46</sup> Thus, Hufbauer's argument provides no rationale for structuring taxes to favor foreign over domestic investment.

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<sup>43</sup> There would also be too much investment in the foreign non-corporate sector, and, accordingly, the total return to the home country would also rise if a dollar were taken from the foreign non-corporate sector and put into corporate investment at home or abroad.

<sup>44</sup> Gary C. Hufbauer, Institute for International Economics, U.S. Taxation of International Income, Blueprint for Reform (1992).

<sup>45</sup> Grubert and Mutti, supra note 30.

<sup>46</sup> They also note that expanding the credit for research and development expenses would be more effective than Hufbauer's proposed approach in promoting research and development.

**e. Adding Strategic Choices, Imperfect Competition and Economic Rents**

In a recent study, Michael Devereaux and Glenn Hubbard<sup>47</sup> have developed a model that incorporated strategic choices, imperfect competition and economic rents. In their model, if the host country does not tax the investment income, the capital-exporting country generally would be better off by deferring the home country tax on direct foreign investment income than by taxing the income currently. Their approach can be criticized for some of the same reasons as the earlier work by Horst,<sup>48</sup> however, because they ignore any revenue constraints on tax policy, they assume implicitly that the tax rate on income from local investment in the capital-exporting country is fixed so that only the tax rate on foreign investment income can be changed, and they do not account for taxes on other factor incomes, such as labor income taxes. Therefore, their analysis leaves unanswered the crucial question whether deferral of the residence-based tax on income from foreign investment would do more to improve national welfare in the capital-exporting country than a reduction in the tax rate on income from domestic investment when these other factors are considered.

**f. Adding Portfolio Investments**

Using a different analysis, Martin Feldstein<sup>49</sup> has argued that the United States might realize greater income by taxing foreign investment income at a lower rate than domestic investment income. He posits a model in which capital is not uniformly mobile internationally. In his framework, international capital movement is accomplished solely through direct investment undertaken by companies: other forms of international capital flows (portfolio equity investments and international debt flows) are assumed to net to zero for each country. Under these assumptions, outward foreign investment can increase the income of domestic residents, even when taxes are significant.

Feldstein's analysis is as follows. Investment by corporations is financed by debt as well as by equity. He assumes that the rate of return to equity is higher than the rate of return to debt and that the corporation therefore makes a profit on investment financed by debt. Also, U.S. companies investing abroad tend to borrow heavily from foreign lenders. Thus, by taking advantage of the spread between equity returns and debt payments to foreign lenders, U.S. companies investing abroad can bring back greater net returns from the exported capital (including the spread on capital borrowed from foreign lenders), even after paying foreign taxes, than the pretax income the capital would have earned if it had been invested locally in the United

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<sup>47</sup> Michael P. Devereaux and Glenn Hubbard, American Enterprise Institute, Seminar Series in Tax Policy, Taxing Multinationals (1999).

<sup>48</sup> Horst, supra note 13.

<sup>49</sup> Martin Feldstein, NBER Working Paper No. 4689, Taxes, Leverage and the National Return on Outbound Foreign Direct Investment (1994).

States.<sup>50</sup> For example, assume a corporation has \$100 of equity to invest and can choose identical, equally leveraged investments either in the United States or abroad. According to Feldstein's analysis, if the corporation invests in the United States, borrowing from U.S. lenders, the total return to the United States would be lower than the return to the United States from the foreign investment (funded by foreign borrowing), because, in the case of the foreign investment, the United States would capture the return on the \$100 of equity plus the spread on the capital borrowed from the foreign lenders.

Feldstein's conclusions depend on the differences in international mobility of different types of investment. He cites empirical work<sup>51</sup> to support the notion that debt and other portfolio capital is not internationally mobile. His assumptions about the mobility of foreign direct investment and portfolio capital flows are not consistent with other empirical research, however, such as that by Roy Ruffin and Farhad Rassekh,<sup>52</sup> who find that U.S. international portfolio flows and direct investment flows largely cancel each other.<sup>53</sup> Moreover, Feldstein does not show that U.S. economic welfare would be higher, even if debt is internationally immobile, because he does not account for the cost in terms of increased risk faced by U.S. investors as a result of being more highly leveraged.

## 2. Conclusion on Maximizing National Welfare

The literature on optimal taxation of foreign direct investment income when the goal is to maximize national economic welfare provides no convincing basis for rejecting the conclusions of the basic economic analysis that a country should tax income from outward foreign investment at a rate that is at least as high as the tax rate imposed on income from domestic investment. This conclusion appears to be valid, even if the possible effects of changes in the rate of return on the amount of saving are considered, if the country simultaneously imports and exports capital, if it is recognized that international mobility of capital may be different for equity investments and debt investments and so international investment offers U.S. domestic residents an opportunity to become more highly leveraged, and if international investment can be accomplished through

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<sup>50</sup> Note that in Feldstein's analysis, the individual U.S. company making a foreign investment does not make the foreign investment to gain greater leverage; its leverage presumably is chosen based on borrowing costs, regardless of where it invests. If the company borrows abroad, however, there is no adverse effect on borrowing costs of *other* U.S. companies that compete for the domestic pool of debt capital.

<sup>51</sup> Martin Feldstein, NBER Working Paper No. 4668, The Effects of Outbound FDI on the Domestic Capital Stock (1994).

<sup>52</sup> Ruffin and Rassekh, supra note 24.

<sup>53</sup> Ruffin and Rassekh assume all capital is homogeneous. Accordingly, their analysis calls into question Feldstein's assumption that U.S. lenders make loans within the United States and foreign lenders make loans outside the United States. See infra Appendix B (review of literature on international capital mobility).

portfolio investments in foreign corporations as well as through foreign investments by corporations.

#### **IV. The Economic Effects of the Foreign-to-Foreign Related Party Rules**

##### **A. Introduction**

This section examines how the foreign-to-foreign related party rules of subpart F affect global and U.S. economic welfare and U.S. tax revenue. For purposes of this part, the term “foreign-to-foreign related party rules” refers to (a) the subpart F rules that treat as foreign personal holding company income dividends and interest received from a related corporation organized in a different country than the controlled foreign corporation or rents and royalties received from a related corporation for the use of property outside of the country where the controlled foreign corporation is organized,<sup>54</sup> (b) the foreign base company services income rules, and (c) the foreign base company sales income rules.<sup>55</sup> The term “foreign-to-foreign related party transactions” refers to transactions that give rise to income that would be characterized as subpart F income under the foreign-to-foreign related party rules. When this chapter uses the term “foreign-to-foreign related party transactions,” however, it is examining the effect of these transactions in the absence of the application of the rules of subpart F.

Section III of this chapter considered whether it might be beneficial to tax outbound foreign investment income at a rate different from that imposed on income from U.S. domestic investment when there is a single foreign tax rate on the foreign investment income. In this section, the analysis is expanded to consider how investment may be affected if investors may choose between investments in various foreign countries with widely divergent tax rates, in order

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<sup>54</sup> In general, interest and dividend payments received from a related corporation organized in the same country as the controlled foreign corporation and rents and royalties received from a related corporation for the use of property within the controlled foreign corporation’s country of organization are excluded from subpart F income. See supra Introduction, section IV (discussion of foreign personal holding company income rules).

<sup>55</sup> This chapter does not, however, address the foreign base company sales income rules or the foreign base company services income rules to the extent that these rules apply to the U.S. export or import of goods or services to or from U.S. affiliates. There are two reasons for not examining the related party rules as applied to U.S. exports or imports in this study. The first reason is that these rules, as applied to U.S. exports and imports, mainly prevent income from being shifted away from the United States through transfer pricing manipulations, whereas the other related party rules mainly prevent income from being shifted away from foreign host countries. The second reason is that the related party rules, as applied to U.S. exports, have different effects on investment incentives than the other related party rules. The related party rules generally influence foreign investment decisions through their effect on the tax rate on income from foreign investments. In contrast, the related party rules, as applied to U.S. exports, influence domestic investment decisions through their effect on the tax rate on profits from production of U.S. exports.

to take into account the fact that policy decisions may affect the tax imposed on U.S. foreign investment in some host countries by more than in others.

## **B. The Effects on Global Economic Welfare**

The foreign-to-foreign related party rules affect global economic welfare to the extent that they influence business decisions of companies and of individuals. For companies, the rules are one of the many factors that may influence the decision about where to locate new investment (at home or abroad, and if abroad, in which foreign country), how much to invest, and whether to invest in physical assets or to develop new technology. The rules can also affect economic decisions by individuals about how much to save and whether to invest in corporate or non-corporate enterprises.

As among these decisions, discussion is limited to focus on how the rules can affect a company's decision about where to locate new investment, because this is probably the most important way the rules can affect economic welfare. The standard framework introduced in the previous section of the chapter, in which there is only one form of capital investment and saving is not influenced by changes in the rate of return, is used because the literature does not reveal a superior approach. Thus, the analysis ignores the possible effect that taxes may have on the total amount of corporate investment or on the mix of corporate investment between tangible and intangible assets. In the analysis, global economic welfare improves if greater output can be produced from the same amount of capital merely by moving it from less productive to more productive business activities. Finally, it is assumed that foreign governments would not respond to changes in U.S. tax rules.

This subsection begins by examining the effect that deferral in general has on the allocation of investments among countries. The narrower issue of the effects of the foreign-to-foreign related party rules on this allocation is then considered.

### **1. Effects of Deferral on the Allocation of Corporate Investments among Countries**

As discussed previously, under the standard economic analysis, the greatest global output is achieved if the capital-exporting country follows the principle of capital export neutrality. If the principle is not applied, for whatever reason, different tax rates may apply to investment income earned in different countries, so the pretax rates of return may differ among countries. Under these circumstances, a country with a low tax rate will tend to attract too much capital, whereas a country with a high tax rate will tend to attract too little capital. In particular, if the total tax rate (including both home and host country taxes) on investment income in a capital-importing country is lower than that on investment income in the capital-exporting country, then there will be too much foreign investment in the capital-importing country. In this case, global output and the allocation of capital could be improved by increasing the tax rate on the investment income earned in the capital-importing country.

To see how closely current tax policies agree with the prescriptions from the standard analysis, consider the overall averages of the effective tax rates faced by U.S. manufacturing subsidiaries abroad. These tax rates represent income taxes paid to foreign host countries divided by the subsidiary's current taxable income as defined by U.S. tax rules. The income usually is close to book income.<sup>56</sup> The tax rates are displayed in the last column of Table 1 for every other year from 1980 through 1996.<sup>57</sup> The table also provides detail on how the tax rates are distributed across countries and how that distribution has changed over time. To show the distribution across countries, the tax rates are grouped into percentiles, according to the assets of the manufacturing subsidiaries in each country. For example, the table shows that in 1980, 40 percent of the assets were in countries where the average effective tax rate on income of U.S. manufacturing subsidiaries was less than 29 percent. By 1996, however, 80 percent of the assets were in countries where the average effective tax rate was less than 29 percent.

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<sup>56</sup> Appendix C, section I, *infra*, describes the methods used to calculate these tax rates. As explained in Appendix C, the tax rate for a country in any year can be misleading, owing to cyclical losses. The cyclical effects cannot be eliminated by looking only at profitable subsidiaries, because losses carried forward from a previous year will influence the foreign taxes paid in the current year.

<sup>57</sup> 1996 is the last year for which comprehensive data on foreign operations of U.S. corporations currently exists.

**Table 1**  
**Country Average Tax Rates 1/**  
**Variations Across Countries By Year**  
**Foreign Manufacturing Subsidiaries of U.S. Companies**  
**(Statistics Weighted By Assets)**

Year	Tenth	Twentieth	<u>Percentiles:</u> Fortieth	Sixtieth	Eightieth	Average Foreign Rate
1980	21 %	26 %	29 %	38 %	39 %	33 %
1982	21	26	28	30	45	31
1984	20	30	36	37	49	35
1986	18	28	36	38	39	34
1988	22	26	31	33	34	30
1990	20	20	27	32	33	27
1992	13	18	22	29	33	24
1994	12	17	21	23	29	21
1996	11	15	20	24	29	21

1/ This table shows the variation across countries of average tax rates (not including withholding taxes imposed on repatriated earnings) for manufacturing firms based upon the assets in each country. Each entry in the table is a tax rate. The row identifies the year and the column identifies the percentile of the distribution for that year. For example, the cell with an entry of 12 in the column headed "Tenth" and the row labeled "1994" can be read as follows: In 1994, 10 percent of assets were in countries with average tax rates of less than 12 percent. A country is included only if there were more than five manufacturing subsidiaries with positive earnings and profits after taxes in that country for every year.

The data in Table 1 show that the average of the foreign host country tax rates on the income of foreign manufacturing subsidiaries of U.S. companies declined from 33 percent in 1980 to 21 percent in 1996. By comparison, the average tax rate on domestic income of U.S. manufacturing corporations was 31 percent in 1996.<sup>58</sup>

Of course, other taxes may be imposed on foreign investment income. Foreign subsidiaries often distribute part of their earnings to the U.S. parent company, even though this means incurring withholding taxes in the host country and sometimes a residual U.S. tax. However, the effective rate of the residual U.S. tax on foreign earnings is often negative. That is, the total foreign and U.S. tax on repatriated earnings (including dividends, interest and royalties)

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<sup>58</sup> This average U.S. tax rate was calculated to be comparable to the foreign tax rates by conforming U.S. income as closely as possible to book income from domestic investments. For a detailed discussion of how this rate was calculated, see *infra* Appendix C, section III.

may be less than the taxes imposed by the foreign host country.<sup>59</sup> In particular, the residual U.S. tax on repatriated earnings often is less than it would be if the United States had a territorial system that exempted dividends from foreign subsidiaries from U.S. tax. This happens because, under current U.S. tax rules, foreign income taxes can be credited against the U.S. tax on the fee, royalty and interest payments that a U.S. parent receives from its foreign subsidiaries. In addition, under the sales source rules, the U.S. parent can apply excess foreign tax credits against a portion of the profits from its U.S. export sales.<sup>60</sup> In effect, this amounts to rebating part of the taxes the company pays to foreign governments. No such rebate would be available under a pure territorial system. Rather, under a territorial system that exempts dividends from active foreign business earnings and that provides a foreign tax credit only for foreign withholding taxes, all of these income items would be taxed at the full U.S. corporate income tax rate with a credit only for the withholding taxes on the fees, royalties and interest.

The present value of the residual, but deferred, U.S. tax on retained earnings of foreign subsidiaries is often negligible: the longer the tax is deferred, the smaller is its present value. In 1994, the average effective rate of total tax, including the foreign host country income tax, any foreign withholding taxes, and the residual U.S. tax, on all repatriated foreign earnings in the general basket, which contains almost all of the earnings from the manufacturing subsidiaries, was approximately 26 percent.<sup>61</sup>

This average effective rate of total tax on foreign earnings indicates that the tax rate on foreign investment income was lower than that on U.S. domestic investment in 1996. Hence, the standard economic analysis described in the previous chapter implies that the deferral of the residual U.S. tax on foreign earnings has tended to worsen the global allocation of capital. The analysis does not imply, however, that just any change in U.S. tax rules that raises the tax on foreign investment income necessarily would improve the allocation of capital. There are a number of capital-importing countries, each with its own effective tax rate on investment income, and a change in U.S. policy that increases the total tax rate for investments in some countries more than others may improve or worsen the allocation of capital, as discussed further below.

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<sup>59</sup> For example, Grubert and Mutti, *supra* note 30, calculated that the residual U.S. tax on foreign earnings was negative and amounted to a subsidy of 2.6 percent to foreign operations in 1990.

<sup>60</sup> Under Treas. Reg. § 1.863-3, income derived from the sale of inventory property produced in the United States and sold abroad or produced abroad and sold within the United States is sourced partly within and partly outside the United States under one of the methods provided in the regulations.

<sup>61</sup> Appendix C, section II, *infra*, explains in detail how this rate was calculated. Because U.S. companies can combine foreign earnings and foreign taxes on their U.S. tax return when claiming the foreign tax credit, the total average effective tax rate on overall foreign earnings, including the repatriation tax, cannot be calculated for individual host countries.

## 2. The Effects of the Foreign-to-Foreign Related Party Rules on the Allocation of Corporate Investments among Countries

The data in Table 1 show that average foreign tax rates on foreign manufacturing subsidiaries of U.S. companies differ substantially among countries, which implies that there are likely to be substantial differences in pretax rates of return investors would expect to earn on new investments in different countries.<sup>62</sup> A method of limiting deferral that primarily reduces the tax advantage where tax rates are lowest would offer the best chance for improving the global allocation of capital. This is true because capital moved away from the low-tax countries is more likely to end up in other countries where the local tax rates, and hence the required pretax rates of return, are higher.

The higher the tax rate in the country where the foreign investment is located, the more the subpart F foreign-to-foreign related party rules tend to raise the total tax rate on foreign investment income (i.e., by preventing the shifting of income from that high-tax country to a low-tax country).<sup>63</sup> As a result, these rules have ambiguous effects on the allocation of capital. The question is whether raising the rate of tax on investment in countries where the investment is not particularly low-taxed leads investors to move investments away from those countries to countries where investment income is taxed at a higher rate and pretax rates of return are higher, or to countries where the income is taxed at a lower rate and pretax rates of return are lower.<sup>64</sup> To the extent that the investments are moved to countries where the pretax rates of return are higher, the global allocation of capital tends to improve and global pretax income tends to rise. To the extent the investments are moved to countries where the pretax rates of return are lower, global pretax income tends to fall. The net effect on global pretax income is ambiguous, that is, global income can rise or fall as a result of the investment shifts. The box contains a numerical example that demonstrates in greater detail how the response of investment flows affects global income and what determines whether the net effect is likely to be an increase or a decrease in global income.

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<sup>62</sup> That is, there are likely to be differences in true pretax rates of return (the rates of return adjusted for the riskiness of investments) that investors expect. Note, however, that data on reported earnings and amount of investment may poorly reflect these true, expected pretax rates of return for a number of reasons. One reason is that investment flows tend to bring equality to the *ex ante* (i.e., anticipated) rates of return and the observed earnings are *ex post*, so they do not reflect risks associated with the investments. Another reason is that reported earnings can be distorted by income shifting. For example, countries with very low local tax rates often have observed pretax rates of return that are substantially higher than those in countries with much higher tax rates, which suggests that income is being shifted to the low-tax jurisdictions.

<sup>63</sup> In other words, in the absence of the subpart F foreign-to-foreign related party rules, income shifting through foreign-to-foreign related party transactions would reduce taxes on investment in high-tax jurisdictions more than it would reduce taxes on investment in low-tax jurisdictions. See *infra*, note 67 for further explanation.

<sup>64</sup> The reason lower taxes tend to be accompanied by lower pretax rates of return and higher taxes tend to be accompanied by higher pretax rates of return is explained in the box in section III.B.1, *supra*.

***The Effect of Foreign-to-Foreign Related Party Transactions on the Allocation of Capital, Absent the Application of the Subpart F Rules, a Numerical Example***

*The following example illustrates how foreign-to foreign related party transactions might affect the allocation of capital among countries. Suppose that investment opportunities of U.S. companies are divided into three groups: investments in the United States, investments in a high-tax foreign country, and investments in a low-tax foreign country. To keep the example as simple as possible, suppose also that related party transactions are used to reduce only the tax rate in the high-tax foreign country and that the amount of the tax reduction is small. Finally, suppose that the effective total tax rate on investment income is 30 percent in the United States, 20 percent in the high-tax foreign country and 10 percent in the low-tax foreign country, and that the required annual after-tax rate of return for a U.S. corporate investor choosing among the three locations is 10 percent.*

*Under these conditions, to provide the required after-tax return of 10 percent, the investment in each country would be required to provide a pretax return equal to 10 percent divided by one minus the tax rate. Thus, the required pretax return would be 14.3 percent in the United States, 12.5 percent in the high-tax foreign country and 11.1 percent in the low-tax foreign country.*

*Now, suppose that foreign-to-foreign related party transactions can be used to reduce slightly the tax rate faced by U.S.-owned subsidiaries in the high-tax foreign country. This would make investment in the high-tax foreign country more attractive compared to investment in the United States or in the low-tax foreign country, so it would attract capital to the high-tax foreign country from both the United States and the low-tax foreign country. If equal amounts of capital were attracted from both locations, there would be an annual net loss in global output equal to \$2 for each \$1,000 of investment that moved to the high-tax foreign country. The net loss is composed of the following elements. There would be a loss of \$9 for each \$500 of investment that the high-tax foreign country attracts from the United States ( $= .125 \times \$500$  minus  $.143 \times \$500$ ). However, this loss in output would be partly offset by a gain of \$7 of output for each \$500 of investment that the tax reduction would attract from the low-tax foreign country ( $= .125 \times \$500$  minus  $.111 \times \$500$ ).*

*If the high-tax foreign country attracted more capital from the low-tax foreign country than from the United States, the reduction in effective tax rates achieved through the use of foreign-to-foreign related party transactions might improve the global allocation of capital. If the foreign-to-foreign related party transactions reduced the tax rates in the high-tax foreign country by a large amount, however, then it becomes more likely that such transactions will worsen the global allocation of capital by attracting more capital from the United States than from the low-tax foreign country. Thus, capital attracted from the low-tax foreign country would provide a smaller efficiency gain, whereas capital attracted from the United States would impose a greater efficiency loss.*

Thus, there are two main pieces of information that are needed to evaluate how foreign-to-foreign related party transactions<sup>65</sup> might affect the global allocation of capital. These are the effects of the transactions on the required pretax rates of return and the effects on investment in the various locations. For example, if such transactions reduce tax rates on all foreign investments below the rate in the United States (and pretax rates of return are thus lower abroad than at home), and if the main effect on investment is to cause capital to flow from the United States to the foreign locations, then they would worsen the global allocation of capital. In contrast, if the transactions reduce tax rates only in countries where taxes are very high (and pretax rates of return are high), and if the main effect on investment is to cause capital to flow to these countries away from countries with lower tax rates (and with lower pretax rates of return), then they would improve the global allocation of capital. There is a great deal of uncertainty among economists about the mobility of U.S.-owned capital among foreign countries compared with its mobility between the United States and foreign countries; none of the existing empirical studies provide such a comparison.<sup>66</sup>

It is not known how much foreign-to-foreign related party transactions might alter required pretax rates of return on foreign investments, though it is reasonable to suppose that the reduction in foreign taxes that can be accomplished through foreign-to-foreign related party transactions depends on the initial foreign tax rate. Foreign-to-foreign related party transactions probably reduce the tax rates by a smaller amount and, hence, reduce the required pretax rates of return by less in the low-tax foreign countries than in the high-tax foreign countries.<sup>67</sup> Accordingly, foreign-to-foreign related party transactions probably pull capital away from the United States towards both high-tax and low-tax foreign locations and cause U.S.-owned capital to flow from the low-tax foreign countries to the high-tax foreign countries. The pull on capital

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<sup>65</sup> As noted previously, references in this part to the “foreign-to-foreign related party transactions” refer to the effect of those transaction in the absence of the application of the rules of subpart F.

<sup>66</sup> See *infra* Appendix B (review of literature on international capital mobility).

<sup>67</sup> The higher the initial foreign tax rate, the more likely it is that foreign-to-foreign related party transactions will significantly reduce foreign taxes (and thus reduce required pretax rates of return). Accordingly, taxpayers in high-tax jurisdictions will have a greater incentive to engage in such transactions. For the same proportional reduction in tax rate in the example set forth above, the proportional reduction in the required pretax rate of return would be more than twice as great in the high-tax country as in the low-tax country. Using the tax rates set forth in the example above, assume that related party transactions allow for a 10 percent reduction in the tax rate in both the high-tax country and the low-tax country. Thus, the rate of tax in the high-tax country is reduced from 20 percent to 18 percent, and the rate of tax in the low-tax country is reduced from 10 percent to 9 percent. The required pretax rate of return in the high-tax country would decrease from 12.5 percent to 12.2 percent, while the required pretax rate of return in the low-tax country would only decrease from 11.1 percent to 11.0 percent. For small changes, this can be expressed mathematically in the following manner: the proportional change in the required pretax rate of return equals  $t/(1 - t)$  multiplied by the proportional change in the tax rate, where  $t$  is the initial tax rate.

away from the United States to the high-tax foreign countries should be stronger than the pull away from the low-tax foreign countries to the high-tax foreign countries, because the required pretax rate of return should decline by more in the high-tax foreign countries compared to the United States (where it remains unchanged) than compared to the low-tax foreign countries (where it also declines).<sup>68</sup>

Further, the U.S. multinational companies hold much more capital in the United States than in low-tax foreign countries. In 1994, U.S. manufacturing parents had about 37 percent of their total manufacturing investment abroad. According to the data in Table 1, only about 10 percent of the foreign investment abroad was in countries with a tax rate of 12 percent or less.<sup>69</sup> Thus, if investments in the different countries were equally substitutable (a somewhat arbitrary assumption), the amount of U.S. domestic investment that would move to the high-tax foreign countries as a result of effective tax rate changes caused by foreign-to-foreign related party transactions would exceed the amount of U.S.-owned capital that would move to high-tax foreign countries from the low-tax foreign countries. Further, there probably would be relatively little U.S. domestic investment that would move to the low-tax foreign countries. This is because there is relatively little capital in the low-tax foreign countries, and because the foreign-to-foreign related party transactions should have little effect on the local required pretax rates of return in these countries.

Even if we accept these presumptions about the effects of the foreign-to-foreign related party transactions, however, it would be difficult to say whether such transactions are more likely to improve or worsen the global allocation of U.S. manufacturing assets.

### **C. The Effects of the Foreign-to-Foreign Related Party Rules on U.S. Tax Revenue and on U.S. Domestic Economic Welfare**

#### **1. The Effects on U.S. Tax Revenue**

In general, limiting deferral of the U.S. (residual) tax on foreign income would increase U.S. tax revenue, whether or not it would encourage more domestic and less foreign investment. Taxpayers have argued, however, that foreign-to-foreign related party transactions are used only to reduce foreign taxes and that such transactions actually may increase the U.S. tax revenue by increasing the residual U.S. tax on repatriated foreign earnings.

There are several reasons to believe that U.S. tax revenue will be reduced by allowing taxpayers to defer income from foreign-to-foreign related party transactions, however. First, to the extent that the foreign tax reductions cause capital to leave the United States in favor of tax-

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<sup>68</sup> This result is illustrated in the numerical example in the box on page 48, *supra*.

<sup>69</sup> According to data from the U.S. Department of Commerce, in 1994 U.S. manufacturing parents had domestic assets of \$1,164 billion, whereas foreign manufacturing affiliates of U.S. parents had total assets of \$678 billion. See U.S. Department of Commerce, U.S. Direct Foreign Investment Abroad: 1994 Benchmark Survey, Final Results (1988).

avored foreign investment opportunities, the transactions reduce total U.S. income and the U.S. tax base. Though the degree of international capital mobility, and hence the amount of the capital outflow, are subject to debate,<sup>70</sup> taxes are one of many factors that may influence investment flows.<sup>71</sup>

Second, related-party transactions will lead to an increase in the number of locations in which U.S. investment income faces a tax rate that is lower than the U.S. tax rate. Because companies have an incentive to attribute as much of their income as possible to locations in which it will face a lower tax rate,<sup>72</sup> the increase in the number of low-tax locations will put additional

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<sup>70</sup> See infra Appendix B (literature review on international capital mobility).

<sup>71</sup> A recent study disputes the view that direct foreign investment outflows reduce investment income subject to U.S. tax. Jason Cummins and Kevin Hassett have recently argued that a reduction in foreign income taxes may actually cause U.S. multinational companies to expand investment both at home and abroad. See Jason Cummins and Kevin Hassett, American Enterprise Seminar Series in Tax Policy, Structural Estimates of Factor Substitution from Firm-Level Panel Data on Multinational Corporations (Feb. 19, 1999) (conference paper). The analysis ignores the effects on other U.S. companies, however, that may lose investment opportunities to the multinational companies benefitting from the foreign tax breaks. For example, suppose the multinational companies expand mostly abroad, but sell most of the increased output in the United States, displacing U.S. domestic production. Then the net result could be a loss in U.S. domestic investment.

<sup>72</sup> It has been argued that foreign-to-foreign related party transactions affect only the average tax rate on investment income and that they therefore do not affect the incentives to shift income, which depend on the statutory tax rates at the origin and destination. This argument is incorrect. The following two examples show how the ability to use foreign-to-foreign related party transactions encourages a U.S. company to shift income away from the United States, even though there is no change in statutory tax rates at home or abroad. In the first example, the U.S. company has a subsidiary in a country with a statutory tax rate higher than that in the United States. The company would have an incentive to finance part of the subsidiary's operations with loans from the U.S. parent, giving interest income to the U.S. parent and an equivalent deduction from taxable income to the subsidiary. If the company routed the loan through a subsidiary in a tax haven, the interest payments would be subject to current U.S. tax under subpart F, so there is no incentive for such routing. However, there is a clear incentive to route the loan through a hybrid entity in a tax haven, one that appears for U.S. tax purposes to be a branch of the subsidiary, but to the subsidiary's host country appears to be a separately incorporated entity. In this case, instead of generating interest income to the United States, the loan generates interest income to the hybrid entity, and the income is not subject to current tax under subpart F. In the second example, the foreign subsidiary effectively splits the profits from its operations with a hybrid entity by paying a royalty for intangible assets the hybrid got by sharing development costs with the U.S. parent. In this case, the effective tax rate on a dollar of profits shifted from the U.S. parent to the subsidiary's operations is an average of the statutory tax rates of the countries hosting the subsidiary and the hybrid entity. Without a hybrid arrangement, the royalty payments would be subject to current U.S. tax under subpart F.

pressure on administration of U.S. transfer pricing rules. U.S. multinational corporations transfer hundreds of billions of dollars of goods and services between related parties in the United States and their foreign subsidiaries annually. Even a small change in the prices charged for these transfers could create a substantial revenue loss to the United States. The opportunity to make deductible payments (such as interest or royalty payments) to a low-tax location also reduces the incentive to make such payments to the U.S. parent company. That U.S. companies appear to engage in such tax minimization strategies is evident from readily observed tax planning activities and, in addition, has been substantiated by a number of academic studies.<sup>73</sup>

Finally, the effects on U.S. tax revenue depend on how the transactions increase profits of U.S. foreign subsidiaries, on how much of these profits are paid as dividends to U.S. investors, and on how the U.S. residual tax affects repatriations to the U.S. parent. On average, however, the residual U.S. tax on foreign source income in the general (“active”) basket is quite small, suggesting that U.S. investors generally choose not to repatriate earnings if such repatriation will result in a significant residual U.S. tax liability. Accordingly, it is likely that little revenue can be expected from any reduction in foreign taxes that might occur as a result of foreign-to-foreign related party transactions.

## **2. Effects on U.S. Economic Welfare**

As is evident from the discussion in section III, there is no precise consensus among economists on how best to structure U.S. taxes on foreign investment income when the goal is to maximize the national economic welfare in the United States. There is, however, no convincing evidence for the contention that the optimal tax structure would involve taxing foreign investment income more lightly than domestic investment income.

If the subpart F foreign-to-foreign related party rules were tightened to eliminate opportunities for their avoidance, however, the effect that this greater enforcement of the rules would have on the national U.S. economic welfare is also ambiguous. In the short run, real investment may be largely unaffected by tightening the rules, in which case the main effect would be to cause a transfer of revenue from U.S. companies to both the U.S. Government and to foreign governments. In that case, however, the loss to U.S. companies that use the transactions would be greater than the gain in U.S. tax revenue, because some companies would structure their business without foreign-to-foreign related party transactions, thus causing them to pay greater foreign tax.

In the long run, however, tightening the foreign-to-foreign related party rules would cause companies to choose U.S. investment rather than foreign investment, which could produce a net national gain in economic welfare. The gain would come partly from greater productivity of U.S. labor, which would accompany the greater domestic investment, and partly from greater U.S. tax collections (in place of foreign tax collections) on U.S. investment income.

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<sup>73</sup> See *infra* Appendix D (review of literature on international income shifting by multinational corporations).

## V. Conclusions Relating to Economic Welfare and the Taxation of Foreign Income

A principal goal of subpart F was to promote economic efficiency by preventing U.S. companies from shifting income away from the United States or from other non-tax-haven countries to foreign tax havens. This chapter considered whether preventing income shifting from the United States or other non-tax-haven jurisdictions to foreign tax havens is still a valid economic goal and how well subpart F (as an economic matter) actually achieves this goal. To do this, the chapter first examined what is known about the best way to tax international investment income. It then looked at the narrower question of how the subpart F foreign-to-foreign related party rules likely affect economic welfare.

A basic economic analysis indicates that capital export neutrality is probably the best policy for promoting economic efficiency in a tax system that includes taxes on income of capital. This standard analysis makes a number of perhaps overly simplistic assumptions in order to facilitate a rigorous analysis. Researchers advanced our understanding of this issue by examining whether the conclusions of the standard analysis are sensitive to changes in the assumptions or the structure of the economic model. A careful review of the literature finds that the implications of the standard analysis are robust. Previous studies that concluded that foreign investment income should be taxed at a lower rate than domestic investment income typically have embedded in them unjustified implicit assumptions about constraints on tax policy. In certain studies, for example, the tax rate on domestic investment income is fixed and only the tax rate on foreign investment income can be changed, and factor incomes besides capital income are not taxed.<sup>74</sup> Other studies assume that the development of new technology is not sufficiently promoted through current U.S. tax treatment of research and development expenditures and that there is no more efficient means of promoting research and development other than reducing the tax rate on international investment income.<sup>75</sup> Absent such constraints, there appears to be little reason to abandon the conclusions from the simple, standard analysis, which concludes that foreign investment income should be taxed no lower than domestic investment income.<sup>76</sup>

Whether the goal of U.S. tax policy is to maximize the global or the national U.S. economic welfare, it generally would be beneficial to reduce the disparities in tax rates that cause investment income earned in foreign countries to be taxed at lower rates than investment income earned in the United States. This reduction in tax rate disparities should improve the allocation of capital by encouraging it to move to locations where the pretax rate of return is higher. In general, reducing such tax rate disparities where they are greatest (in most cases, where the foreign tax rates are lowest) is even more likely to improve global and U.S. economic welfare.

On the other hand, the current subpart F foreign-to-foreign related party rules may not in every case be the most effective way to increase global and U.S. economic welfare. Application

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<sup>74</sup> Horst, supra note 13; Devereaux and Hubbard, supra note 47.

<sup>75</sup> Hufbauer, supra note 44, and Frisch, supra note 29.

<sup>76</sup> Richman, supra note 4; Musgrave, supra note 4; and Hufbauer, supra note 26.

of the foreign-to-foreign related party rules tends to raise the overall tax by more for investments in high-tax foreign countries than for investments in lower-tax foreign countries. Allowing U.S. companies to reduce foreign tax burdens through foreign-to-foreign related party transactions would have an uncertain effect on the global allocation of capital and U.S. economic welfare. The result depends on how the foreign-to-foreign related party transactions reduce the variation in effective foreign tax rates, how much they reduce the overall level of these tax rates, and the response of international investment flows.

The effect of the subpart F foreign-to-foreign related party rules on tax revenue, however, must also be considered. Because foreign-to-foreign related party transactions reduce foreign taxes, these transactions make foreign investments more tax-favored. To the extent foreign tax reductions provide an incentive for capital to move abroad, limiting deferral on income from foreign-to-foreign related party transactions protects the U.S. tax base.

## CHAPTER 4

### COMPETITIVENESS AND THE TAXATION OF FOREIGN INCOME

#### I. Introduction

When subpart F was enacted, consideration was given not only to its effect on economic welfare but also its effect on the competitiveness of U.S. business.<sup>1</sup> Given the focus on multinational competitiveness when subpart F was enacted, this chapter evaluates whether subpart F has materially affected the competitiveness of U.S. business and, in particular, whether subpart F places U.S.-owned foreign corporations at a tax disadvantage with regard to their foreign-owned competitors. For purposes of this chapter, competitiveness is defined as a measure of the ability of firms headquartered in the United States with production facilities abroad to compete in foreign markets with residents of the host country and other multinational firms based elsewhere. Concerns about competitiveness may conflict with overall economic welfare goals. For example,

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<sup>1</sup> In a 1991 committee print prepared for hearings before the House Ways and Means Committee on U.S. international competitiveness, the Joint Committee on Taxation identified three definitions of the term competitiveness: trade competitiveness; standard of living competitiveness; and multinational competitiveness.

The JCT defined “trade competitiveness” as “the ability of firms located in the United States to sell their output in foreign markets and to compete in domestic markets with output produced in foreign countries.” This definition measures competitiveness by the trade deficit.

The second definition identified was “standard of living competitiveness,” which measures competitiveness by comparing the current and projected future U.S. standard of living with standard of living data from other countries. The most important factors in this determination are the productivity growth of U.S. labor and the saving rate of the United States.

The third definition was “multinational competitiveness.” This measures competitiveness by examining the ability of U.S. firms headquartered in the United States with production facilities abroad to compete in foreign markets with residents of the host country and other multinational firms based elsewhere. See Staff of the Joint Committee on Taxation, *Factors Affecting the International Competitiveness of the United States, Scheduled for Hearings before the Committee on Ways and Means on June 4-6 and 18-20 and July 16-18, 1991*, 7-8 (1991).

Of these three types of competitiveness, standard of living competitiveness is most closely related to the concepts of global and national economic welfare discussed in Chapter 3. Thus, policies that maximize standard of living competitiveness would likely be very similar to policies that maximize economic welfare. Policies that focus exclusively on maximizing trade competitiveness or multinational competitiveness, by contrast, might not necessarily lead to improvements in global or national economic welfare. For purposes of this study, however, references to “competitiveness” refer to multinational competitiveness, which is the definition of competitiveness most often used by the business community in discussing subpart F and is also the definition that was considered most relevant in the 1962 congressional discussions that led to the enactment of subpart F.

the conclusions reached in the prior chapter suggest that a policy that enhances the ability of domestic companies to compete abroad by subjecting their income from foreign investment to a lower rate of tax than their income from domestic investment could cause a decrease in overall economic welfare. Consequently, possible effects on competitiveness must be balanced against other important factors that must be considered in formulating U.S. international tax policy.<sup>2</sup>

## II. Has Subpart F Affected Competitiveness?

Multinational competitiveness – the ability of U.S.-owned multinationals to compete with foreign-owned multinationals – is an amalgam of many factors, only a few of which relate to tax. For example, to rank the competitive position of 47 countries for its 2000 global survey, the Institute for Management Development studied 290 separate factors, of which 14 related to tax.<sup>3</sup> It is questionable whether any single feature of a tax system is likely to have a significant effect on multinational competitiveness. Further, selective use of the available data can give a misleading impression. For example, it has been noted that in 1960, 18 of the world's 20 largest corporations ranked by sales were U.S.-headquartered and that by 1996, this figure had fallen to 8.<sup>4</sup> However, a different benchmark can lead to a markedly different conclusion. For example, as of July 2000, the world's top 5 companies, 61 of the world's top 100 companies and 484 of the world's top 1000 companies, based on market value, were U.S. corporations.<sup>5</sup> Further, U.S. corporations' share of worldwide profits rose during the last decade, from 36 percent in 1990 to 44 percent in 1998.<sup>6</sup> Additionally, the United States, as a general matter, is agreed by almost any measure to be one of the most competitive countries in the world.<sup>7</sup>

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<sup>2</sup> See Hon. Donald C. Lubick, Assistant Secretary (Tax Policy), U.S. Department of the Treasury, Address at the GWU/IRS Annual Institute on Current Issues in International Taxation (December 11, 1998).

<sup>3</sup> See International Institute for Management Development, 2000 World Competitiveness Yearbook, available at <<http://www.imd.ch>>, discussed in note 7, *infra*.

<sup>4</sup> National Foreign Trade Council, The NFTC Foreign Income Project: International Tax Policy for the 21<sup>st</sup> Century, Part One: A Reconsideration of Subpart F, at xxii (Washington, 1999) (“NFTC Study”).

<sup>5</sup> The Global 1000, The World's Most Valuable Companies, Bus. Week 107, 111, 138 (July 10, 2000). By contrast, the countries with the next highest number of companies in the top 100 and 1000 companies were Great Britain and Japan, respectively. Nine British companies were in the top 100 and 149 Japanese companies were in the top 1000. *Id.* at 111, 120-22.

<sup>6</sup> G. Morgenson, Dow Finishes Day over 10,000 Mark for the First Time, N.Y. Times, Mar. 30, 1999, §A, at 1. See also Sinking in Sync: The Global Slowdown Surprises Economists and Many Companies, Wall St. J., Dec. 21, 2000 at A1 (noting that U.S. GDP accounts for almost 30 percent of world output, up from 26 percent in 1992, and U.S. companies now make up almost half of all world corporate profits, a 33 percent increase from 1990).

<sup>7</sup> Overall it seems that on many criteria the United States ranks high in overall competitiveness. For example, in two significant surveys of global competitiveness -- the World Competitiveness

These statistics, however, provide little evidence about the impact of subpart F on multinational competitiveness. As noted above, competitiveness depends on many factors, only a few of which relate to tax. Many non-tax factors could have influenced these figures, such as the openness of foreign markets and the degree of regulation to which American-owned companies are subject. Indeed, the available data simply do not provide a reliable basis for evaluating whether subpart F has affected multinational competitiveness to any significant extent.

### **III. Has Subpart F Substantially Affected Comparative Tax Burdens of U.S. Multinational Corporations?**

#### **A. Introduction**

Although the available data do not support the conclusion that subpart F has had a significant effect on competitiveness, some have argued that the U.S. subpart F regime is more stringent than that of other countries and must necessarily disadvantage U.S.-owned foreign corporations. This section first considers whether subpart F has materially affected comparative tax burdens, based on a comparison of tax rates, an admittedly difficult exercise. The section next examines current trends among foreign countries in addressing the issue of deferral to determine whether subpart F is consistent with international norms.

#### **B. Tax Rate Comparison**

The available data allow only certain tax rate comparisons. For example, it is possible to determine the foreign effective tax rates of U.S.-owned foreign corporations. Significantly, these rates are consistently lower than the effective rates for domestic corporations.<sup>8</sup> In addition, the Organization for Economic Cooperation and Development (OECD) gathers data to determine the rates of tax in each OECD country as a percentage of GDP. Based on these statistics, the United States has one of the lowest rates of tax as a percentage of GDP of any OECD country.<sup>9</sup>

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Yearbook (The World Competitiveness Yearbook 2000, available at <<http://www.imd.ch>>) and the World Economic Forum's Global Competitiveness Report (World Economic Forum, Global Competitiveness Report (2000), available at <<http://www.weforum.org>> (WEF Report)) -- the United States ranked first and second, respectively. Further, the WEF Report indicates that U.S. competitiveness is improving: ranked fourth in the world in 1996, the United States improved to third in 1997 and second in 1999.

<sup>8</sup> In 1996, the average foreign tax rate on such U.S. overseas operations was 10 percentage points below the average U.S. tax rate on similar domestic investment (21 percent versus 31 percent). See *supra* Chapter 3, section IV.B.1; see also *infra* Appendix C.

<sup>9</sup> In 1998, United States tax as a percentage of GDP was 28.9%, compared with, for example, Germany at 37.0% and France at 45.2%. Organization for Economic Co-operation and Development, Revenue Statistics 1965-1999, at 66 (2000). Moreover, other countries do appear to regard the U.S. tax system, as a general matter, to impose a lighter tax burden than other systems. See, e.g., Terence Roth, *Paradigm Gained: New Economy Spurs Germany to Break its Corporate Mold*, Wall St. J. Eur., Jan. 28, 2000, available in 2000 WL-WSJE 2944145 (quoting

However, it is hard to compare the tax rates on income from direct U.S. investment in facilities located outside the United States to the tax rates on income from investment in such facilities made by non-U.S. persons. This comparison requires that income be measured in the same way for both foreign and U.S. companies. Foreign and U.S. tax laws have different definitions of income, allow different deductions and require different accounting methods, resulting in both differences in income amount and differences in income timing. When income is computed differently, comparing the effective income tax rates of U.S. and foreign companies will not accurately reflect the effect of taxes on competitiveness. In short, available data do not allow for an accurate and comprehensive comparison of effective income tax rates of U.S. companies with the effective income tax rates of their foreign competitors.

### C. Tax Regime Comparison

In light of the difficulty of directly comparing the tax burden of U.S. and foreign firms investing abroad, another factor to indicate whether subpart F imposes a competitive burden on U.S. multinational corporations is the extent to which subpart F is consistent with current international trends.

When subpart F was enacted in 1962, no other country had a similar anti-deferral regime. Currently, virtually all major U.S. trading partners have enacted controlled foreign corporation (CFC) legislation.<sup>10</sup> When subpart F was enacted, U.S. tax rates were high relative to the tax rates in most other countries, foreign direct investment by residents of the United States accounted for over half of total international direct investment flows,<sup>11</sup> and the United States was committed to a policy of free trade that foreclosed the possibility of controlling foreign investment through exchange controls. By contrast, at that time, most other developed countries had exchange controls that allowed them to monitor foreign direct investment and thus limit the extent

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German Finance Minister Hans Eichel as saying: “With the many trans–Atlantic companies now, we need to be able to compete with the U.S.A. in corporate taxation, or investment will pass us by.”).

<sup>10</sup> As of November, 2000, the following countries, in addition to the United States, had CFC legislation: Germany (1972); Canada (1972); Japan (1978); France (1980); United Kingdom (1984); New Zealand (1988); Sweden (1990); Australia (1990); Norway (1992); Finland (1995); Spain (1995); Indonesia (1995); Portugal (1995); Denmark (1995); Korea (1996); Hungary (1997); Mexico (1997); South Africa (1997); Estonia (2000); Italy (2000). In addition, Israel is currently considering CFC legislation. See Joel Lubell, Israeli Finance Minister Presents Second Revised Tax Reform Proposal, 2000 Tax Analysts Worldwide Tax Daily, Oct. 17, 2000; available in 2000 WTD 201-4.

<sup>11</sup> See Brian Arnold, Taxation of Controlled Foreign Corporations: An International Comparison, 40-41 (Canadian Tax Paper No. 78, 1986).

to which tax havens could be used to defer or avoid domestic tax.<sup>12</sup> Thus, in 1962, most other countries did not need anti-deferral rules to discourage tax motivated offshore investments.

Within the last two decades, most developed countries have eliminated or relaxed exchange controls,<sup>13</sup> allowing capital to flow offshore. During this period, there has been a corresponding increase in CFC legislation. Although many different factors have influenced countries' decisions to enact CFC legislation, common factors have included: substantial disparities between the tax rates in those countries and the rates in many capital-importing countries, a high rate of foreign direct investment, and a lack of exchange controls or other impediments to the flow of capital abroad.<sup>14</sup> When these conditions exist, tax base erosion becomes a concern. A 1996 OECD study of CFC legislation in 14 OECD countries concluded that the elimination of foreign exchange controls motivated most of these countries to adopt CFC legislation.<sup>15</sup> Significantly, 15 of the 21 countries that have adopted CFC legislation were among the 25 jurisdictions with the highest average foreign direct investment outflows between 1990 and 1994.<sup>16</sup>

Generally, CFC legislation has taken one of two basic approaches. One approach, which is often referred to as the transactional approach, ends deferral only for certain types of tainted income, generally passive income and base company income. A second approach, referred to as the entity approach, ends deferral for all of the income of the CFC, but only if certain conditions are present.<sup>17</sup> These conditions may include, for example, that the CFC is a resident of a tax haven, that its income is taxed below a certain rate, or that a certain percentage of its income is from tax haven-type activities. Only seven countries, including the United States, use a

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<sup>12</sup> See Revenue Act of 1962, Hearings before the Committee on Finance on H.R. 10650, 87<sup>th</sup> Cong., 2d Sess. (Part 1) 102, 201 (1962).

<sup>13</sup> For example, the United Kingdom suspended currency controls in 1979 (and subsequently repealed them).

<sup>14</sup> See Daniel Sandler, Tax Treaties and Controlled Foreign Company Legislation, Pushing the Boundaries 9-11 (2d ed.1998) (Sandler).

<sup>15</sup> Organization for Economic Cooperation and Development, Studies in Taxation of Foreign Source Income, Controlled Foreign Company Legislation, at 18 (1996). For example, the United Kingdom began work on CFC legislation soon after it suspended exchange controls in 1979 and it enacted its CFC legislation in 1984. Sweden's exchange controls expired in 1989 and its CFC legislation became effective January 1, 1990. South Africa enacted CFC legislation that targeted investment income in 1997 when it relaxed certain exchange controls and adopted worldwide taxation for investment income.

<sup>16</sup> See Sandler, supra note 14, at 12-13, Table 2.

<sup>17</sup> Japan was the first country to adopt this "all or nothing" approach, in 1978.

transactional approach targeting specific types of income.<sup>18</sup> The remaining countries apply some variation of the second approach.

Many of the countries that have enacted CFC laws have found it necessary to tighten their rules after enactment. For example, the United Kingdom amended its laws, effective July 1, 1999, to make its CFC laws apply automatically, rather than at the discretion of the Inland Revenue.<sup>19</sup> France amended its CFC regime in 1992 to lower the ownership threshold for attribution from 25% to 10% or an ownership interest greater than or equal to FF150 million and to make the CFC regime applicable to permanent establishments of French corporations in the same manner as foreign subsidiaries.<sup>20</sup> Germany also amended its CFC provisions in 1992 to add a new category of tainted income.<sup>21</sup> Canada added rules similar to the U.S. PFIC rules in 1984<sup>22</sup> and, in 1995, it amended certain definitions to expand the class of income subject to current inclusion under its CFC regime.<sup>23</sup> Japan amended its CFC rules in 1992. Prior to 1992, Japan used a list of tax haven countries to determine when income was attributed.<sup>24</sup> The 1992 amendment replaced the tax haven list with an effective tax rate test and lowered the ownership threshold for attribution from 10% to 5%.<sup>25</sup>

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<sup>18</sup> Germany, Canada, Australia and Spain use a transactional approach that targets specific types of income. Denmark and South Africa target only passive income. Under South Africa's recent proposal to tax residents on their worldwide income, however, the CFC regime would be expanded to impute all income of the CFC to resident owners.

<sup>19</sup> For a description of the new U.K. CFC provisions, see John Mongan and Michael Gordon-Brown, U.K. CFC Regime Enters Self-Assessment Era, 19 Tax Notes Int'l 1046 (1999). The U.K. also announced in its 2000 budget that it would lower the required ownership threshold for CFC status from more than 50% to 40% in some circumstances. See Michael Swanick, Stephen N. Mosha and Justin O'Hagan, The Impact of the U.K. Budget 2000 on U.S. Multinationals, 29 Tax Mgmt. Int'l J. 463 (2000).

<sup>20</sup> Section 107 of the Finance Act of 1992 (modifying section 209B of the French Tax Code). See Patrice Lefevre-Pearon, French CFC Rules- New Guideline, 25 Tax Plan. Int'l Rev., at 3 (August 1998).

<sup>21</sup> The new category of tainted income, called income with capital investment character, is subject to current inclusion in the gross income of 10% German shareholders (even if the foreign corporation is not German-controlled) if income with capital investment character (generally portfolio income) is more than 10% of the foreign corporation's gross income or DM120,000 and certain other conditions are met. See Juergen Killius, 962 Tax Management, Foreign Income, Business Operations in Germany A-73 (1996).

<sup>22</sup> Section 94, Income Tax Act, RSC 1985, c.1 (5<sup>th</sup> Supplement), as amended ("ITA").

<sup>23</sup> See ITA §95.

<sup>24</sup> See Sandler, supra note 14, at 27.

<sup>25</sup> See Way, Brockman, Otsuka & Takagi, 969 Tax Management, Foreign Income, Business Operations in Japan A-68 (1999).

The OECD's Report on Harmful Tax Competition (OECD HTC Report) provides another indication that the international community views effective CFC legislation as important.<sup>26</sup> To address the effects of harmful tax competition, the OECD HTC Report recommends that member states take certain unilateral, bilateral and multilateral measures. One of the recommendations in the OECD HTC Report is that countries without CFC legislation adopt such rules, and countries with CFC legislation expand their existing rules to apply them in a manner that reduces the effects of harmful tax competition.

A review of the trends in CFC legislation thus indicates that the concerns about deferral that made the enactment of subpart F necessary in 1962 have since become relevant in many other countries as capital barriers have been removed and business has become more international. While the specific provisions of each country's CFC legislation differ, the overall trend indicates that other countries are increasingly finding it necessary to enact legislation that, like subpart F, limits deferral of foreign-earned income.

#### **IV. Conclusion on Competitiveness and the Taxation of Foreign Income**

Although competitiveness concerns were considered relevant when subpart F was enacted and continue to be cited in more recent discussions on deferral, the available data provide no reliable basis for evaluating whether subpart F has had a significant effect on multinational competitiveness. However, the fact that many countries have recently introduced or strengthened their CFC regimes suggests that the U.S. policy limiting the deferral of income earned by U.S.-owned foreign corporations is fully consistent with the policies of our major trading partners and that foreign multinational corporations are subject to rules that are similar in effect to our subpart F rules.

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<sup>26</sup> Organization for Economic Cooperation and Development, Harmful Tax Competition: An Emerging Global Issue (1998). Although a full explanation of the OECD HTC Report and the implementing work being conducted by the member countries is beyond the scope of this report, the principal goal of the OECD's efforts is to eliminate harmful tax competition, both in member and non-member countries. See supra Chapter 2, note 12.

## CHAPTER 5

### AVOIDING THE RULES OF SUBPART F

#### I. General

Previous chapters have discussed the principal factors that influenced the enactment of subpart F. These were, principally, preventing tax haven abuse, taxing passive income currently, promoting equity among taxpayers, promoting economic efficiency and avoiding undue harm to competitiveness.

The purpose of this chapter is to examine generally the effectiveness of the specific rules of subpart F in meeting these goals. Subpart F attempts to achieve its goals through specific rules that are intended to tax passive income on a current basis and to prevent the deflection of income to low-tax jurisdictions and other special tax regimes. This chapter considers two illustrative categories of transactions that avoid the application of those specific rules.

#### II. Illustrations of Techniques to Avoid Subpart F

##### A. Hybrid Entity Techniques

The rules of subpart F are largely premised on the assumption that for non-tax reasons business will be carried on in corporate form (e.g., to limit liability). Even if this assumption still holds true in the foreign context, it is no longer true in the United States. As a result, subpart F can be avoided by planning techniques that exploit both the corporate focus of the subpart F related party rules and the failure of subpart F to address directly inter-branch passive income payments. These tax avoidance techniques generally involve the use of hybrid entities. A hybrid entity is an entity that is classified differently for U.S. tax purposes than it is classified for foreign tax purposes.<sup>1</sup>

For example, the foreign personal holding company income (FPHCI) rules that relate to the receipt of passive income, such as interest, do not expressly deal with payments between “branches” of a single corporation, even if for foreign law purposes the CFC and branch are respected as two separate entities. The foreign base company sales income (FBCSI) rules, by contrast, treat a branch of a single corporation as a separate entity in certain circumstances in order to prevent the deflection of income to a low-tax jurisdiction. This disparity in treatment between the FPHCI rules and the FBCSI rules can lead to seemingly inconsistent results. For example, if sales income is shifted from one CFC to a related CFC in a different jurisdiction,

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<sup>1</sup> Generally, an entity taxed as a corporation in a foreign jurisdiction but treated as a partnership or disregarded entity for U.S. tax purposes is referred to as a “hybrid.” An entity taxed as a partnership or other passthrough in a foreign jurisdiction but treated as a corporation for U.S. tax purposes is referred to as a “reverse hybrid.”

subpart F income (i.e., FBCSI) may arise. Similarly, if sales income is shifted from one CFC to its branch in a different jurisdiction, FBCSI may also arise, because the branch may be treated as a separate corporation under the FBCSI rules. If income is shifted through interest payments from one CFC to a related CFC in a different jurisdiction, subpart F income (i.e., FPHCI) may arise. If, however, income is shifted through interest payments from one CFC to its hybrid branch in a different jurisdiction, subpart F income currently will not arise.<sup>2</sup> Given the outcome in the first three situations, the final result seems anomalous.

The examples below illustrate how hybrid entities have been used to deflect income from a high-tax jurisdiction to a low-tax jurisdiction and exploit the same country exceptions to the FPHCI rules.

### **1. Use of Hybrids to Deflect Income from High-Tax Jurisdictions to Low-Tax Jurisdictions**

A number of hybrid arrangements involve related party payments the purpose of which is to deflect income from a high-tax jurisdiction to a low-tax jurisdiction while avoiding subpart F. For example, assume a U.S. person wholly owns an operating CFC (“CFC1”) in Country A, a high-tax jurisdiction. To deflect operating income from Country A (where it would be subject to a high tax) to Country B, a low-tax jurisdiction, the U.S. person could cause CFC1 to establish an entity (“BR1”) in Country B that would be treated as a corporation in Country A but would be disregarded for U.S. tax purposes. The U.S. person would then cause BR1 to make a loan to CFC1. Because Country A would treat BR1 as a corporation, the interest payments from CFC1 to BR1 would be deductible in Country A and, therefore, would reduce the amount of CFC1 operating income that otherwise would be subject to the high tax imposed by Country A. Because Country B is a low-tax jurisdiction, the interest payments received by BR1 from CFC1 would be subject to little or no tax in Country B. Finally, because the United States would treat BR1 as a disregarded entity for U.S. tax purposes, the taxpayer would take the position that the interest payment between CFC1 and BR1 should be disregarded for U.S. tax purposes, and thus should not be subpart F income. Accordingly, by exploiting the difference in the U.S. tax treatment of corporations and disregarded entities, as well as differences in entity classification among different jurisdictions, the U.S. person takes the position that it is able to deflect operating income from a high-tax jurisdiction to a low-tax jurisdiction while avoiding the application of the subpart F rules.

### **2. Use of Hybrids to Shelter Income From Current Tax in All Jurisdictions**

Hybrid arrangements also have been used to shelter income from taxation in any jurisdiction. This can be accomplished without the need to deflect the income to a tax haven or other low-tax jurisdiction. For example, assume a U.S. person owns an operating CFC (“CFC1”)

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<sup>2</sup> Proposed regulations under section 954 would tax certain hybrid transactions described in this section. However, such regulations will not have effect until after July 1, 2005, at the earliest. See 64 Fed. Reg. 37727 (July 13, 1999).

in Country A, a high-tax jurisdiction. To shelter CFC1's operating income from country A tax and to avoid subpart F, the U.S. person could establish a reverse hybrid in Country A ("FP1") (i.e., an entity that would be treated as a partnership in Country A and a corporation in the United States). FP1 must be engaged in a trade or business located in Country A. The U.S. person could then contribute cash to FP1, and cause FP1 to make a loan to CFC1. CFC1 should get a deduction in Country A for the interest paid to FP1 thereby reducing the amount of CFC1 operating income that otherwise would be subject to high Country A tax. Because, for purposes of Country A tax, FP1 is a transparent entity, no entity level tax would be imposed on FP1 on the interest paid to it. Instead, Country A would treat the interest paid to FP1 as actually paid to the U.S. shareholder. Assuming Country A has an income tax treaty with the United States (and that the interest paid to FP1 would qualify for treaty benefits<sup>3</sup>), this interest likely would be subject to little or no withholding taxes in Country A. Finally, because the United States would treat FP1 as a Country A corporation, the interest payment between CFC1 and FP1 would not be subpart F income, pursuant to the same country exception in section 954(c)(3)(A)(i).<sup>4</sup>

A U.S. person could achieve the same result by using other deductible payments such as royalties.<sup>5</sup> Thus, by exploiting (1) the difference in the tax treatment of corporations and partnerships, (2) differences in entity classification among jurisdictions, and (3) the same country exceptions to the FPHCI rules in section 954(c)(3)(A), a U.S. person is able to use hybrid structures to shelter foreign source income from current tax in any jurisdiction.

## **B. Manufacturing Exception to FBCSI**

As previously noted, FBCSI is income of a CFC from the sale of personal property that is purchased from, or on behalf of, or sold to, or on behalf of, a related person where the property is both manufactured and sold for use outside the CFC's country of incorporation. If the CFC manufactures the property that it sells, the sales income generally will not be subject to the FBCSI rules. The FBCSI rules are intended to prevent the deflection of income from the jurisdiction in which the goods are manufactured to a low-tax jurisdiction. Thus, when the manufacturing is carried on by related corporations, the FBCSI rules often will apply. Further, the FBCSI provisions contain a branch rule, which provides that, even when both the manufacturing and sales activities are conducted by the CFC, the FBCSI rules may apply if the sales and manufacturing activities are conducted in separate tax jurisdictions and the effective rate of tax imposed on the

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<sup>3</sup> If the principles of the recent OECD report on partnerships were applied, this might not be the case. See The Application of the OECD Model Tax Convention to Partnerships (1999).

<sup>4</sup> I.R.C. § 954(c)(3)(A)(i) exempts from FPHCI dividends and interest received from a related corporation organized under the laws of the same country as the recipient, provided that the related payor corporation has a substantial part of its assets used in a trade or business in the same foreign country.

<sup>5</sup> I.R.C. § 954(c)(3)(A)(ii) provides a similar exemption from the FPHCI rules for rents and royalties received from a related corporation for the use of property within the country in which the recipient is organized.

sales income is significantly lower than the rate that would be imposed on such income if the sales income were subject to tax in the jurisdiction where the manufacturing activities occurred.

One weakness of the FBCSI rules is that they may not apply to some types of transactions through which income from the sale of goods manufactured in a high-tax jurisdiction can be diverted to a low-tax jurisdiction, such as certain transactions in which there are no purchases or sales involving related persons. These transactions are illustrated below.

## **1. Contract Manufacturing**

The first technique relies upon the focus in the FBCSI rules on the owner of the property being sold. Thus, if at all stages in the acquisition, production, and disposition of the property from or to unrelated persons, only one CFC holds title to the property (although others may be involved in manufacturing the property to be sold), then the FBCSI rules will never apply. This is because there will have been no sale to, from, or on behalf of a related person.

Assume CFC2, a contract manufacturer, is related to CFC1, the selling CFC. CFC1 holds title to raw materials that are being processed by CFC2, and CFC1 pays CFC2 for processing them. CFC2 is incorporated and has its operations in a high-tax jurisdiction, while CFC1 is incorporated and has its operations in a low-tax jurisdiction. The processing takes place outside of CFC1's country of incorporation. CFC1 purchases the raw materials from an unrelated party and sells the finished goods to an unrelated party outside CFC1's country of incorporation. If CFC1 had instead sold raw materials to CFC2 and then repurchased the manufactured goods from CFC2, or if CFC1 had purchased finished goods from CFC2, CFC1's resulting sales income would have been FBCSI.

However, in this case, the taxpayer takes the position that subpart F does not apply to CFC1 because there has been no sale to, from or on behalf of a related person. This is despite the fact that the group of related corporations has managed to reduce income in a high-tax jurisdiction by splitting off the sales profit into CFC1 and reducing the manufacturer's profit in CFC2 (for example, to a small mark-up over costs). Thus, the sales profits have been diverted within the group to an entity (CFC1) in a low-tax jurisdiction, in the manner that the FBCSI rules were intended to prevent.<sup>6</sup> The taxpayer might also take the position that the amounts paid to CFC2 are not foreign base company services income because the goods are manufactured (and hence the manufacturing services are performed) in the country where CFC2 is incorporated.

## **2. Commissionaire Arrangements**

Another technique to avoid subpart F involves so-called "commissionaire" arrangements. In these arrangements, a subsidiary earns commission income for arranging the sales of goods, rather than taking title to the goods and selling them for a profit.

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<sup>6</sup> This example is based on the facts of Vetco v. Commissioner, 95 T.C. 579 (1990).

Assume CFC1 (often called the “principal”), incorporated and operating in Country A, a low-tax jurisdiction, owns CFC2 in Country B and CFC3 in Country C. CFC2 manufactures a product in Country B, a high-tax jurisdiction, from raw materials the supply of which is arranged by CFC1. CFC1 at all times keeps title to the raw materials. CFC3 “arranges” the sale of the product in Country C, another high-tax jurisdiction. CFC2 and CFC3 are both compensated for their costs plus a small mark-up. In this way, most of the profit is kept by CFC1 in the low-tax jurisdiction. As discussed above, the use of the contract manufacturer (CFC2) in this structure allows CFC1 to reduce CFC2's manufacturing profit to a small mark-up over cost and to shift much of the profit to CFC1. The use of the commissionaire (CFC3) allows for an additional shifting of income to CFC1, thereby enabling CFC1 to keep more profit than it would in a buy-sell arrangement (i.e., an arrangement in which CFC3 took title before selling the goods and, thus, arguably, as an economic matter, was entitled to additional profits to reflect the risk of loss, etc.).

In such a case, the taxpayer might assert that: (a) the sales revenue received by CFC1 is not FBCSI because the income arises from sales of products that were neither purchased from, nor sold to, related persons; (b) the cost-plus amount paid to CFC2 is not FBCSI or foreign base company services income because the goods are manufactured (and hence the manufacturing services are performed) in the country where CFC2 is incorporated; and (c) the commission income of CFC3 is not FBCSI or foreign base company services income, because the fees are for arranging sales for the use, consumption or disposition of the property in CFC3's country of incorporation. If successful, CFC1 will have shifted income both from the country of manufacture (i.e., from CFC2) and the country of sale (i.e., from CFC3) to its home country, a low-tax jurisdiction.

### **3. Avoiding Application of Foreign Base Company Rules by Using Dual Resident Corporations**

Another technique provides taxpayers with the opportunity to argue for the benefits of both contract manufacturing and commissionaire arrangements while avoiding subpart F treatment if the manufacturing country determines tax residence based on something other than the place of incorporation.

Assume that CFC2 is a manufacturing corporation incorporated in Country A, a high-tax jurisdiction. The U.S. parent forms a sister corporation, CFC1, which is a Country A corporation but non-resident for purposes of Country A's laws (e.g., because it is managed and controlled in another country). CFC1 enters into a contract manufacturing arrangement for CFC2 to manufacture goods from raw materials that CFC1 purchased from the U.S. parent and provided to CFC2 (thus leaving less profit in CFC2). CFC1 can then sell through a commissionaire (or branch) established in the country of sale.

CFC1 will not be taxed on its sales profits in Country A because Country A treats it as a non-resident. U.S. tax law treats CFC1 as a Country A corporation because it was incorporated in Country A. For the FBCSI rules to apply, the sales income would have to be derived in connection with the sale of products both manufactured and sold for use outside CFC1's country of incorporation (Country A). A taxpayer might take the position that CFC1's sales income is not

FBCSI because the income is derived from the sale of products manufactured in Country A. In this case, CFC2 will have reduced its tax in country A without corresponding subpart F income in the hands of CFC1 because of arbitrage between the U.S. and foreign determination of where the corporation resides.

### **III. Is Subpart F Still Effective?**

The examples in this chapter show that it may be possible to circumvent crucial provisions of subpart F. In these cases, subpart F may no longer effectively prevent deflection of income. The next chapter examines challenges that subpart F faces now and will face in the future.

## CHAPTER 6

### CHALLENGES TO SUBPART F: ENTITY CLASSIFICATION, SERVICES AND ELECTRONIC COMMERCE

#### I. Introduction

The last chapter described how parts of subpart F may now be avoided, particularly by the use of hybrid entities. The creation of these hybrid entities are facilitated by changes in the federal tax entity classification rules. However, changes in the entity classification rules are not the only changes that have challenged the current rules of subpart F. The nature of business is also changing. Subpart F was designed and enacted in the 1960s when the foreign business paradigm was a manufacturing plant. Since that time, however, services activities have grown significantly as a percentage of the overall U.S. economy, and this growth appears likely to continue. The treatment of services under subpart F is already posing a number of challenges to subpart F. Further, it is possible now to perceive some of the challenges to subpart F that will be posed by electronic commerce.

#### II. Impact of the Check-The-Box Entity Classification Rules<sup>1</sup>

##### A. General

As described above, subpart F applies almost exclusively to transactions between one corporation and another. This in part is a reflection of business conditions that existed in 1962 (when subpart F was enacted), when most U.S. businesses operating abroad chose (or in some cases, for local law reasons, were required) to operate in corporate form. However, it also reflects an assumption that the entity classification rules of the Internal Revenue Code would work in a certain way. For example, at the time, it was assumed that foreign limited liability entities would be treated as corporations both by the United States and by the foreign country of incorporation.<sup>2</sup> This assumption is no longer valid.

The most important development in foreign entity classification in the past 40 years has been the growth in opportunities for creating hybrid entities. As discussed in the prior chapter, the proliferation of techniques involving hybrids has lessened the effectiveness of the current subpart F regime. Although not the exclusive source of these planning techniques, the check-the-box regulations, which became effective January 1, 1997, have resulted in significantly increased use of hybrid entities.

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<sup>1</sup> The entity classification rules of Treas. Reg. §§ 301.7701-1 through -3, popularly known as the “check-the-box” regulations, allow many entities to elect to be treated as associations taxable as corporations, partnerships, or disregarded entities (i.e., branches). This is done by checking a box on Form 8832, rather than by a legal change in corporate status.

<sup>2</sup> See *infra* Appendix A, part 2, section III.B. (prior to Rev. Rul. 88-76, achieving limited liability outside of corporation/association status was relatively difficult).

## **B. Entity Classification of Foreign Entities**

Planning techniques involving hybrids were available to, and used by, taxpayers before the introduction of the check-the-box regime. Under prior law, entities were classified as corporations or partnerships for U.S. tax purposes based on the presence or absence of four characteristics: continuity of life; centralization of management; limited liability; and free transferability of interests.<sup>3</sup> An entity that possessed more than two of these four characteristics would be classified as an association taxable as a corporation. Entities that had two or less of these characteristics were classified as partnerships.

The four-factor test gave taxpayers significant flexibility to employ tax planning techniques involving hybrids. In particular, with respect to many foreign jurisdictions, it was relatively easy for taxpayers to create a hybrid partnership by forming an entity that was a corporation under the national business statute of the jurisdiction, but that lacked continuity of life and free transferability of interests and, therefore, was a partnership for U.S. tax purposes.<sup>4</sup>

Thus, the availability of tax avoidance techniques involving hybrids did not originate with the check-the-box regulations. However, the check-the-box regulations exacerbated the problem in three significant ways. First, they eliminated the uncertainty associated with applying the four-factor test. This reduced the costs and risks associated with hybrid arrangements and thus greatly facilitated their use. Second, they focused attention on the use of hybrid arrangements. The result was a considerable increase in design and marketing efforts among tax planners that introduced hybrid planning techniques to mainstream taxpayers.<sup>5</sup> Finally, and perhaps most importantly, the check-the-box regulations facilitated the formation of a new type of entity (or non-entity): an entity “disregarded as an entity separate from its owner” (often referred to as a “disregarded entity”).<sup>6</sup> It is the disregarded entity that features prominently in a number of significant subpart F tax planning techniques.

As a result of the check-the-box regulations, the number of foreign hybrid structures, as well as the number of taxpayers employing these structures, has increased dramatically.

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<sup>3</sup> Treas. Reg. § 301.7701-2(a) (1960).

<sup>4</sup> During the early 1970s, the IRS took the position that entities formed under foreign laws that used a concept of “incorporated” that was substantially similar to the U.S. concept would be treated as corporations for U.S. tax purposes, without regard to whether they met the four-factor test. In 1988, the IRS formally reversed this position, holding that all foreign entities must be classified under the four-factor test. See Rev. Rul. 88-8, 1988-1 C.B. 403. See also Appendix A, part 2, section IV.

<sup>5</sup> See, e.g., Bruce N. Davis, International Tax Planning under the Final Check-the-Box Regulations, 26 Tax Mgmt. Int'l J. 3 (1997); David S. Miller, The Tax Nothing, 74 Tax Notes 619 (1997).

<sup>6</sup> Treas. Reg. § 301.7701-2(c)(2).

Specifically, the data available as of March 2000 indicate that, since the regulations became effective, 640 foreign entities have elected to be treated as corporations, 3,920 foreign entities have elected to be treated as partnerships and 7,875 foreign entities have elected to be treated as disregarded entities.<sup>7</sup> Based upon anecdotal evidence, it appears that prior to 1997, at most a few hundred foreign entities were being treated by their owners as disregarded entities. Thus, the growth in disregarded entities has been particularly dramatic. This may be attributable in part to the considerable doubt as to whether disregarded entity characterization was correct under prior law.<sup>8</sup>

A change in the law outside of subpart F has thus had an adverse impact upon its effectiveness. The data described above suggest that this trend will continue, and perhaps accelerate, in the future.

### **III. Subpart F and Services**

As noted above, services activities are a significantly greater contributor to the overall U.S. economy today than when subpart F was originally enacted, and this growth in services activities seems likely to continue.<sup>9</sup> Subpart F was designed principally to deal with manufacturing industries operating in high-tax, developed countries, rather than with service industries. The treatment of services is already posing a number of challenges to subpart F. One example of these challenges is provided by the financial services exception to subpart F under section 954.

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<sup>7</sup> All data are provided by the Statistics of Income Division of the Internal Revenue Service. These data are based on approximately 25,000 elections under the check-the-box regulations. Actual numbers are higher because data from an additional 10,000 elections were not available for inclusion in this study.

<sup>8</sup> Under prior law, many legal advisors apparently refused to opine that entities could be disregarded for tax purposes. In 1977, the IRS issued several private letter rulings classifying certain foreign organizations with single owners as an integral part of their owner for tax purposes. See Priv. Ltr. Rul. 77-43-060 (July 28, 1977) (classifying a German GmbH); Priv. Ltr. Rul. 77-43-077 (July 29, 1977) (classifying a French *société à responsabilité limitée*); Priv. Ltr. Rul. 77-47-083 (Aug. 26, 1977) (classifying a German GmbH); Priv. Ltr. Rul. 77-48-038 (Aug. 31, 1977) (classifying a German limited liability company); Priv. Ltr. Rul. 78-02-012 (Oct. 11, 1977) (classifying a Brazilian limited liability company). All of these private letter rulings were withdrawn in November of 1977, and in February of 1978 the IRS issued further guidance that classified each of these foreign organizations as an association taxable as a corporation.

<sup>9</sup> Services employment has grown steadily relative to manufacturing employment. In 1950, the ratio of manufacturing employment to services employment was 57 percent. In 1962, it was 48 percent, declining to 41 percent by 1970 and to 18 percent by 1999. Economic Report of the President Transmitted to the Congress February 2000, together with the Annual Report of the Council of Economic Advisers 358-59 (2000).

## A. The Financial Services Exception as an Illustration

### 1. General

Dividends, rents, interest, interest equivalents, and other kinds of typically passive income are easily deflected to (or realized in) low-tax jurisdictions and thus are susceptible to tax haven planning. Accordingly, in general, these types of income are considered subpart F income not eligible for deferral. However, under section 954(h), a temporary exception is provided from FPHCI treatment for these types of income if derived in the active conduct of a banking, financing, or similar business.<sup>10</sup> This financial services exception, which was first enacted in the Taxpayer Relief Act of 1997,<sup>11</sup> and then extended and modified by the Tax and Trade Relief Extension Act of 1998,<sup>12</sup> reflects Congress' belief that certain financial service businesses are active and, therefore, should have the deferral benefits enjoyed by other active businesses.<sup>13</sup>

A financial services exception raises three main concerns, however. First, because such an exception applies to income that is generally intended to be treated as passive income, it is important to develop a good definition of "active" that can be applied in this context. Second, the types of entities covered by such an exception may be highly mobile in that they can be relatively easily located in a tax-favorable jurisdiction completely unrelated to where the recipients of the services are based. Third, the type of income covered by such an exception is highly mobile in that it may be easily shifted from jurisdiction to jurisdiction, often without imposition of tax. The financial services exception in Section 954 attempts to deal with all three of these concerns.

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<sup>10</sup> A temporary exception from FPHCI treatment is also provided for certain income derived from a securities dealer business ( I.R.C. §§ 954(c)(2)(C)(ii)) and for certain income derived in the active conduct of an insurance business (I.R.C. § 954(i)).

<sup>11</sup> P.L. No. 105-34, 111 Stat. 788 (1997).

<sup>12</sup> P.L. No. 105-277, 112 Stat. 2681 (1998).

<sup>13</sup> The Taxpayer Relief Act of 1997 included a one-year exception from subpart F for certain income earned by financial services companies. The provision was line-item vetoed by the President in August 1997 because of concerns that certain of its provisions would permit the use of tax avoidance techniques, but was reinstated after the Supreme Court ruled that the line-item veto was unconstitutional in June 1998. In a February 8, 1999 letter to Senator Byron Dorgan, Assistant Secretary (Tax Policy) Donald Lubick outlined Treasury's concerns with the active finance exception as enacted in 1997 and expanded in 1998. See U.S. Treasury Shares Dorgan's Concerns about CFC Extenders Provision, 1999 Worldwide Tax Daily, February 19, 1999; available in 1999 WTD 33-32. The current version of this provision was passed in December 1999, and is effective only for the taxable years of a foreign corporation beginning after December 31, 1998, and before January 1, 2002. For a detailed description of this provision, see infra Appendix A, part 1, section V.B.11.g. and 12.

## 2. Services and the Distinction Between Active and Passive

The first issue relates to the question of when a business is active and when income is passive. As noted above, this active/passive distinction is fundamental to subpart F. Congress found no reason to except passive income earned through a foreign corporation from current inclusion in the worldwide income of U.S. taxpayers.

The financial services exception seeks to ensure that the business benefitting from the exception is active. The CFC must be predominantly engaged in the active conduct of a financial services business *and* the CFC must actively earn the income. This test covers the head office and any branches. It is a facts and circumstances test to be applied with reference to the size of the CFC, the amount of its revenues and expenses, the number of employees and a series of other factors. The legislative history also lists a series of illustrative activities that financial services businesses of certain types generally perform. It makes clear that the CFC “is required to conduct substantially all of the activities necessary for the generation of income with respect to the business.” In the case of cross-border business (the amount of which is limited in the case of finance companies and insurance companies by the “home country requirement”, described below), further activity requirements are imposed. This is because such income is more mobile than home country income. In this case, the statute requires the branch (rather than the CFC as a whole) to perform all of the activities required to generate the income.

The activity rules, however, are imperfect. For example, the insurance industry relies upon independent third parties to perform many key tasks for it.<sup>14</sup> One of these key tasks is making the investments that produce much of the profit for the business. The explanation of the legislation provided by the staff of the Joint Committee on Taxation specifically states that one of the indicative factors of substantial activity is the “making (or arranging for) investments.”<sup>15</sup> The parenthetical language in this portion of the explanation seems specifically to allow outsourcing of investment activities. When marketing can also be performed by independent contractors and actuarial analysis provided by separate actuarial firms, many of the major functions of certain insurance companies can be performed by third parties. As more of these activities are performed by outside contractors, the insurance company begins to look more like a passive entity.

In the case of finance companies, it may also be difficult to distinguish an active company from a passive one. The definition of “finance company” is broad enough to encompass the

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<sup>14</sup> Certain types of insurance, for example, can be very mobile: “unlike the direct writing of insurance, the business of reinsurance is mobile and not subject to uniform regulation. . . . As a result, reinsurance business has thrived in domiciles having a favorable tax and regulatory environment such as Bermuda.” Joe Taylor and Andrew Immerman, The Curious Role of Motive in the Tax Court’s Analysis in UPS, 17 Ins. Tax Rev. 1089, 1091 (1999). See also, e.g., PXRE Corp. Plans to Join Wave, Move to Bermuda for Tax Benefits, BestWeek, July 12, 1999, at 1.

<sup>15</sup> Staff of the Joint Committee on Taxation, General Explanation of the Tax Legislation Enacted in 1998 259 (Joint Committee Print 1998).

incorporated pocket-book of high net worth individuals or a pool of offshore passive assets. For example, it may be possible for a large multinational with a significant amount of retained foreign earnings to capitalize a finance company and then have it engage in a few significant transactions with unrelated persons. While this may be little different from purchasing corporate debt or other passive assets which would generate subpart F income, in this case the income earned will be “active” and, thus, not subject to subpart F.

### 3. Services and Mobility of Enterprise

The statute also attempts to address concerns related to the mobility of the enterprise.<sup>16</sup> One of the premises underlying subpart F, as expressed in the legislative history, is that a U.S.-owned foreign corporation conducting an active business will be in a certain country for valid business reasons (e.g., to be close to the market, for local content requirement purposes, or to exploit a skilled workforce). In the case of certain active financial services businesses, however, the non-tax factors that affect the location of a manufacturing business may not apply, and, accordingly, the financial services business may be able to choose its location based on tax considerations rather than non-tax, business considerations.

The statute attempts to deal with the issue of mobility of enterprise by imposing certain local country customer requirements on finance companies and insurance companies (but not on banks or securities dealers) in order for such companies to qualify for the financial services exception. In the case of a finance company, more than 30% of the gross income of the CFC or qualified business unit (QBU)<sup>17</sup> must arise from transactions with unrelated customers located in the CFC or QBU’s home country.<sup>18</sup> For insurance companies, more than 50% of aggregate net written premiums must be derived from insurance or reinsurance of home country risks of unrelated persons (i.e., risks in connection with property, liability for activities, or lives or health located in the country of the CFC or QBU).<sup>19</sup> Furthermore, the income of any one branch of the

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<sup>16</sup> Interestingly, Rosanne Altshuler and Glenn Hubbard demonstrate in a recent paper that the location of financial services operations became much less correlated to differences in foreign tax rules once deferral for financial services was ended in 1986. See Rosanne Altshuler and Glenn Hubbard, The Effect of the Tax Reform Act of 1986 on the Location of Assets in Financial Services Firms, (Feb. 19, 1999) (conference paper at Taxation of International Investment: Principles and Policies, American Enterprise Institute). This analysis suggests that, when deferral was available for financial services businesses, foreign tax rates may have played a significant role in determining where such businesses chose to locate.

<sup>17</sup> A QBU is defined in I.R.C. § 989(a) as “any separate and clearly identified unit of a trade or business of a taxpayer which maintains separate books and records.” Because this definition allows taxpayers some flexibility in determining when a QBU exists, it may give rise to planning opportunities.

<sup>18</sup> See I.R.C. § 954(h)(3)(B).

<sup>19</sup> See I.R.C. § 953(e)(3)(B).

CFC (including the head office) will only qualify if that branch earns 30% of its net written premiums in respect of same country risks of unrelated persons.<sup>20</sup>

Currently, therefore, at least for finance companies and insurance companies, the statute may limit the ability of businesses to exploit some of their potential mobility. However, this provision may become less effective in the future as it becomes more difficult to tell where activities are performed and to which QBU (or QBUs) activities should be attributed. For example, some of these rules might potentially be circumvented if a taxpayer were to provide financial services over the Internet and were to argue that it had a QBU in each country in which there is a customer.<sup>21</sup>

#### **4. Services and Mobility of Income**

Financial services income is by its nature highly mobile, and it is thus often hard to determine precisely where such income is earned.<sup>22</sup> The statute attempts to address this problem, for example in the context of “qualified banking or financing income,” by providing that the income must be “treated as earned by such corporation or unit in its home country for purposes of such country’s tax laws.”<sup>23</sup> This provision was intended to ensure that the income be reported as earned for tax purposes in the country where it was actually earned as an economic matter. One weakness in the provision, however, is that, although it may ensure that the items are included in gross taxable income where they are actually earned, it does not prevent subsequent deflection of this income for foreign purposes by some of the hybrid transactions described above. Thus, the amount may be included in gross taxable income but not in the actual net amount on which tax is imposed.

Additionally, the statute prevents all active financial services income from constituting foreign base company services income.<sup>24</sup> As a result, to the extent that active financial services income can be earned in a low-tax jurisdiction, such income (unlike other types of services income) is insulated from treatment as foreign base company services income.

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<sup>20</sup> See I.R.C. § 953(e)(2)(B).

<sup>21</sup> The issue of identifying the location of services is considered further in the section below on electronic commerce.

<sup>22</sup> Financial services income is generally not tied to hard physical assets or people. The factors of production that give rise to financial services income are cash (which is highly mobile) and risk, the location of which is inherently unclear.

<sup>23</sup> The statute defines “home country”, in the case of a controlled foreign corporation, as the country under the laws of which the controlled foreign corporation is created or organized.

<sup>24</sup> See I.R.C. § 954(e)(2).

## **B. Conclusion on the Potential Impact on Subpart F of a More Service-Based Economy**

Subpart F does not deal with other service industries in anywhere near the level of detail of the financial services rules. Nevertheless, despite their level of detail, the financial services rules do not sufficiently address the mobility of business enterprises or of income, nor do they adequately distinguish active from passive businesses. However, even if changes were made to deal properly with services within the current structure of subpart F, the result would be more complexity. Industry specific lists of factors indicating when a business is active, for example, would need to be produced and then kept updated. Bright line rules would be replaced by subjective facts and circumstances tests. This complexity is disadvantageous for both taxpayers and the government. Complexity may require taxpayers to spend more on compliance (or may discourage them from complying). Government may also be required to devote more resources to administering the system, and the complex nature of the law may hinder uniform government enforcement.

## **IV. The Challenges to Subpart F Posed by Electronic Commerce**

### **A. General**

The previous section noted the difficulties of applying subpart F to the provision of services generally. The ability of taxpayers to provide services (as well as goods) over the Internet and through other electronic media will present further challenges to the current subpart F regime. None of these challenges is entirely new. The increased commercial use of the telephone, radio, television, and facsimile has contributed to a trend in which the physical location of the provider of goods and services is less significant and more difficult to determine.

Subpart F must be evaluated by considering where this trend might lead and what challenges it poses. For example, as the Treasury observed in its 1996 report on electronic commerce:

If CFCs can engage in extensive commerce in information and services through Web sites or computer networks located in a tax haven, it may become increasingly difficult to enforce Subpart F. . . . because it may be difficult to verify the identity of the taxpayer to whom foreign base company sales income accrues and the amount of such income. It may be necessary to revise Subpart F or the regulations thereunder to take these new types of transactions into account.<sup>25</sup>

In addition to enforcement challenges, electronic commerce and its underlying technologies also have implications for the content and scope of the substantive subpart F rules. This section briefly considers, through examples, whether the current subpart F regime is capable

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<sup>25</sup> U.S. Treasury, Selected Tax Policy Implications of Global Electronic Commerce § 7.3.5 (1996) (“Treasury E-Commerce Report”).

of achieving its objectives in a world in which electronic commerce and new technologies seem sure to play a large role.<sup>26</sup>

## **B. Specific Issues**

### **1. Location of Activities**

Electronic commerce may present challenges to the subpart F rules to the extent that such rules look to where transactions or activities take place. For example, the technologies underlying electronic commerce make possible new sorts of services, such as Internet access, and make easier the remote provision of other services, such as remote database access, video conferencing and remote order processing. With respect to all such services, it is difficult to assign a place of performance, a factor that is relevant with respect to certain subpart F rules. Similarly, it may be difficult to ascertain a place of use, consumption or disposition (another factor relevant in the application of certain subpart F rules) with respect to the sale of digitizable products, such as images and computer software, delivered electronically.

New technologies increase opportunities for CFCs to be incorporated in low- or no-tax jurisdictions. These technologies increase the ease with which employees of a CFC can be located outside the CFC's jurisdiction of incorporation, and increase the ease with which certain products and services can be provided to a CFC.<sup>27</sup> They also allow CFCs to provide services to customers located outside their jurisdiction of incorporation with relative ease. As discussed in the examples later in this chapter, these developments together increase opportunities for CFCs to earn income that may not be subpart F income.

### **2. Classifying Income**

Electronic commerce also may pose challenges to the extent subpart F has different rules for different types of income. For example, under certain circumstances it may be unclear whether payments for digitized products are treated as payments for a good, a right or a service.<sup>28</sup> As discussed in the examples below, results under subpart F may differ significantly depending on how the payment is classified.

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<sup>26</sup> This study does not further address the enforcement or administrative concerns raised by electronic commerce. These concerns are discussed in Treasury E-Commerce Report, *supra* note 25, at § 8.

<sup>27</sup> See Allen R. Myerson, *Ideas and Trends: Virtual Migrants; Need Programmers? Surf Abroad*, N. Y. Times, Jan. 18, 1998, at § IV, 4 (discussing the use of overseas programmers who telecommute from India, the Philippines, South Africa and elsewhere).

<sup>28</sup> Treasury has provided guidance with respect to the proper characterization of payments for one type of digitized product, computer programs. Treas. Reg. § 1.861-18 provides that a transfer of a computer program is treated as: (a) the transfer of a copyright right; (b) the transfer of a copyrighted article; (c) the provision of services; or (d) the provision of know-how, based on all the facts and circumstances of the transaction.

### **C. Examples of Potential Effects of Electronic Commerce on Subpart F**

The following examples illustrate the ways in which electronic commerce and its underlying technologies may present challenges to subpart F. In most cases, the planning techniques described in these examples are available in both the electronic commerce and traditional commerce context. However, because the technologies underlying electronic commerce allow these techniques to be accomplished more easily and effectively than in traditional commerce, these techniques have now become more generally available.<sup>29</sup>

#### **1. Offshore Development, Production, and Sale and Licensing of Goods**

The relocation of activities can be used as a subpart F planning technique. As previously noted, income is foreign base company sales income (FBCSI) if it is derived from the sale of property that (a) is purchased from, or on behalf of, or sold to, or on behalf of, a related person and (b) is both manufactured and sold for use outside the CFC's country of organization. Thus, if a CFC purchases copies of software from its parent that the parent has developed and produced in the United States, the income of the CFC from the sales of such software for use outside its country of incorporation would be FBCSI in its entirety.<sup>30</sup> Suppose, however, that the parent restructures so that its software development and production activities are conducted within the CFC, rather than the parent. Income from the sale of software manufactured by the CFC and sold by the CFC to unrelated persons will not necessarily give rise to subpart F income, even with respect to sales for use outside the CFC's country of incorporation.<sup>31</sup> Thus, by restructuring its operations, which in this case may mean no more than having software development personnel transferred on paper from the parent to the CFC, the parent company may isolate offshore at least some of the profit from the sale of the software.

The extent to which a U.S. parent could achieve deferral in such a manner, however, would depend on where the software development and production and sales of the software were

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<sup>29</sup> The examples below assume that the CFC is located in a low-tax jurisdiction and that the United States does not have an income tax treaty with that jurisdiction. The United States is actively engaged in discussions at the OECD on electronic commerce issues arising under income tax treaties, including jurisdictional issues (e.g., whether certain activities give rise to a permanent establishment) and issues relating to the appropriate characterization of activities and income.

<sup>30</sup> This example is not intended to comment on what constitutes the manufacture of software.

<sup>31</sup> If the CFC conducts its software manufacturing activities within its country of incorporation, the income would be excluded from subpart F income because the FBCSI rules do not apply where manufacture occurs within the CFC's country of incorporation. If the CFC conducts the manufacturing activities through a branch located in a separate tax jurisdiction, the income may be excluded from subpart F income under the manufacturing exception of Treas. Reg. § 1.954-3(a)(4) unless the branch rule applies. (The branch rule will treat the sales income as FBCSI if the CFC conducts the sales and manufacturing activities in separate tax jurisdictions and the sales income is subject to a significantly lower tax rate than it would have been in the jurisdiction where the manufacturing occurs. See Treas. Reg. § 1.954-3(b)).

taking place. If the CFC's development and production activities were kept within the United States, the CFC may be considered engaged in a U.S. trade or business. If so, the CFC would be subject to tax in the United States on the income effectively connected with the conduct of that business.<sup>32</sup> Regular and continuous sales of the software into the United States by the CFC would also likely create a U.S. trade or business. However, sales outside the United States of software developed and produced by the CFC within the United States likely would not generate income taxable by the United States under either subpart F or the U.S. trade or business rules, except to the extent that either the branch rule applies or any such income were deemed to be effectively connected to any U.S. trade or business of the CFC (for example, the U.S. software development). Assuming the CFC's sales income was not effectively connected income, U.S. tax on income not subject to the branch rule would be deferred. Further, as noted previously, the technologies underlying electronic commerce make it easier to locate software development activities outside the United States, through the use, for example, of "virtual migrants."<sup>33</sup>

Moreover, it may be possible to prevent regular and continuous sales of the software into the United States by the CFC from being treated as a U.S. trade or business. If the CFC advertised its products in the United States and had an agent in the United States that maintained a stock of inventory from which it regularly filled orders for the public, the CFC likely would be engaged in a U.S. trade or business. If, however, the CFC advertised solely on the Web and digitally delivered its products to U.S. customers, then it is less clear that the CFC is engaged in a trade or business within the United States. If the CFC is not engaged in a U.S. trade or business under those circumstances, even income from sales into the United States could be isolated offshore (at least to the extent that inclusions are not required under section 956).

Finally, the above example also assumes that the sale of the software will be regarded as the sale of a good. If instead the CFC is considered to license the software to customers, then the CFC would be considered to receive royalties, not sales proceeds, and the royalties would not be considered subpart F income if the CFC "has developed, created, or produced, or has acquired and added substantial value to" the software and if the CFC is "regularly engaged in the development, creation or production of, or in the acquisition of and addition of substantial value to" the software.<sup>34</sup> Thus, it may be possible for a CFC that purchases software from its parent and adds substantial value to the software by, for example, customizing the software for unrelated licensees, to receive royalties that are not subpart F income. In addition, even if a CFC/licensor does not develop, or add substantial value to, the property it licenses, the CFC may nevertheless exclude the royalties from subpart F income if it licenses the property as a result of performing marketing functions.<sup>35</sup>

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<sup>32</sup> This U.S. source effectively connected income, however, is excluded from subpart F income. See I.R.C. § 952(b).

<sup>33</sup> See *supra* note 27.

<sup>34</sup> Treas. Reg. § 1.954-2(d)(1)(i).

<sup>35</sup> This exception applies only if the CFC/licensor "through its own officers or staff of employees located in a foreign country, [maintains and operates] an organization in such country that is

## 2. Offshore Provision of Services to Unrelated Third Parties

If the sale of the software is characterized not as the sale of a good or as a license but rather as the provision of services, a different set of rules will apply. Income from the provision of services is foreign base company services income if the services are performed for or on behalf of a related person outside the CFC's country of incorporation.<sup>36</sup> If the CFC purchases software from its U.S. parent, but, instead of selling the software to a third party, either provides services to unrelated third parties making use of the software or, in the alternative, transfers the software to the unrelated third party in the form of services, the income the CFC receives likely would not be foreign base company services income.<sup>37</sup> If the sale of the software had been characterized as the sale of a good, however, it would have been foreign base company sales income because the income was derived from the purchase of software, which was manufactured outside the CFC's country of incorporation, from a related person, the U.S. parent, and sold for use outside the CFC's country of incorporation.<sup>38</sup>

Problems arising from the distinction between the provision of a good and a service are not limited to computer programs and may in fact be more acute with respect to digitizable products other than software. Consider, for example, a reference work, such as a legal treatise or

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regularly engaged in the business of marketing, or of marketing and servicing, the licensed property and that is substantial in relation to the amount of royalties derived from the licensing of such property.” Treas. Reg. § 1.954-2(d)(1)(ii).

<sup>36</sup> I.R.C. § 954(e). In addition, if a related person provides the CFC with substantial assistance contributing to the performance of the services, the services will be treated as performed for or on behalf of a related person. See Treas. Reg. § 1.954-4(b)(1)(iv).

<sup>37</sup> This example assumes that the parent is not rendering substantial assistance to the CFC within the meaning of Treas. Reg. § 1.954-4(b)(1)(iv).

<sup>38</sup> It may be difficult to manipulate the rules to change the classification from the sale of goods to the provision of services with respect to computer programs, because Treasury Regulations clarify the distinction between the sale of goods and the provision of services in the context of computer software. Treas. Reg. § 1.861-18(d) provides that whether the transfer of a computer program is treated as the provision of services or otherwise “is based on all the facts and circumstances of the transaction” including “the intent of the parties . . . as to which party is to own the copyright rights in the computer program and how the risks of loss are allocated between the parties.” For example, the regulations provide that, if a developer of computer programs agrees to provide upgrades of the program when they become available, the developer is not treated as providing services to its customers. Treas. Reg. § 1.861-18(h), Ex.12. In contrast, if the person commissioning the creation of the program bears all of the risk of loss associated with its creation and will own all of the copyright rights in the underlying program when it is completed, the developer is treated as providing services. Treas. Reg. § 1.861-18(h), Ex.15. With respect to the provision of other digitizable products, the distinction between the provision of a good and the provision of a service may not be as clear.

set of court cases, that previously would have been sold only as a set of bound volumes. The sale of the bound volumes would have resulted in sales income. Today, a potential purchaser might be able to choose between a set of bound volumes, a set of CD-ROMs and an on-line database. The sale of the CD-ROMs may be characterized as the sale of a good.<sup>39</sup> However, a taxpayer may take the position that income arising from the provision of access to an on-line database should be considered the provision of a service. If so, taxpayers may claim that sales by a CFC to unrelated third parties of access to an on-line database the CFC purchases from its parent would not generate subpart F income because the services are not performed for or on behalf of a related person.<sup>40</sup> Similar issues may be implicated with respect to the provision of other services such as telecommunications services and Internet access.

### **3. Offshore Provision of Services to Related Parties within the Country of Incorporation**

Electronic commerce and its underlying technologies make it possible to set up CFC offshore service centers to provide services to related parties.<sup>41</sup> Foreign base company services income includes income from services performed for or on behalf of a related person only if the services “are performed outside the country under the laws of which the controlled foreign corporation is organized.”<sup>42</sup> Thus, under the current subpart F rules, depending on how the place where services are performed is determined, taxpayers may claim that formation of such offshore service centers to service related parties may not generate subpart F income. For example, assume a U.S. corporate vendor of goods over the Internet establishes a CFC in Country A to process customer orders and arrange for product delivery outside of Country A through the use of the CFC’s computer software and servers and other equipment located within Country A. The U.S. corporate vendor pays CFC a fee for performing these processing and product delivery services. Unless it is determined that the services are performed outside Country A, the U.S. vendor may be able to use such an arrangement to isolate offshore income associated with the processing and delivery function with no corresponding income inclusion under subpart F.

As communication equipment becomes more efficient and reliable, the relationship between the service provider’s location and the service consumer’s location will be further weakened. For example, increased use of the Internet, as well as intranets, e-mail and video conferencing, will make it easier to provide services across vast distances. That increases the

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<sup>39</sup> See Priv. Ltr. Rul. 96-33-005 (Aug. 19, 1996).

<sup>40</sup> As under the prior example, the foreign base company services income would nevertheless apply if the parent were rendering substantial assistance to the CFC within the meaning of Treas. Reg. § 1.954-4(b)(1)(iv).

<sup>41</sup> This example assumes that income that was previously earned by people performing certain functions (e.g., accepting orders) can now be “earned” by machines performing the same functions.

<sup>42</sup> I.R.C. § 954(e).

possibility that rules that are premised on the coincidence of the service provider's and service customer's locations may no longer be adequate.

#### **D. Summary of Possible Effects of Electronic Commerce on Subpart F**

Many of the issues identified in this section (e.g., classifying and locating activities and associated income) are not unique to CFCs engaged in electronic commerce. As noted above, some of the same issues arise, for example, with respect to CFCs that provide financial services and businesses involved in more "traditional" activities, such as the development and manufacturing of tangible goods. Electronic commerce and new technologies do, however, affect the ease with which structures that are not contemplated by the rules of subpart F can be used. Furthermore, they affect the interaction between subpart F and the more general international taxation rules, such as the general source of income rules and the definition of a U.S. trade or business.

As planning opportunities become more generally known, offshore companies may become the operating vehicles of choice for many newly formed electronic commerce companies. In addition, many U.S. electronic commerce companies are relatively new. Therefore, it may be possible for them to move offshore without incurring a significant tax liability. These developments, taken together, may pose greater challenges to subpart F in the future.

#### **V. Conclusions Relating to Challenges to Subpart F**

As noted in Chapter 1, subpart F was intended to address a systemic problem in the U.S. tax system that created inequity and caused tax base erosion. Many of the specific rules of subpart F, however, may no longer operate effectively. In addition, weaknesses in these rules are exacerbated by the new entity classification rules, which have facilitated the creation of hybrid entities. The growth in service industries is creating new issues that may be difficult to resolve without adding considerable complexity to the subpart F rules. The challenges that will be posed by electronic commerce and the Internet are only just beginning to emerge. Thus, although the policies underlying subpart F may be as important (or more important) today as they were in 1962 (when subpart F was enacted), new developments are already challenging the effectiveness of subpart F, and these challenges seem likely to increase in the future.

## CHAPTER 7

### CRITERIA AND OPTIONS FOR CHANGE

#### I. Introduction

This chapter considers options for reforming or replacing the current subpart F regime. The fundamental goals of international tax policy provide the appropriate criteria for analyzing these options. These fundamental goals of international tax policy are (1) meeting our revenue needs in an equitable manner, (2) promoting economic welfare, (3) minimizing compliance and administrative burdens, and (4) conforming with international norms to the extent possible. In addition, as in 1962 when subpart F was enacted, one should also consider whether any policy option would place undue burdens on the competitive position of U.S. companies.<sup>1</sup> To determine how these goals should be implemented in the specific context of subpart F, this chapter relies upon the analysis and conclusions set out in the prior chapters of this study. No specific recommendations about the reform or replacement of subpart F, however, are being made at this time.

#### II. Criteria for Evaluating Changes to Subpart F

##### A. Equity

A core objective of any tax system is to raise the revenue necessary to fund government functions and services. A perception of unfairness can undermine the willingness of taxpayers to comply voluntarily with a tax system.<sup>2</sup> For a tax system to raise revenue effectively, taxpayers must believe that the tax burden is being equitably distributed. Taxation on the basis of worldwide income is grounded in the equitable principle that the tax burden should be imposed equally on all income, without regard to its source.<sup>3</sup>

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<sup>1</sup> See supra Introduction, section I (quoting Assistant Secretary Lubick).

<sup>2</sup> The goal of equity is related to the goal of efficiency, discussed below. Over the long-term, differing treatment of businesses operating solely in the United States and U.S.-based businesses operating in foreign jurisdictions may not result in unequal treatment of shareholders (who are free to invest wherever they can get the highest after-tax rate of return), but it could result in a sub-optimal allocation of investments between the United States and foreign countries.

<sup>3</sup> See, e.g., Peggy Brewer Richman, Taxation of Foreign Investment Income, An Economic Analysis 11-12 (1963) (residents and citizens who enjoy equal benefits should be taxed at equal rates for equal income, regardless of source); Hugh Ault and David Bradford, Taxing International Income: An Analysis of the U.S. System and its Economic Premises, in Taxation in the Global Economy 27 (Assaf Razin and Joel Slemrod eds., 1990) (because the source of income has no relationship to the ability to pay tax on that income, the tax burden should be based on worldwide income). See also Chapter 1, Section II. A more detailed analysis of equity concepts

Chapter 1 noted that the worldwide taxing jurisdiction of the United States generally subjects the income from domestic and foreign investment of U.S. citizens and residents to the same tax burden and provides a foreign tax credit to alleviate double taxation. The foreign tax credit generally prevents U.S. persons from being unfairly penalized for earning foreign income. Under current law, however, U.S. businesses continue to be able to limit worldwide taxation of their foreign income to some extent by separately incorporating their foreign operations in a foreign tax jurisdiction. To the extent that this arrangement subjects the income from those foreign operations to a lower tax burden than the income of a U.S. citizen or resident that conducts activities entirely in the United States or conducts foreign activities in branch form, equity concerns arise. As discussed in Chapter 2, this basic inequity was one of the principal reasons that the Kennedy Administration advocated an end to deferral.

Although narrower than the original Kennedy Administration proposal, subpart F was intended to reduce this potential inequity by limiting the ability of taxpayers to reduce or eliminate taxes on income from foreign investment. The subpart F regime operates through specific rules that are intended to tax passive income on a current basis and to prevent the deflection of income to low-tax jurisdictions. Chapter 5 discussed some of the rules of this regime that may no longer operate effectively. One example is the foreign personal holding company income rules, which have been made less effective by hybrid transactions. Hybrid transactions allow taxpayers to exploit the differences between U.S. and foreign entity classification to deflect income from a high-tax country to a low-tax country and to reduce or avoid the overall tax on their foreign income. Chapter 5 also noted that the foreign base company sales income provisions, which are intended to prevent the shifting of sales income to low-tax jurisdictions, might be circumvented through contract manufacturing arrangements. Chapter 6 described how changes in the U.S. and world economies are posing challenges to subpart F and noted that these challenges are likely to increase in the future. For example, subpart F generally does not deal with services industries in any detail, and where subpart F does provide rules (i.e., for financial services income), those rules may be inadequate to deal with issues relating to the mobility of enterprise and the mobility of income and may not adequately distinguish between active and passive income.

To promote the goal of equity, income from domestic investment and income from foreign investment should be subject to a similar tax burden. To further this goal, some form of anti-deferral regime is necessary to prevent U.S. taxpayers from using tax avoidance techniques involving foreign corporations to lower the tax on their income from foreign investment. In particular, to prevent the shifting of passive income to low-tax jurisdictions, such an anti-deferral regime should recognize, as Congress did over 60 years ago when it enacted the foreign personal holding company regime, that foreign passive income should be taxed on a current basis. Further, any such anti-deferral regime should eliminate inappropriate distinctions between business conducted in corporate form and business conducted in other forms, such as through partnerships and disregarded entities.

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in international taxation is beyond the scope of this study.

## **B. Efficiency**

Another important tax policy objective is economic efficiency or the promotion of economic welfare. Generally, global economic welfare is promoted when resource allocation decisions are based solely on which investments are expected to be the most productive.

Chapter 3 concluded that, whether the goal is to maximize global or U.S. economic welfare, it is generally beneficial to reduce disparities in tax rates that cause investment income earned in foreign countries to be taxed at lower rates than investment income earned in the United States. Chapter 3 also concluded that capital export neutrality, which requires structuring taxes so that they are neutral and do not cause investors to favor either domestic or foreign investment, is probably the best policy for promoting economic welfare. Chapter 3 found the efficiency effect of the subpart F foreign-to-foreign related party rules (even when these rules operate as intended) to be uncertain.

Thus, to further the goal of promoting economic welfare, it appears that income from foreign investment should be taxed at the same rate as income from U.S. investment. To the extent that deferral of foreign income does not result in such tax treatment, it is likely to be inefficient from an economic perspective. It may be preferable, however, for an anti-deferral regime to deal directly with tax disparity, rather than using proxies such as the current foreign-to-foreign related party rules.

## **C. Simplicity and Administrability**

Promoting simplicity and administrability is another important tax policy goal.<sup>4</sup> There are a number of different aspects of this goal. On a basic level, simplicity can mean that rules are drafted simply. Rules that are drafted simply, however, may not always be adequate to address complex situations and thus might undermine administrability. Therefore, a balance must be struck. In general, however, simple tax rules facilitate voluntary compliance and minimize administrative costs for taxpayers and government. Further, overly complex rules may create “traps for the unwary,” which could penalize poorly advised taxpayers.<sup>5</sup>

Chapter 6 noted that the business model upon which the foreign base company sales and services provisions of subpart F are designed – relatively immobile manufacturing operations in high-tax foreign countries – no longer represents the norm. Rather, the United States is shifting toward a more service-based economy and one in which business income and income-producing

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<sup>4</sup> See, e.g., Gordon Henderson, Controlling Hyperlexis- The Most Important “Law and . . . ,” 43 Tax Law. 177 (1989) (discussing lack of simplicity in the tax law). See also Bayliss Manning, Hyperlexis: Our National Disease, 71 Nw. U.L. Rev. 767 (1977) (discussing lack of simplicity in the law more generally).

<sup>5</sup> In this respect, the goal of simplicity is closely related to the goal of equity. That is, to the extent that the tax system avoids penalizing poorly advised taxpayers or rewarding those who engage in sophisticated tax planning techniques, the overall tax burden is apportioned more fairly among all taxpayers.

activities are increasingly mobile. As a result, new issues are arising with respect to the mobility of income, the mobility of business enterprise, and the distinction between active and passive income. Chapter 6 also noted that other economic developments, particularly the rapid growth of electronic commerce, may give rise to numerous interpretative issues for which the current subpart F regime provides no clear answers. Specifically, electronic commerce and new technologies can affect the ease with which structures that are not contemplated by the rules of subpart F can be used. Furthermore, they can affect the interaction between subpart F and the more general international taxation rules, such as the general source of income rules and the definition of a U.S. trade or business.

To further the goal of promoting simplicity and administrability, an anti-deferral regime should provide a clear, simple and coherent distinction between passive and active income (if the necessity for such a distinction cannot itself be eliminated). To address the increasing mobility of business activities, alternatives to rules based on the location of business activities may be more appropriate. Further, in general, an anti-deferral regime should avoid rules that rely heavily on the form in which transactions are structured. Such rules are often not flexible enough to keep pace with changing business practices. Attempts to modify the rules to address these changing business practices may increase complexity (and may nevertheless fail to address the changes in an adequate and fair manner). For example, to avoid income classification issues that result from the changing nature of business, to the extent possible an anti-deferral regime should avoid separate sets of rules for different types of income.

#### **D. International Norms**

To promote the tax policy goal of conforming with international norms, countries should, to the extent possible, adopt broad tax policies that harmonize with the tax policies generally in use internationally. The adoption by one country of tax policies that deviate significantly from international norms can lead to double taxation or double non-taxation. Further, rules that are inconsistent with those generally in use internationally tend to increase administrative burdens.

Chapter 4 noted that, as more countries have eliminated foreign exchange controls, they have found it necessary to adopt anti-deferral measures to prevent tax base erosion and to reduce the effect of harmful tax competition. It also noted that the trend among countries is to enact controlled foreign corporation (CFC) legislation or tighten existing CFC legislation. Because the United States was the first country to enact CFC legislation, it has had the longest experience with the strengths and weaknesses of its regime.

This study indicates that limiting deferral through an anti-deferral regime is consistent with international norms, and reforming an existing anti-deferral regime to limit deferral in an appropriate and effective manner is also consistent with international norms. Although the United States should continue to set the standard for an appropriate anti-deferral regime, any anti-deferral regime should, to the extent possible, be designed in a manner that minimizes any

disharmony with international norms. This will help prevent double taxation, double non-taxation and increased administrative burdens.

### **E. Competitiveness**

Multinational competitiveness measures the ability of U.S. firms headquartered in the United States with production facilities abroad to compete in foreign markets with residents of the host country and other multinational firms based elsewhere. In 1962, when subpart F was enacted, Congress considered the effect of any anti-deferral rules on the competitiveness of U.S. multinationals. Thus, in evaluating any policy options regarding subpart F, one should still consider any potential effects on competitiveness.

Chapter 4 noted, however, that multinational competitiveness is measured by many factors, only a portion of which relate to the tax burden imposed on a business. In addition, Chapter 4 noted that the available data provide no reliable basis for concluding that subpart F has had a significant effect on multinational competitiveness. Chapter 4 also indicates that our major trading partners all have anti-deferral regimes. Thus, while there is no direct way to measure the extent to which subpart F has affected multinational competitiveness, it appears that foreign multinationals are subject to rules that are similar in effect to our subpart F rules. In addition, as noted in Chapter 4, the United States, as a general matter, is agreed by almost any measure to be one of the most competitive countries in the world.

Finally, Chapter 4 found that policies that enhance the ability of a particular firm to compete may not necessarily promote overall economic welfare. As a result, because multinational competitiveness may conflict with tax policy goals such as economic efficiency or equity, the effects on multinational competitiveness, if any, should not be considered in isolation, but should be weighed against the possible positive effects of implementing the option (such as promoting economic efficiency).

## **III. Alternatives**

### **A. General**

This section briefly outlines three alternative options to the current subpart F regime for taxing foreign income and evaluates them against the principles described immediately above. Because of the difficulty in measuring how any specific anti-deferral regime would affect multinational competitiveness, this section will not attempt to analyze this issue separately for each option. As noted above, any potential effects of any policy option regarding subpart F on multinational competitiveness would need to be considered in light of the possible positive effects of implementing the option (such as any improvements in economic efficiency or administrability).

The options described below clearly do not (and are not intended to) represent the entire range of possibilities.<sup>6</sup> They merely illustrate certain routes that might be explored. In addition, for each option, numerous implementation alternatives are possible. Although some of these alternatives are briefly mentioned, the study does not attempt to examine them in detail.

Option 1 is the repeal of deferral. This could be done in a number of ways. However, the result in all cases would be to subject foreign income to current U.S. taxation. Option 2 would tax all active foreign income currently, but at a lower rate of tax than the normal U.S. rates. There would be no subsequent tax upon repatriation. Option 3 would retain most of the current subpart F rules, with the exception of the foreign-to-foreign related party rules. To reduce tax disparity, however, Option 3 would include an effective tax rate test for active income, which would require a U.S. shareholder of a CFC to include in income the income of the CFC that was not otherwise treated as subpart F income if the effective rate of foreign tax on this income were less than a certain percentage. Under all options, income from passive investment would continue to be subject to current U.S. tax at full U.S. rates.

These options thus represent a range of alternatives that could be considered to reform or replace the current subpart F rules. Option 1 would clearly represent a tightening of the current anti-deferral regime. Options 2 and 3 may, depending on the specific parameters chosen, represent either a tightening or a relaxation compared to the current anti-deferral rules.<sup>7</sup>

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<sup>6</sup> Other possible reforms are discussed briefly in section III.E of this chapter. One option that is not discussed in this chapter is the adoption of a territorial system of taxation. As noted in the introduction to this study, in its purest form, a territorial system completely exempts both the active and passive foreign income of its residents and provides no foreign tax credit. Few countries, and no major trading partners of the United States, have such a complete exemption system. More common is a partial exemption system under which, by treaty or statute, branch profits and subsidiary dividends are exempted and other foreign source income, e.g., royalty income, is included in gross income with a credit to offset the foreign tax imposed on this income. Countries that use a partial exemption system, such as France, have nevertheless found it necessary to adopt a CFC regime to prevent base erosion. Thus, an exemption system is not necessarily an alternative to the implementation of an anti-deferral regime. An analysis of the merits of an exemption system as compared to a worldwide system of taxation with a foreign tax credit more appropriately belongs in the context of an examination of methods to avoid double taxation and is therefore beyond the scope of this study. For an example of a paper examining the merits of a dividend exemption system, see Harry Grubert and John Mutti, Dividend Exemption Versus the Current System for Taxing Foreign Business Income (Dec. 6, 1999) (unpublished paper).

<sup>7</sup> Another approach that could be considered would be to strengthen the effectiveness of the foreign-to-foreign related party rules. As discussed in Chapter 3, strengthening the effectiveness of these rules would have an uncertain effect on economic welfare, but would help protect the U.S. tax base by minimizing the incentive for capital to leave the United States in favor of lower-

## **B. Option 1: Repeal of Deferral**

### **1. Description of Option**

There are at least three methods by which deferral could be ended: the full inclusion method, the branch method, and the domestic corporation method. Under any of these methods, the income of controlled foreign corporations would be subject to current U.S. taxation. The differences between the methods, however, might yield somewhat different tax results. Each method is briefly described below.

#### **a. Full Inclusion Method**

The full inclusion method would operate in a manner similar to the current subpart F regime except that all of the net income of the CFC, and not just certain targeted income, would be includible on a current basis in the gross income of U.S. shareholders as a deemed dividend. As under the current regime, a net loss of the CFC could not be used to reduce the U.S. shareholders' income. In general, the full inclusion method would achieve significant simplification over the current subpart F regime. Because all of the income of the CFC would be includible on a current basis, this method would permit the repeal of certain provisions that classify subpart F income into different types (e.g., insurance income under section 953 and foreign personal holding company income and foreign base company income under section 954). Other rules, however, would continue to be needed to prevent earnings from being taxed again when actually distributed to the U.S. shareholders, although such rules could be made significantly simpler than the current rules under section 959.

The full inclusion method would also lessen the current form-based distinction between branches and subsidiaries. However, unlike the branch method (described below), the full inclusion method would continue to treat the CFC as a separate entity. Therefore, under this method, net income would continue to be determined at the CFC level and the amount of the inclusion would be subject to an earnings and profits limitation. Thus, as under the current

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taxed foreign investment opportunities.

Alternatively, consideration could be given to relaxing or repealing the foreign-to-foreign related party rules and making no other significant changes to current subpart F. This approach would, however, decrease equity between U.S. taxpayers with significant foreign investments and those without such investments. Further, by relaxing the current anti-deferral rules, this approach would be out of step with developments in many other countries (which, as previously noted, have either recently enacted or recently tightened existing CFC legislation). This approach would also retain much of the complexity of the current subpart F regime while eviscerating the rules that were designed to prevent excessive tax disparity. Accordingly, unlike the options presented in this chapter, such an approach does not appear to be a useful alternative to the current regime.

regime,<sup>8</sup> rules to calculate net income and earnings and profits of the CFC would be necessary. A determination would have to be made about whether income would be calculated on a consolidated basis or continue to be calculated on a CFC-by-CFC basis as under current law or, for example, on a QBU-by-QBU<sup>9</sup> basis.

**b. Branch Method**

The branch method would treat a CFC as though it were a branch or transparent entity when it was wholly-owned by a single U.S. shareholder and as a partnership or flow-through entity when it was owned by multiple U.S. shareholders. Unlike the current subpart F regime, there would be no need for rules to prevent the double taxation of previously taxed income because the CFC would not be treated as a separate taxable entity. Rather, the U.S. shareholders would be treated as earning the income. Thus, unlike the current regime under which net losses are not included in the income of the U.S. shareholders, the U.S. shareholders would take into account both the income and losses of the CFC. Rules would be required for apportioning income, losses, deductions and credits among unrelated U.S. owners of the CFC. Since actual branches are entitled to the benefits of tax treaties, arguably a CFC taxed under the branch method also should be entitled to treaty benefits to avoid double taxation. Achieving that result, however, may require some renegotiation of our existing tax treaties.

**c. Domestic Corporation Method**

The domestic corporation method would treat a CFC as though it were a domestic corporation for all purposes of the Internal Revenue Code. Under this method, the CFC itself, rather than its U.S. shareholders, would be taxed in the United States on its worldwide income. This method would allow for the complete repeal of subpart F. An elective version of this regime currently applies to certain CFCs that are insurance companies.<sup>10</sup> Further, an elective version that would apply to all CFCs has been formally proposed in the past.<sup>11</sup> This method might also require re-negotiation of our tax treaties. Issues raised by this method include: whether controlled foreign entities should be allowed to consolidate with affiliated domestic corporations; whether there should be recapture of earnings or gain (and loss) recognition when the corporation is treated as becoming “domestic”; and other issues similar to those involving the “domestication” of a foreign entity under a state domestication statute.

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<sup>8</sup> See I.R.C. §§ 954(b)(5); 952(c); 964(a).

<sup>9</sup> A qualified business unit (“QBU”) is “any separate and clearly identified unit of a trade or business of a taxpayer which maintains separate books and records.” I.R.C. § 989.

<sup>10</sup> See I.R.C. § 953(d).

<sup>11</sup> Foreign Income Tax Rationalization and Simplification Act of 1992, H.R. 5270, 102<sup>d</sup> Cong., 2<sup>d</sup> Sess. § 202.

## 2. Summary Evaluation of Option 1

In terms of the policy principles set forth above, ending deferral would do the most to promote equity among U.S. taxpayers by ensuring that taxpayers could not limit taxation of foreign income by separately incorporating their foreign operations. This would further the equitable principle that a similar tax burden should be imposed on all income, without regard to its source. Among all of the options considered, ending deferral would also be likely to have the most positive long-term effect on economic efficiency and welfare because it would do the most to eliminate tax considerations from decisions regarding the location of investment. Because of the foreign tax credit limitation, taxpayers expecting to be in an excess credit position would still have a disincentive to invest in countries where they would be subject to a rate of tax that was higher than the rate of tax imposed in the United States.<sup>12</sup> Depending on the method chosen, ending deferral could provide considerable simplification as compared to the current subpart F rules. There would be no need, for example, to distinguish between different types of foreign income (active vs. passive, manufacturing vs. sales, etc.). In addition, many of the other technical rules of operation of subpart F could also be eliminated. Further, if consolidation of foreign operations were an element of this regime, intra-group transactions could be ignored, which would also represent a simplification of the current rules.

With regard to the policy objective of conforming to international norms, very few other countries, and no major U.S. trading partners, have completely eliminated deferral. Ending deferral would thus set the U.S. regime apart from the regimes of its major trading partners. As noted above, however, most major U.S. trading partners now have some form of an anti-deferral regime, and some of these countries have moved recently to tighten their existing regimes. Further, a U.S. regime that completely eliminates deferral generally would operate harmoniously with the tax laws of other countries. For example, ending deferral generally would not lead to international double taxation because of the availability of the foreign tax credit to offset foreign taxes on the income subject to current U.S. tax.<sup>13</sup>

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<sup>12</sup> The effects of any disincentive to invest in high-tax jurisdictions would presumably be mitigated to some extent because, within each foreign tax credit basket, some “cross crediting” of foreign taxes may occur. That is, the disadvantage of high-tax countries in attracting capital would be lessened somewhat since U.S. companies with investments in low-tax countries could offset the U.S. tax on income earned in these countries with the taxes paid to the high-tax countries.

<sup>13</sup> The domestic corporation method, however, may raise questions under current international norms (generally reflected in treaties) relating to the consequences of classification of an entity as foreign or domestic.

**C. Option 2: Foreign Income Currently Includible But Subject to a Lower Rate of Tax**

**1. Description of Option 2**

This option is similar to the full inclusion method, discussed under Option 1, in that it would operate in a manner similar to the current subpart F regime but would require the U.S. shareholders to currently include all of the net income of the CFC in gross income as a deemed dividend.<sup>14</sup> Under Option 2, however, the portion of the deemed distribution that was attributable to the active foreign income of the CFC would be subject to a lower rate of U.S. tax.<sup>15</sup> This could be done in a number of ways. For example, active foreign income could be subject to a lower rate of U.S. tax (determined as a percentage of either the U.S. shareholder's marginal rate or the maximum U.S. rate), with foreign tax credits, or the foreign income could be subject to an even lower rate of tax, without foreign tax credits. This latter option would represent more significant simplification because it would narrow the scope of the foreign tax credit.

If foreign tax credits were allowed, calculations of income and tax could be made under the current system on a CFC-by-CFC basis or on a QBU or groupwide basis. The portion of the deemed distribution that was attributable to passive income of the CFC would continue to be subject to U.S. tax at the U.S. shareholder's marginal rate. Foreign taxes paid on passive income could either be creditable against U.S. tax or deductible from taxable income. As under the full inclusion method of Option 1, there would be no further tax upon the earnings when they were subsequently distributed to the U.S. shareholders.

**2. Summary Evaluation of Option 2**

As discussed above, to enhance equity among U.S. taxpayers, the disparity between the tax burden borne by domestic income (or income from foreign branch operations) and that borne by income earned through a foreign corporation should be reduced. Accordingly, the extent to which this option promotes the goal of equity would depend upon the rate at which the tax on foreign income is set. To the extent that this option reduces tax disparity compared to the current subpart F regime (which would depend on the rate of tax imposed on foreign income), it would enhance economic efficiency.

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<sup>14</sup> This option could also be designed using the branch method or the domestic corporation method described above in the discussion of Option 1.

<sup>15</sup> A decision to subject foreign income to a lower rate of tax would only be made to address the concerns of those who believed that an outright end to deferral would impose too great a burden on multinational competitiveness. As previously noted, however, this section does not attempt to evaluate the effect of any of these proposals on multinational competitiveness.

This option would promote the goal of simplicity by eliminating the tax and reporting requirements on repatriated income. Further, if consolidation of foreign operations were an element of this regime, intra-group transactions could be ignored, which would also represent a simplification of the current rules. In other respects, however, this option would not promote simplification. To prevent the “exportation” of income or the “importation” of losses, rules would continue to be needed to determine when income was foreign or domestic. Because passive income would continue to be subject to tax at regular U.S. rates, it would be necessary to distinguish adequately between active and passive income. The variant of this option that lowers the rate but eliminates the foreign tax credit could be viewed as inconsistent with international norms and could require renegotiation of some U.S. tax treaties.

**D. Option 3: Retain Current Subpart F, but End Foreign-to Foreign Related Party Rules and Add Effective Tax Rate Test Rule Preventing Tax Disparity**

**1. Description of Option 3**

Under this option, current subpart F would be retained but modified by repealing the foreign-to-foreign related party rules. Thus, the foreign base company sales and services rules would not include income earned in connection with sales to, from, or on behalf of related foreign persons and services performed for or on behalf of related foreign persons.<sup>16</sup> Further, foreign personal holding company income would not include dividends, interest, rents and royalties received from related foreign corporations whether or not the payments were from a corporation organized in, or for the use of property in, the same foreign country as the CFC. In general, the other categories of subpart F income would remain unchanged and other subpart F rules would continue to operate (e.g., investments in U.S. property under section 956, previously taxed income rules under section 959, earnings and profits limitation under section 952(c), computation of net income under section 954(b)(5)).

To address the issue of tax disparity, and to counterbalance any adverse effects of the repeal of the foreign-to-foreign related party rules, an effective tax rate test would be added so that a U.S. shareholder would be required currently to include in income, as a deemed dividend, the income of the CFC that was not otherwise treated as subpart F income if the effective rate of foreign tax on this income were less than a certain percentage. In effect, this rule would create a new category of subpart F income defined based on the effective tax rate imposed on the income rather than the type of activity that produced the income. (It may be appropriate to extend this effective tax rate test to the income of foreign branches of U.S. corporations and partnerships.) It would have to be determined whether the effective tax rate was to be calculated on a CFC, QBU,

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<sup>16</sup> The foreign base company sales and services rules would continue to include income earned in connection with sales to, from, or on behalf of related U.S. persons and services performed for or on behalf of related U.S. persons if the income otherwise fits within the definition of foreign base company sales or services income.

or foreign groupwide basis. To determine the effective tax rate, a test similar to the one used in the regulations under section 954(b)(4) could be adopted.<sup>17</sup>

Alternatively, rather than full inclusion if the effective tax rate test were not met, U.S. shareholders might be required to make an equalizing payment of tax to the United States sufficient to bring the effective tax rate on the foreign income up to the threshold rate (with a credit for foreign taxes as well as for the equalization payment upon repatriation of the foreign income).<sup>18</sup> A similar alternative would be an actual or deemed minimum distribution regime, under which taxpayers would be required to make distributions (or pay tax on deemed distributions) from a CFC unless the effective tax rate on the income of the CFC equaled or exceeded a certain percentage.<sup>19</sup>

## 2. Summary Evaluation of Option 3

As with Option 2, the extent to which this option would enhance equity among U.S. taxpayers would depend on the level at which the effective tax rate was set. If the effect of this option were to decrease the disparity between the taxation of U.S. income and foreign income, equity would be enhanced. Similarly, economic efficiency would be enhanced if the effect of this option were to decrease the disparity between rates of taxation on U.S. income and foreign income, because taxpayers would have less of an incentive to locate in low-tax countries for tax reasons.

Current subpart F conforms with international norms. The addition of an effective tax rate test, which other countries have also employed, would also conform with international norms.<sup>20</sup> It is unlikely, however, that this option would significantly promote the goal of simplicity. The current subpart F regime is complicated, and retaining much of the current regime would mean retaining much of its complexity. Although elimination of the foreign-to-foreign related party rules could eliminate some complexity, calculating an effective tax rate could add complexity. Because the portion of the U.S. shareholder's subpart F inclusion attributable to passive income

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<sup>17</sup> See Treas. Reg. § 1.954-1(d) (2) (effective tax rate determined as the ratio of the U.S. dollar amount of foreign taxes on an item of income to the U.S. dollar amount of the item of income).

<sup>18</sup> For example, if the effective tax rate of the unit were 10 percent and the effective tax rate threshold were 25 percent, then an equalization payment of 15 percent would be currently payable by the U.S. taxpayer. Upon subsequent repatriation, the 10 percent of foreign tax and 15 percent of equalization payment would both be creditable (subject to foreign tax credit limitation rules, etc.)

<sup>19</sup> Subpart F previously contained a minimum distribution regime. This regime was repealed in 1975. For a brief discussion of the enactment of this regime, see Appendix A, part 1, section IV.D.

<sup>20</sup> For example, as discussed in Chapter 4, Japan uses an effective tax rate test.

would continue to be subject to tax at regular U.S. rates, the distinction between active and passive income would need to be retained.

### **E. Other Reforms**

As already noted, the options described above represent only a sampling of possible reforms to subpart F. Many other reforms could be considered, some of which could be incorporated into one or more of the options described above. For example, as suggested above, the calculations of foreign taxes paid under Option 2 or the effective foreign tax rate under Option 3 could be made on a foreign groupwide basis (rather than on an entity-by-entity basis). To avoid the formalistic distinctions that currently characterize subpart F (and facilitate avoidance of its rules), the rules could be amended to provide that all foreign entities, regardless of how they would otherwise be classified for U.S. tax purposes, would be subject to identical treatment under subpart F. Alternatively, clearer, more rational rules could be provided with respect to the treatment of non-corporate entities (e.g., partnerships and branches) under subpart F.

In addition, other fundamental changes to the U.S. anti-deferral regime could be considered, similar to the approaches that have been adopted in other countries. For example, some countries apply some form of a “list” approach to the taxation of foreign income. Under a “negative” list approach, income earned by an entity incorporated and/or resident in any of the jurisdictions on the list is currently taxable to the entity’s shareholders. Under a mirror image of such an approach, a “positive” list approach, if an entity is resident in or incorporated in any of the jurisdictions on the list, non-passive income of such an entity would automatically qualify for deferral.<sup>21</sup> Other intermediate alternatives could involve combining a list of jurisdictions with an effective tax rate test, with the result that income earned by an entity in a jurisdiction on the list would only qualify for deferral if the income was subject to a specified minimum rate of tax.

Other possible reforms relate to the basic active/passive distinction that is currently used in subpart F. For example, rather than specifying types of income that do *not* qualify for deferral, rules could be provided that would specify when income would be considered “active” and would thereby qualify for deferral. Alternatively, certain types of income could presumptively qualify for deferral, while other types would qualify only if certain tests (focused on the activity involved in earning the income) were met. Another alternative would determine whether income was actively earned based on the ratio of the income to the costs properly associated with earning that income.

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<sup>21</sup> Australia considered a negative listing approach but ultimately rejected it in favor of a positive listing approach, in part because of the perceived administrative and informational burden of maintaining a list of jurisdictions to be included on a negative list. See the Honorable P. J. Keating, M.P., Treasurer of the Commonwealth of Australia, Taxation of Foreign Source Income, An Information Paper 35 (1989) (forming part of the economic statement delivered by the Treasurer on April 12, 1989).

Each of these reforms, as well as numerous others not discussed, could be considered to amend the existing subpart F regime. Each such reform should be evaluated under the general international tax policy principles set forth at the beginning of this chapter and the analysis and conclusions of this study.

#### **IV. Conclusion on Options for Change**

Although no specific recommendations for reform or replacement of subpart F are being made in this study, any subsequent reform of subpart F should be guided by the fundamental goals of international tax policy discussed in this chapter. To promote the goal of equity, the tax system should evenly apportion the tax burden between income from domestic and foreign investment. Because of its mobility and susceptibility to tax avoidance, foreign passive income should be taxed on a current basis. Equity concerns, as well as concerns of simplicity and administrability, also indicate that an anti-deferral regime should avoid inappropriate distinctions between business conducted in corporate form and business conducted in non-corporate form. To further the goal of economic efficiency, it is generally beneficial to reduce tax disparity between income from U.S. investment and income from foreign investment. To promote simplicity and administrability, an anti-deferral regime should provide a clear, simple and coherent distinction between passive and active income (if such a distinction is necessary), and should use a more comprehensive approach in targeting income subject to the anti-deferral rules. To address the increasing mobility of businesses, rules should, to the extent possible, not be based on the location of business activities. Although the tax policy goal of consistency with international norms can be met by a broad range of anti-deferral regimes, any such regime should avoid rules that may lead to international double taxation or double non-taxation or radically increase administrative burdens.

## CHAPTER 8

### RESTATEMENT OF CONCLUSIONS

#### I. Conclusions

##### A. Background to Subpart F

To place subpart F in a broad historical context, Chapter 1 considered developments in the tax laws from 1913 until the enactment of subpart F. As part of this analysis, Chapter 1 considered the extent to which the need for anti-deferral rules was the result of certain structural features of the U.S. tax system. The chapter concluded that subpart F was not a unique response to a specific set of tax avoidance problems that are no longer of concern. Rather, subpart F was, more generally, one in a series of measures addressing tax avoidance problems caused by a structural tension in the tax system. This tension is caused by the incompatibility of certain fundamental features of the U.S. tax system, principally the current taxation of worldwide income and the treatment of corporations as taxpayers and legal persons separate from their owners. These incompatible features are still a fundamental part of the U.S. tax system.

##### B. The Intent of Subpart F

Having placed subpart F in a broad historical context, the study next considered the specific legislative intent of subpart F. Chapter 2 concluded that the aims of subpart F were to prevent tax haven abuse, to prevent passive foreign income from escaping current U.S. taxation, to promote equity between U.S. taxpayers doing business overseas and those doing business in the United States, and to promote economic efficiency without unduly harming competitiveness.

Chapter 2 noted that the original 1961 proposal of the Kennedy Administration to end deferral completely was modified in 1962 because of concerns about the competitiveness of U.S.-owned foreign corporations. Nevertheless, Congress ultimately determined that U.S. taxpayers should not be able to use tax-avoidance techniques to obtain a wide disparity between domestic and foreign tax rates. The relative importance that Congress gave to preserving competitiveness is unclear, however, because in 1962 U.S. multinationals generally conducted their active foreign businesses in high-tax jurisdictions and tax haven devices were the primary cause of significant disparities between U.S. and foreign tax rates. The rules as enacted intended to address such tax haven devices. Congress heard testimony from the Administration indicating that enactment of the tax haven rules would largely preserve the benefits of the Administration's original proposal, although the Administration warned that limiting its proposal in this manner would likely result in increased complexity. Consequently, Congress may have believed that, by ending deferral only in the tax haven context and with respect to passive income, it was addressing the Administration's equity and efficiency goals without unduly harming competitiveness.

### **C. Economic Welfare and the Taxation of Foreign Income**

Chapter 3 examined economic research discussing the best way to tax foreign income. In particular, Chapter 3 asked whether global or national economic welfare would be improved by allowing foreign income to be taxed at a lower rate than domestic income. The chapter summarized numerous economic analyses concerning this question and concluded that capital export neutrality is probably the best policy when the goal is to maximize global economic welfare. Further, whether the goal is to maximize global economic welfare or national economic welfare, Chapter 3 concluded that there appears to be little reason to abandon the conclusion that foreign investment income should be taxed no lower than domestic investment income.

After examining the broader issues, the chapter then examined the foreign-to-foreign related party rules. The chapter concluded that the current subpart F foreign-to-foreign related party rules (even if fully effective) have an uncertain effect on economic welfare.

### **D. Competitiveness and the Taxation of Foreign Income**

Chapter 4 considered the issue of multinational competitiveness. The chapter first noted that promoting multinational competitiveness may conflict with the goal of promoting economic welfare. It then attempted to evaluate the effect of subpart F on competitiveness and concluded that the available data do not provide a reliable basis for evaluating whether subpart F has had a significant effect on multinational competitiveness. Although some have attempted to use statistics selectively in an attempt to show a decline in U.S. competitiveness, there is no convincing evidence of such a decline, nor is there convincing evidence regarding what impact, if any, subpart F may have had on these figures. Further, there are many other statistics that appear to show, generally, that the U.S. economy is highly competitive.

Chapter 4 also noted that the U.S. tax regime imposes a lower overall tax burden than that imposed in many other OECD countries. The chapter further determined that most developed countries did not need anti-deferral rules to discourage tax motivated offshore investments in 1962 because they maintained exchange controls that allowed them to monitor foreign direct investment. As these countries have eliminated or relaxed exchange controls within the last two decades, there has been a corresponding increase in CFC legislation to prevent tax base erosion. Thus, the current trend in other countries is to implement, or strengthen existing, CFC regimes.

### **E. How Effective is Subpart F?**

Chapter 5 examined whether subpart F is effectively fulfilling its original goals (discussed at length in Chapter 2 and summarized above). The chapter concluded that subpart F may in some cases not be doing what it was intended to do. This is because it may now be possible to avoid some important provisions of subpart F, due in part to the proliferation of hybrid entities

and the use of contract manufacturing and other arrangements. Therefore, it may be possible in some cases to deflect income to low-tax jurisdictions and earn passive income in low-tax jurisdictions without triggering subpart F.

#### **F. Challenges to Subpart F: Entity Classification, Services and Electronic Commerce**

Chapter 6 considered three major challenges to the effectiveness of subpart F: the entity classification rules of the Internal Revenue Code, the growth of services in the global economy and electronic commerce. Some of these already have had an effect on subpart F; all of them have the potential to have still greater effect in the future. The chapter concluded that a number of the assumptions underlying subpart F are no longer valid. For example, the rules of subpart F are based on the assumption that relatively immobile manufacturing activities in high-tax foreign countries are the typical active foreign business operations of U.S. multinationals. Further, subpart F assumes that these multinationals generally will conduct their active foreign businesses in jurisdictions with effective tax rates similar to U.S. rates. As such, subpart F deals with the problem of economic inefficiency caused by a disparity between U.S. and foreign tax rates by attempting to ensure that U.S. tax is imposed upon transactions that have the effect of stripping income out of high-tax jurisdictions into low-tax jurisdictions.

However, Chapter 6 concluded that an immobile manufacturing plant as the primary model for an active foreign subsidiary may be obsolete and that targeting related party transactions may no longer be an effective way to address tax disparity. First, the entity classification rules, and, particularly the check-the-box regulations, have greatly facilitated the formation of hybrids, which make many of the related party rules less effective. Second, because the rules preventing income stripping are largely focused on corporation-to-corporation transactions, they do not (even apart from the issue of hybrids) take into account the differing tax treatment of branches, joint ventures, partnerships, and other structures. Third, subpart F may not currently be adequate to prevent services industries from deflecting income to low-tax jurisdictions and otherwise exacerbating tax disparity, in part because of the difficulty in distinguishing between active and passive income in a services industry and the difficulty of defining the location of services. Finally, the growth of electronic commerce is likely to increase and place subpart F under greater pressure for a number of reasons, including the difficulty in identifying the location of activities, the difficulty of identifying the nature of the income arising from transactions, and the increased ease with which offshore activity can be undertaken.

#### **G. Considering Options for Change**

Chapter 7 discussed several options for the reform of subpart F. Although the chapter made no specific recommendations, it noted that any subsequent reform of subpart F should be guided by the fundamental goals of international tax policy as those goals were developed from the conclusions of this study. Thus, Chapter 7 concluded, generally, that to further the goal of

equity, an anti-deferral regime should contribute to the even apportionment of the tax burden between income from domestic and foreign investment, it should tax passive income on a current basis, and it should avoid inappropriate distinctions between the conduct of business in corporate form and the conduct of business in non-corporate form. To promote the goal of economic efficiency, an anti-deferral regime generally should reduce the tax disparity between income from U.S. and foreign investment. To promote simplicity and administrability, an anti-deferral regime should provide a clear, simple and coherent distinction between passive and active income, and should use a more comprehensive approach in targeting income subject to the anti-deferral rules. To promote the goal of consistency with international norms, a broad range of anti-deferral regimes are possible, although any such regime should avoid rules that may lead to international double taxation or double non-taxation or that radically increase administrative burdens. Chapter 7 also noted that the impact of an anti-deferral regime on multinational competitiveness is a relevant factor but should not be considered in isolation, as it may conflict with the fundamental policy goals of equity and efficiency.

## **II. Summary of Conclusions**

Subpart F was intended to address problems arising from incompatible features of U.S. tax law. These features are still incompatible and still in place. The problems they create still exist, and the need to address these problems is perhaps greater than ever. Because of changes in other areas of the law and changes in the nature of business, however, in significant ways subpart F may not effectively address these problems, and it may become less effective in the future.

A careful review of the economic literature reveals that capital export neutrality, which provides that U.S. and foreign income should be taxed at the same rates, is probably the best policy when the goal is to maximize economic welfare (although the foreign-to-foreign related party rules of subpart F may not be maximally efficient in all cases). Therefore, preventing significant tax disparity should remain an important goal.

An anti-deferral regime continues to be needed to prevent significant disparity between the rates of tax on U.S. and foreign income, thereby promoting efficiency, preserving the tax base and promoting equity.

## **REQUEST FOR COMMENTS**

The Department of the Treasury invites and welcomes comments on all aspects of this study. The Treasury particularly solicits the following:

- Comments on whether any of the options outlined in Chapter 7 might form a basis for reforming or replacing subpart F
- Suggestions for other ways in which subpart F might be changed (or replaced)
- Empirical data which might help to resolve the issues raised in this study

Any submissions should be sent to:

Office of International Tax Counsel  
Department of the Treasury, Room 1000  
1500 Pennsylvania Avenue, N.W.  
Washington, D.C. 20220

Comments may also be sent by e-mail to “[subpartf.study@do.treas.gov](mailto:subpartf.study@do.treas.gov)”.

## APPENDIX A

### HISTORICAL REVIEW OF U.S. LAWS RELEVANT TO CURRENT U.S. ANTI-DEFERRAL REGIMES AND ENTITY CLASSIFICATION

This appendix presents a summary of the history of U.S. laws relevant to current U.S. anti-deferral regimes, including subpart F, and federal tax entity classification.

#### PART 1. U.S. ANTI-DEFERRAL REGIMES

##### I. Structural Features of U.S. Tax System Giving Rise to Deferral and the Need for Anti-Deferral Rules

Since the Revenue Act of 1913,<sup>1</sup> which adopted the principles of worldwide taxation of U.S. citizens and residents, the taxation of corporations as entities separate from their shareholders, and the taxation of corporations based on country of organization, taxpayers have had an incentive to defer tax by earning income through corporations over which they maintain control. The historical development of each of these principles is discussed below.

##### A. Taxing Jurisdiction of the United States

Since 1913, individuals that are U.S. citizens or residents and corporations organized in the United States have been subject to tax in the United States on their worldwide income, and nonresident aliens and foreign corporations have been subject to tax only on income having a certain nexus<sup>2</sup> with the United States.<sup>3</sup> To alleviate double taxation, U.S. taxpayers have been

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<sup>1</sup> Revenue Act of 1913, ch.16, 38 Stat. 114.

<sup>2</sup> Current law describes this nexus as income that is either U.S. source or effectively connected with the conduct of a trade or business in the United States. See I.R.C. §§ 872(a) and 882(b).

<sup>3</sup> Precedent for worldwide taxation was established prior to the Revenue Act of 1913. This standard appears to have developed through a series of short-term Civil War era revenue laws. The first income tax law in the United States during the Civil War period imposed a tax on the worldwide income of U.S. residents and the U.S. source income of U.S. citizens residing abroad. See Act of August 5, 1861, ch. 45, § 49, 12 Stat. 292. A subsequent measure enacted in 1864 broadened the U.S. taxing jurisdiction to include the worldwide income of U.S. citizens and residents. See Act of June 30, 1864, ch. 173, § 116, 13 Stat. 223. In 1866, Congress again broadened the U.S. taxing jurisdiction to include not only the worldwide income of U.S. citizens and residents but also “the income of every business, trade or profession carried on in the United States by persons residing without the United States, not citizens thereof.” See Act of July 13, 1866, ch. 184, § 9, 14 Stat. 98.

allowed a deduction, since 1913,<sup>4</sup> and a credit, since 1918,<sup>5</sup> for foreign taxes paid. The United States was the first country to adopt a foreign tax credit applicable to all foreign source income to provide relief from double taxation.<sup>6</sup>

## **B. Taxing a Corporation as a Separate Entity**

The practice of taxing a corporation as a separate entity evolved through a series of short-term revenue laws enacted during the latter half of the 19<sup>th</sup> and early 20<sup>th</sup> centuries. The first income tax laws, enacted during the Civil War era, did not recognize the separate tax status of a corporation. Rather these early revenue laws required individual taxpayers that held an ownership interest in both incorporated and unincorporated businesses to include in income their share of the profits of the business, whether or not distributed.<sup>7</sup> In addition, under these early revenue laws, certain banks, trust companies, and insurance companies, whether incorporated or not, were required to withhold tax on earnings distributed to stockholders or depositors and pay a tax on certain undistributed amounts added to surplus, and certain transportation companies were required to withhold tax on interest, dividends and coupons payable.<sup>8</sup>

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<sup>4</sup> The Revenue Act of 1913, § II.G. (b), allowed corporations to deduct amounts paid “for taxes imposed under the authority of the United States or of any State or Territory thereof, or imposed by the Government of any foreign country.” With respect to individuals, however, § II.B. of the Revenue Act of 1913 allowed a deduction for “all national, State, county, school, and municipal taxes paid” without any specific reference to “foreign” taxes. The Revenue Act of 1916 made clear that foreign taxes were deductible in computing individual net income. See Revenue Act of 1916, ch. 463, Title I, § 5(a), 39 Stat. 756.

<sup>5</sup> See Revenue Act of 1918, ch. 18, § 222(a) (individuals) and § 238(a) (corporations), 40 Stat. 1057.

<sup>6</sup> Peggy Brewer Richman, Taxation of Foreign Investment Income, An Economic Analysis 47 (1963).

<sup>7</sup> See Revenue Act of 1864, ch. 173, § 117, 13 Stat. 223. Section 117 of the Revenue Act of 1864 provided that “the gains and profits, of all companies, whether incorporated or partnership . . . shall be included in estimating the annual gains, profits, or income of any person entitled to the same, whether divided or otherwise.”

<sup>8</sup> See Act of 1864, §§ 120, 122. Section 120 applied to “any bank, trust company, savings institution and . . . any fire, marine, life, inland insurance company, either stock or mutual . . . whether specifically incorporated or existing under general laws.” Section 122 applied to “any railroad, canal, turnpike, canal navigation or slack-water company.” See also Act of July 14, 1870, ch. 255, § 15, 16 Stat. 256.

The Revenue Act of 1894<sup>9</sup>, was the first income tax law that taxed corporations as a class without regard to the type of activity in which they were engaged.<sup>10</sup> The Revenue Act of 1894 was declared unconstitutional in 1895, however, as a direct tax that was not apportioned among the States.<sup>11</sup> In 1909 Congress again enacted legislation that specifically taxed corporations as a class by imposing an excise tax on the net income of “every corporation, joint stock company or association, organized for profit and having a capital stock represented by shares, and every insurance company.”<sup>12</sup>

The Revenue Act of 1913, the first income tax law enacted after the 16<sup>th</sup> Amendment to the U.S. Constitution was ratified, established separate taxing regimes for individuals and corporations. Individuals were subject to both a “normal tax” of 1 percent and a graduated rate surtax.<sup>13</sup> Corporations were subject only to the normal tax.<sup>14</sup> Subsequent U.S. income tax acts have followed this model, taxing individuals and corporations under separate regimes, and case law has confirmed that U.S. tax law generally recognizes a corporation to be a separate taxable entity from its shareholders.<sup>15</sup>

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<sup>9</sup> Revenue Act of 1894, ch. 349, 28 Stat. 553. Section 32 of the Revenue Act of 1894 levied a tax on the annual net profits of certain enumerated companies including banks, insurance companies and certain utility companies “and all other corporations, companies, or associations doing business for profit in the United States, no matter how created and organized, but not including partnerships.”

<sup>10</sup> See P. Hobbs, Entity Classification: The One Hundred-Year Debate, 44 Cath. U.L. Rev. 437, 438-52 (1995) (discussing Revenue Act of 1894).

<sup>11</sup> Pollock v. Farmers’ Loan & Trust Co., 158 U.S. 601, aff’g on rehearing, 157 U.S. 429 (1895). Although the Civil War era tax laws imposed taxes on income, these taxes were treated as indirect taxes, i.e., duties or excise taxes, thereby avoiding questions about their constitutionality. See Springer v. United States, 102 U.S. 586 (1880) (the income tax imposed by the Act of 1865 was not a direct tax but an excise or duty); Pacific Insurance Co. v. Soule, 74 U.S. 433 (1868) (tax imposed by Act of 1866 is a duty or excise).

<sup>12</sup> Revenue Act of 1909, ch. 6, § 38, 36 Stat. 112. This tax was imposed as an excise tax, rather than a direct tax, to avoid a constitutional challenge.

<sup>13</sup> Revenue Act of 1913, § II.A.

<sup>14</sup> Revenue Act of 1913, § II.G.

<sup>15</sup> See, e.g., Moline Properties, Inc. v. Commissioner, 319 U.S. 436 (1943); New Colonial Ice Co. v. Helvering, 292 U.S. 435, 442 (1934); Eisner v. Macomber, 252 U.S. 189, 213-214 (1920).

### **C. Taxation of Corporation Based on Country of Organization**

Although the short-lived Revenue Act of 1894 based taxing jurisdiction solely on whether the corporation, company or association was “doing business for profit in the United States,”<sup>16</sup> subsequent revenue laws based taxing jurisdiction on U.S. residence as well as U.S. business activity. For example, the Revenue Act of 1909 imposed the excise tax on corporations “organized under the laws of the United States” or “organized under the laws of any foreign country and engaged in business in any State or Territory of the United States.”<sup>17</sup> Similarly, the Revenue Act of 1913 imposed a tax on the income from all sources of corporations “organized in the United States, no matter how created or organized” and on certain U.S. source income of corporations “organized, authorized or existing under the laws of any foreign country.”<sup>18</sup> The Revenue Act of 1918 provided that, while gross income generally included income from all sources, the gross income of a foreign corporation included only income from sources within the United States<sup>19</sup> and defined the term “foreign,” when applied to corporations, to mean “created or organized outside the United States.”<sup>20</sup> The current Internal Revenue Code contains similar provisions.<sup>21</sup>

### **D. Tension Between Worldwide Taxation and the Corporate Veil**

Because of the three components of the U.S. tax regime discussed above, world-wide taxing jurisdiction for U.S. citizens and residents, taxation of corporations as separate entities, and taxation of corporations based on country of organization, the form through which a taxpayer chooses to earn income can have a significant impact upon its tax liability. Economically identical transactions can have materially different tax results. For example, a U.S. corporation that directly conducts a business overseas is taxable on that business income. If the U.S. corporation, instead, separately incorporates its foreign operations, the foreign subsidiary will not be subject to tax in the U.S. on this foreign source income. Further, the U.S. parent generally is not subject to tax in the U.S. on the income of its foreign subsidiary until that income is repatriated through dividend distributions, except to the extent subpart F or another anti-deferral regime requires the U.S. parent to include this income currently in its own gross income.

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<sup>16</sup> Revenue Act of 1894, § 32.

<sup>17</sup> Revenue Act of 1909, § 38.

<sup>18</sup> Revenue Act of 1913, § II.G.

<sup>19</sup> Revenue Act of 1918, Title II, Part III, §§ 213 and 233(b).

<sup>20</sup> Revenue Act of 1918, Title I, § 1.

<sup>21</sup> See I.R.C. §§ 61, 882(b) and 7701(a)(4) and (5).

## **II. Anti-Deferral Provisions Prior to 1962**

Since 1913, Congress has responded to taxpayers' use of corporations to defer tax in one of two ways. It has either imposed an additional tax on the corporation, thus reducing the benefit of earning the income through a separate entity, or taxed the shareholder on undistributed profits of the corporation, thus ignoring, to a certain extent, the separateness of the corporation and its shareholder. For example, the personal holding company regime imposed an additional tax at the corporate level, while the foreign personal holding company regime and the subpart F regime taxed shareholders on undistributed profits of the corporation. Since 1913, except during the period between 1921 and 1937, the Internal Revenue Code has contained provisions that taxed shareholders on undistributed profits of corporations used to defer income.

### **A. 1913 to 1934**

#### **1. "Formed Or Availed Of" Standard**

While the Revenue Act of 1913 generally treated a corporation as separate from its shareholders, it created an exception in the case of corporations "created or organized, formed or fraudulently availed of for the purpose of preventing the imposition of" the graduated surtax on individuals. U.S. shareholders of such corporations were required to include in income their share of the corporation's gains and profits, whether or not distributed.<sup>22</sup> This provision, a predecessor to the accumulated earnings tax and personal holding company provisions, limited the separate entity treatment of a corporation and its shareholders to prevent tax avoidance. In Senate floor debates on the Revenue Act of 1913, Senator Williams explained the need for this provision:

The Senator will see that unless we provide for this evil in some way men might escape not the normal tax but escape the additional tax by merely forming themselves, or using a brother, wife, . . . or an office boy. Then, while perfectly willing to pay the normal tax as a corporation, they would escape the additional tax by not having their amount distributed by an arrangement so that they could draw upon the corporation, of course, for whatever they needed. . . . Of course they could have any arrangement with the corporation they chose, because they would be the corporation.<sup>23</sup>

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<sup>22</sup> Revenue Act of 1913, § II.A. Subdivision 2.

<sup>23</sup> 50 Cong. Rec. 5318-19 (1913), reprinted in J.S Seidman, Seidman's Legislative History of Federal Income Tax Laws, 1938-1861 986 (1938).

The Revenue Act of 1921<sup>24</sup> replaced this provision requiring current inclusion of the corporation's undistributed earnings at the shareholder level with one that imposed an additional income tax directly on the corporation if it was formed or availed of to avoid the surtax. The amendment was made after the decision in Eisner v. Macomber<sup>25</sup> created doubt about the constitutionality of taxing shareholders on the corporation's undistributed earnings.<sup>26</sup>

## **2. Transfers to Foreign Corporations**

U.S. taxpayers were able to defer U.S. tax not only by earning income through a foreign corporation but also by transferring appreciated property to a foreign corporation in a tax-free exchange. If the foreign corporation was formed in a jurisdiction that did not impose a tax on the sale of capital assets, both U.S. and foreign tax would be avoided on the capital gain. The income could subsequently be repatriated in a tax-free exchange. To address this potential for tax avoidance, the Revenue Act of 1932<sup>27</sup> added a new provision, section 112(k), to the gain recognition rules.<sup>28</sup> Section 112(k), the predecessor to section 367, provided that the nonrecognition rules would not operate where a foreign corporation was a party to a transaction, unless, prior to the exchange, it was established to the satisfaction of the Commissioner that the exchange was not in pursuance of a plan having as one of its principal purposes the avoidance of tax.

### **B. Personal Holding Companies – 1934**

The Revenue Act of 1934<sup>29</sup> contained provisions intended to prevent tax avoidance or postponement.<sup>30</sup> The House Report accompanying the Revenue Act of 1934 explained one of the specific tax avoidance schemes with which Congress was particularly concerned:

Perhaps the most prevalent form of tax avoidance practiced by individuals with large incomes is the scheme of the 'incorporated pocketbook.' That is, an individual forms a corporation and exchanges for its stock his personal holdings in stock, bonds, or other income-producing property. By this means the income from

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<sup>24</sup> Revenue Act of 1921, ch. 136, § 220, 42 Stat. 227.

<sup>25</sup> 252 U.S. 189 (1920).

<sup>26</sup> See H.R. Rep. No. 350, 67<sup>th</sup> Cong., 1<sup>st</sup> Sess. 177-78 (1921).

<sup>27</sup> Revenue Act of 1932, ch. 209, 47 Stat. 169.

<sup>28</sup> See H.R. Rep. No. 708, 72<sup>d</sup> Cong., 1<sup>st</sup> Sess. 20 (1932).

<sup>29</sup> Revenue Act of 1934, ch. 277, 48 Stat. 680.

<sup>30</sup> H.R. Rep. No. 704, 73<sup>d</sup> Cong., 2<sup>d</sup> Sess. 1 (1934) (1934 House Report) .

the property pays corporation tax, but no surtax is paid by the individual if the income is not distributed.<sup>31</sup>

Although the tax avoidance practices involving personal holding companies that Congress identified in 1934 were not new,<sup>32</sup> the post-1921 anti-avoidance provisions, which required a showing that the corporation was organized or availed of for the purpose of preventing the surtax on the shareholders, had proved to be ineffective. Taxpayers often were able to show some need for the accumulation of profits in the corporation.<sup>33</sup> To address this problem, the Revenue Act of 1934 imposed the additional tax on the undistributed profits of a corporation that fell within the definition of a “personal holding company” without regard to the purposes for which the corporation was formed. A personal holding company was defined as a corporation, 80 percent of whose gross income for the taxable year was derived from certain passive income, and more than 50 percent of the stock of which was owned by not more than 5 individuals. Thus, the personal holding company regime was intended to remove the tax benefit available to an individual from earning income through a separate corporation.

### **C. Foreign Personal Holding Companies – 1937**

In 1937, Congress again enacted legislation to address the proliferation of tax avoidance schemes that used corporations to lower the rate of tax on shareholders’ income. The Revenue Act of 1937<sup>34</sup> (1937 Act) contained a series of provisions that were based on recommendations by the Joint Committee on Tax Evasion and Avoidance. This Joint Committee was formed pursuant to a resolution of Congress to investigate methods of tax evasion and avoidance disclosed in a letter from President Roosevelt to Congress, dated June 1, 1937.<sup>35</sup> In his letter, President Roosevelt explained:

A condition has been developing during the past few months so serious to the Nation that the Congress and the people are entitled to information about it. The

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<sup>31</sup> *Id.* at 11.

<sup>32</sup> *See* Tax Evasion and Avoidance, Letter from the Chairman of Joint Committee on Tax Evasion and Avoidance Transmitting Report of the Joint Committee on Tax Evasion and Avoidance of the Congress of the United States, House Doc. No. 337, 75<sup>th</sup> Cong., 1<sup>st</sup> Sess. 7 (1937) (1937 Report of the Joint Committee on Tax Evasion) (“The problem of the personal holding company has been one requiring the continued attention of Congress beginning with the Revenue Act of 1913.”).

<sup>33</sup> 1934 House Report, *supra* note 30, at 11.

<sup>34</sup> Revenue Act of 1937, ch. 815, 50 Stat. 813.

<sup>35</sup> Tax Evasion and Avoidance, Hearings before the Joint Committee on Tax Evasion and Avoidance, 75<sup>th</sup> Cong., 1<sup>st</sup> Sess. (Part 1) 1 (1937) (1937 Hearings).

Secretary of the Treasury has given me a report of a preliminary study of income-tax returns for the calendar year 1936. This report reveals efforts at avoidance and evasion of tax liability so widespread and so amazing both in their boldness and their ingenuity that further action without delay seems imperative.<sup>36</sup>

At hearings before the Joint Committee on Tax Evasion and Avoidance, Henry Morgenthau, Jr., Secretary of the Treasury, discussed some of the problems the government faced in addressing tax avoidance devices, including the following:

In the highly competitive situation which exists among expert tax attorneys, plausible devices spread rapidly and tax evasion and tax avoidance increase without anyone realizing the extent of the impairment of tax administration until the end of the taxable year.<sup>37</sup>

Vested interests grow up in tax-avoidance devices in the course of time, so that it becomes very difficult to change them after they receive a semi-respectable standing.<sup>38</sup>

Those tax devices which defeat the intent of Congress cost the Government huge sums which Congress never actually intended to give away.<sup>39</sup>

In a letter accompanying the President's letter to Congress, Henry Morgenthau Jr., Secretary of the Treasury, outlined the tax evasion devices that were leading to serious tax base erosion. Among those devices was the use of foreign personal holding companies established in tax havens to avoid tax.<sup>40</sup>

Under Secretary of the Treasury, Roswell Magill, testifying before the Joint Committee on Tax Evasion and Avoidance, explained that foreign personal holding companies were used "as a means of siphoning assets and income out of the United States into foreign countries where there are no income taxes, or where such taxes are low."<sup>41</sup> Under Secretary Magill explained how the foreign personal holding company had been used as a tax avoidance device:

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<sup>36</sup> 1937 Report of the Joint Committee on Tax Evasion, supra note 32, at 1.

<sup>37</sup> 1937 Hearings, supra note 35, at 16.

<sup>38</sup> Id.

<sup>39</sup> Id.

<sup>40</sup> 1937 Report of the Joint Committee on Tax Evasion, supra note 32, at 1-2.

<sup>41</sup> 1937 Hearings, supra note 35, at 85.

1. By assignment of income to the foreign personal holding company corporation in order to avoid taxation of that income in the United States.
2. By transfer of assets to the foreign personal holding corporation in order to have the income on the assets paid to a foreign corporation and so reduce the personal tax of the sole stockholder.
3. By creating large interest deductions when the sole stockholder of the personal holding corporation borrows back its capital or its annual income and pays interest thereon.
4. By consummating abroad in the name of the foreign personal holding corporation a profitable deal which the sole stock holder negotiated in the United States.
5. By selling personally held securities to a foreign personal holding corporation to create a profit in order to offset personal realized losses on securities and step up the cost basis of the securities sold.
6. By assigning royalty income to a foreign personal holding corporation, thus avoiding taxes in the high surtax brackets.<sup>42</sup>

Based upon the evidence presented at the hearings, the Joint Committee on Tax Avoidance and Evasion determined that legislation directed at the device of the foreign personal holding company was “necessary to protect the revenue and prevent further use of one of the most glaring loopholes now existing.”<sup>43</sup> The Joint Committee noted that jurisdictional and tax collection problems prevented Congress from enacting a regime parallel to the personal holding company regime, which imposed a surtax directly on the corporation. Thus, the Joint Committee proposed a method of taxation under which the undistributed income of the foreign personal holding company would be included in the gross income of shareholders that were U.S. citizens or residents whether or not this income was distributed to them.<sup>44</sup>

The 1937 Act defined a foreign personal holding company as a foreign corporation that met two requirements: (1) more than 50 percent of its stock was owned by not more than five individuals who were citizens or residents of the United States; and (2) at least 60 percent of its gross income was derived from dividends, interest, annuities and other specified passive income. Pursuant to the recommendation of the Joint Committee, U.S. shareholders were required to take

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<sup>42</sup> Id. at 29.

<sup>43</sup> 1937 Report of the Joint Committee on Tax Evasion, supra note 32, at 17.

<sup>44</sup> Id.

into income, on a current basis, their pro rata share of the undistributed net income of the foreign personal holding company.

Although the Joint Committee generally was satisfied that the foreign personal holding company provisions would adequately deal with the tax evasion problems raised at the hearings, they also recognized that this legislation might not be sufficient to address devices involving foreign corporations that might arise in the future. In its report, the Joint Committee stated that:

[The Committee] . . . also recognizes the complex character of the problem and the difficulty of framing a tax law which is proof against all the varied and complicated devices involving the use of foreign entities which legal ingenuity may evolve in the future. The committee is therefore of the view that it should continue its study of this problem and should consider other and additional measures which may be feasible for preventing the use of spurious foreign entities to thwart the intent and purposes of the revenue laws. Accordingly, it is the intention of the committee to consider possible measures for the creation of administration and judicial procedure, including criminal penalties, to prevent the formation and compel the dissolution of artificial foreign entities availed of by American citizens and residents to evade or avoid Federal income taxes, and to make recommendations at a later date with respect thereto.<sup>45</sup>

#### **D. Foreign Investment Companies - 1962**

In 1962, in conjunction with the enactment of subpart F, Congress enacted certain provisions to address the tax deferral obtained by small investors in foreign investment companies. Domestic mutual funds or regulated investment companies were taxed on their current earnings. A domestic regulated investment company, however, was not subject to tax on its earnings if it distributed at least 90% of those earnings and certain other conditions were met. In any case, at least one level of tax was imposed, at the investor level. By contrast, foreign investment companies could avoid U.S. tax if they had no U.S. source income. U.S. investors in such companies generally were taxed only when they sold the stock, and the gain from the stock sale was taxed at capital gain rates, rather than ordinary income rates.

During the 1950s, Congress was aware that foreign investment companies were used for tax avoidance but determined that by the early 1960s, “the seriousness of the problem [had] increased substantially.”<sup>46</sup> In his 1961 tax message to Congress, President Kennedy noted that:

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<sup>45</sup> *Id.* at 22.

<sup>46</sup> H.R. Rep. No. 1447, 87<sup>th</sup> Cong., 2d Sess. 72 (1962) (1962 House Report).

For some years now we have witnessed substantial outflows of capital from the United States into investment companies created abroad whose principal justification lies in the tax benefits which their method of operation produces.<sup>47</sup>

The Kennedy administration recommended a regime for foreign investment companies similar to that which it recommended for U.S.-controlled foreign corporations, i.e., current inclusion of the income of the foreign corporation by the U.S. shareholders.<sup>48</sup> Congress, however, rejected this approach. Instead, the foreign investment company provisions, sections 1246 and 1247, taxed the U.S. shareholders of the foreign investment company at ordinary income rates on their share of the post-1962 accumulated earnings and profits when they sold the stock of the company. To avoid this treatment, taxpayers could elect to have the foreign corporation distribute 90 percent of the taxable income other than capital gains. U.S. shareholders who made this election were, however, required currently to include in income their share of the capital gains whether or not distributed. These provisions applied to a foreign corporation that was either registered as a management or unit investment trust or that was primarily engaged in investing or trading in securities, where more than 50 percent of the stock of the corporation was held by U.S. persons. U.S. persons included individuals, corporations, partnerships and trusts. Because these provisions applied without regard to the ownership percentage of the U.S. person, small investors were subject to this regime.

### **III. Subpart F**

#### **A. Brief Chronology**

Subpart F of the Internal Revenue Code, enacted by the Revenue Act of 1962, was based on a proposal by President Kennedy outlined in his tax message to Congress on April 20, 1961.<sup>49</sup> (President's Tax Message). The President cited "changing economic conditions at home and abroad, the desire to achieve greater equity in taxation, and the strains which have developed in our balance of payments position in the last few years," as the reasons to target features of the

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<sup>47</sup> See President's Tax Message along with Principal Statement, Detailed Explanation and Supporting Exhibits and Documents Submitted by Secretary of the Treasury Douglas Dillon in Connection with the President's Recommendations contained in his Message on Taxation at Hearings conducted by the Committee on Ways and Means, H.R. Doc. No. 140, 87th Cong., 1st Sess. 7-8 (1961), reprinted in Committee on Ways and Means, 90<sup>th</sup> Cong., 1<sup>st</sup> Sess., Legislative History of H.R. 10650, 87<sup>th</sup> Congress, The Revenue Act of 1962, Part 1, 147-48 (1967) (President's Tax Message).

<sup>48</sup> 1962 House Report, supra note 46, at 72-73.

<sup>49</sup> President's Tax Message, supra note 47, at 6-7.

U.S. tax system that favored U.S. investment abroad over investment in the U.S. economy.<sup>50</sup> Among the features of the U.S. tax system targeted in the President's Tax Message was the availability of tax deferral for American firms operating abroad through foreign subsidiaries, the income of which was not taxed until repatriated as a dividend.<sup>51</sup> The President's Tax Message recommended elimination of tax deferral in developed countries and, in all countries, "the elimination of the tax deferral privileges for those forms of activities, such as trading, licensing, insurance and others, that typically seek out tax haven methods of operation."<sup>52</sup>

Under the President's proposal, where certain ownership thresholds were satisfied, the U.S. shareholders of a foreign corporation would include in gross income each year as a deemed dividend their pro rata share of the corporation's entire profits for the year.<sup>53</sup> As with an actual dividend, the deemed dividend would carry with it foreign tax credits.<sup>54</sup> These current inclusion rules would not apply with respect to corporations organized in less developed countries, however, unless they were classified as tax haven corporations.<sup>55</sup> A tax haven corporation would be defined as any corporation that derived more than 20 percent of its income from sources outside the less developed country in which it was created. Income would be treated as derived from sources outside the country of incorporation if it fell into one of the following categories: (1) income from the sale of personal property not produced by the corporation, to the extent the personal property is sold for consumption outside the country of incorporation; (2) commissions in connection with the sale of personal property outside the country of incorporation; (3) interest and dividends from corporations created under the laws of another country; (4) compensation for certain services rendered outside the country of incorporation; (5) rents or royalties from property located or used outside the country of incorporation; (6) premiums for the insurance of risks located outside the country of incorporation; and (7) profits from the operation of international shipping and aircraft.<sup>56</sup>

The House Committee on Ways and Means conducted hearings on President Kennedy's tax proposal during May and early June of 1961. Following the hearings, the Ways and Means

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<sup>50</sup> Id. at 6.

<sup>51</sup> Id.

<sup>52</sup> Id. at 7.

<sup>53</sup> President's 1961 Tax Recommendations, Hearings before the Committee on Ways and Means on the Tax Recommendations of the President Contained in his Message Transmitted to the Congress, April 20, 1961, 87<sup>th</sup> Cong., 1<sup>st</sup> Sess. (Vol. 1) 261 (1961 Hearings before the House).

<sup>54</sup> Id. at 262.

<sup>55</sup> Id. at 263.

<sup>56</sup> Id. at 263-64.

Committee considered the President's proposal in executive sessions, during which the Treasury presented a modified version of the President's proposal.<sup>57</sup> The modified Treasury draft, which was released to the public for comment on July 28, 1961, was prepared in response to suggestions of committee members and testimony during the hearings.<sup>58</sup> The modified Treasury draft did not incorporate the President's broader proposal to eliminate deferral for all of the income of a foreign subsidiary organized in a developed country, but dealt only with ending deferral for income from tax haven transactions. The modified Treasury draft defined income from tax haven transactions to include many of the same types of income that were identified as tax haven income in the President's original proposal. The modified Treasury draft, however, also required that the income be derived from transactions with related parties.<sup>59</sup>

Following a decision to defer action on the President's proposal until the following session, a bill reflecting the President's proposal, H.R. 10650, was introduced into the House on March 12, 1962, and reported by the Ways and Means Committee on March 16, 1962.<sup>60</sup> H.R.10650 was passed by the House on March 29, 1962. The House bill followed the modified Treasury proposal in targeting tax haven operations. It did not adopt the President's recommendation to eliminate tax deferral completely in the case of operating companies located in developed countries. The House bill ended deferral only for earnings attributable to certain targeted income: (1) income from insuring or reinsuring U.S. risks; (2) income from patents, copyrights, etc. developed in the United States or acquired in the United States from related persons; (3) certain passive income; and (4) income from purchases or sales involving related persons where the property was produced and sold for use outside the foreign corporation's country of incorporation. The House bill also provided that the U.S. shareholder would be subject to tax on the undistributed earnings of the foreign corporation that did not fall into any of the above-categories to the extent the earnings were not reinvested in substantially the same business or in a foreign corporation organized in a less developed country where certain ownership requirements were satisfied.

On April 2, 1962, the Senate Finance Committee began hearings on H.R.10650. On that date, Douglas Dillon, the Secretary of the Treasury, addressed the Senate Finance Committee,

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<sup>57</sup> General Explanation of Committee Discussion Draft of Revenue Bill of 1961 Released for Information and Study, August 24, 1961, Prepared for the Committee on Ways and Means by the Staff of the Joint Committee on Internal Revenue Taxation 1, 51 (1961), reprinted in Committee on Ways and Means, 90<sup>th</sup> Cong., 1<sup>st</sup> Sess., Legislative History of H.R. 10650, 87<sup>th</sup> Cong., The Revenue Act of 1962 (Part 1) 567, 617 (1967) (1961 Explanation of Discussion Draft).

<sup>58</sup> Id. at 51.

<sup>59</sup> Id.

<sup>60</sup> H.R. Rep. No. 1447, 87<sup>th</sup> Cong., 2d. Sess. (1962).

continuing to push for the complete elimination of deferral for all the income of U.S.-owned foreign subsidiaries operating in developed countries.<sup>61</sup>

On May 31, 1962, Secretary Dillon transmitted a draft of statutory language to the Senate Finance Committee.<sup>62</sup> Again, the Treasury draft, which targeted tax haven-type income, was submitted as an alternative proposal to the President's broader proposal to eliminate all deferral.<sup>63</sup>

The Treasury draft differed from the House bill in that it proposed to narrow some of the categories of income subject to current inclusion. For example, the Treasury draft attempted to narrow the definition of foreign personal holding company income to include only "passive income" and "tax haven income." Passive dividends, interest, rents and royalties were those received from unrelated persons not in connection with the active conduct of a trade or business. Tax haven dividends, interest, rents and royalties were those received from related persons in connection with income producing activities located outside the recipient's country of incorporation.<sup>64</sup> Thus, the Treasury draft intended to carve out, as non-passive income, dividends, interest, rents and royalties derived from the active conduct of activities such as banking, financing, shipping, insurance and leasing of property, if those activities were conducted with unrelated persons.<sup>65</sup> The Treasury draft also intended to carve out, as non-tax haven income, dividends, interest, rents and royalties received from related persons organized in the same country as the recipient, or earned from using property within the recipient's country of incorporation. The Treasury draft proposed to replace the provision in the House bill requiring current inclusion of earnings not reinvested in the foreign corporation's business with a narrower provision that targeted earnings of the foreign corporation invested in U.S. property.<sup>66</sup> The Treasury draft proposed to remove the category pertaining to income from U.S. patents and

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<sup>61</sup> Revenue Act of 1962, Hearings Before the Committee on Finance on H.R. 10650, 87th Cong., 2d Sess. (Part 1) 99 (1962) (1962 Hearings before the Senate).

<sup>62</sup> Committee on Finance, 87<sup>th</sup> Cong, 2d Sess., Draft of Statutory Language with Accompanying Explanation of Amendments Proposed by the Secretary of the Treasury on May 10, 1962, to Sections 13, 15, 16 and 20 of H.R. 10650, III (Comm. Print 1962), reprinted in Revenue Act of 1962, Hearings before the Committee on Finance on H.R. 10650, 87<sup>th</sup> Cong., 2d Sess., (Part Eleven) 4415 (1962) (1962 Treasury Draft).

<sup>63</sup> Id.

<sup>64</sup> Id. at 1-2.

<sup>65</sup> Id. at 3.

<sup>66</sup> Id.

replace it with a separate provision that, in certain circumstances, would tax the gain from the sale of the U.S. patent.<sup>67</sup>

The Treasury draft proposed certain additions to the rules. One such addition was a new category of income subject to current inclusion, income from performing services for or on behalf of a related person outside the foreign corporation's country of incorporation.<sup>68</sup> The Treasury draft also proposed adding a branch rule to the foreign base company sales income provisions to apply to situations "in which a branch or similar establishment acts in the same manner as a controlled foreign corporation."<sup>69</sup>

On August 16, 1962, the Senate Finance Committee reported out the bill.<sup>70</sup> The Senate Report noted that, although the Senate version of the bill differed in some respects from the House version, the Senate amendments "like the House bill, also are designed to end tax deferral on 'tax haven' operations by U.S. controlled corporations."<sup>71</sup> The Senate version of the bill incorporated many of the suggested changes contained in the Treasury draft transmitted on May 31, 1962. However, the Senate version of the bill added two relief provisions. Under the first, the undistributed income of the foreign corporation was not subject to current inclusion to the extent the foreign tax paid on the income was not substantially below the U.S. rate. The second relief provision allowed deferral to continue, subject to certain limitations, for foreign corporations engaged in export trade when the products they sold abroad were produced or grown in the United States.

The bill was debated on the floor of the Senate in late August and early September of 1962. On September 5, 1962, Senator Jacob Javits introduced an amendment that effectively would have treated the European Economic Community (EEC) as one country for purposes of the foreign base company sales and services rules.<sup>72</sup> Thus, for example, under the amendment, a controlled foreign corporation organized in an EEC country could have earned income from selling a product on behalf of a related person that was both manufactured and sold for use in other countries in the EEC and have avoided the foreign base company sales income rules. This result could have occurred because the sales and manufacturing activity would have been deemed to have taken place within the controlled foreign corporation's country of incorporation. Senator Javits argued that his amendment was necessary to enable U.S. firms to compete with other

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<sup>67</sup> Id. at 2-3.

<sup>68</sup> Id. at 2.

<sup>69</sup> Id.

<sup>70</sup> S. Rep. No. 1881, 87<sup>th</sup> Cong., 2d Sess. (1962) (1962 Senate Report).

<sup>71</sup> 1962 Senate Report, supra note 70, at 79.

<sup>72</sup> 108 Cong. Rec. 18594 (1962).

corporations organized in an EEC country.<sup>73</sup> This proposed amendment was rejected after Senator Kerr, the ranking Democratic member of the Senate Finance Committee, argued that, although the EEC countries could be regarded as one economic entity, they continued to maintain separate taxing regimes and, thus, the amendment would have allowed controlled foreign corporations to take advantage of differing tax systems to lower their overall tax contrary to the purposes of the bill.<sup>74</sup>

H.R. 10650 was passed by the Senate on September 6, 1962. The conference report on the bill was filed on October 1, 1962, and the bill was signed into law on October 16, 1962. The provisions of the legislation as enacted are discussed in part 1, section IV of this Appendix A, below.

## **B. Factors Leading to President's Tax Proposal**

### **1. New Opportunity for Tax Deferral Through Tax Haven Operations**

As noted above, prior to the enactment of subpart F, U.S. firms were able to obtain indefinite deferral of U.S. tax on the profits of their foreign subsidiaries that were not subject to the foreign personal holding company regime because these profits were not subject to tax in the United States until repatriated through dividend distributions. To the extent the foreign tax rate was comparable to the U.S. rate, as it was in many of the European countries in the early 1960s,<sup>75</sup> deferral provided no particular tax benefit. An incentive to defer U.S. tax on the earnings of a foreign subsidiary existed only to the extent the foreign tax rate was significantly lower than the U.S. rate.

Although U.S. businesses previously had been able to benefit from deferral by operating through a foreign subsidiary in a low-tax country, their use of tax haven corporations to obtain a tax advantage for income otherwise earned in a high-tax foreign country was a new and rapidly growing phenomenon.<sup>76</sup> The Administration's figures indicated that over one-third of the approximately 500 American-owned firms in Switzerland had been formed in 1960.<sup>77</sup> The

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<sup>73</sup> 108 Cong. Rec. 18597 (1962).

<sup>74</sup> 108 Cong. Rec. 18598 (1962).

<sup>75</sup> President's Tax Message, supra note 47, at 24.

<sup>76</sup> 1961 Hearings before the House, supra note 53, at 303, 343; President's Tax Message, supra note 47, at 6, 26.

<sup>77</sup> 1961 Hearings before the House, supra note 53, at 303, 343.

Administration's anti-deferral proposal was largely motivated by its concern about the proliferation of U.S.-owned tax haven corporations.<sup>78</sup>

The Administration identified a number of artificial or paper transactions through which profits could be diverted to a subsidiary organized in a tax haven, most of which required the tax haven subsidiary to act as a middleman.<sup>79</sup> For example, the tax haven subsidiary could acquire the right to license patents developed by the parent or sister corporation; provide the services of technicians of a corporate affiliate to a firm located in another country; acquire the distribution rights of products manufactured by its affiliates;<sup>80</sup> or reinsure the U.S. risks of its parent.<sup>81</sup> Further, dividend and interest payments could be used to move earnings from a high-tax country, such as Germany, to a tax haven.<sup>82</sup> To illustrate the tax savings available through the use of tax haven subsidiaries, the Administration gave the example of a U.S. company operating through a German subsidiary.<sup>83</sup> Although the tax rate in Germany was 51 percent, this tax rate could be artificially lowered by diverting half of the profits, through one of the arrangements cited above, to another subsidiary located in a tax haven country, such as Switzerland. Assuming the Swiss tax was 8 percent, the overall tax rate on the income could be reduced to less than 30 percent.<sup>84</sup>

## 2. Economic Conditions

Certain economic conditions at the time of the Kennedy administration's 1961 tax proposal led the administration specifically to examine tax provisions that encouraged U.S. taxpayers to move capital outside the United States. First, the United States was experiencing a deficit in its international balance of payments, which the Administration was concerned would threaten the stability of the U.S. dollar.<sup>85</sup> Second, by the early 1960s, Japan and the countries of Europe had become economically competitive with the United States, having completed post-World War II reconstruction of their economies. Thus, the Kennedy Administration determined that it was no longer necessary, as it had been during the immediate postwar period, to promote

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<sup>78</sup> *Id.* at 303, 305.

<sup>79</sup> 1962 Hearings before the Senate, *supra* note 61, at 98.

<sup>80</sup> President's Tax Message, *supra* note 47, at 25.

<sup>81</sup> 1962 Hearings before the Senate, *supra* note 61, at 98.

<sup>82</sup> President's Tax Message, *supra* note 47, at 25.

<sup>83</sup> *Id.*

<sup>84</sup> *Id.*

<sup>85</sup> 1961 Hearings before the House, *supra* note 53, at 347; President's Tax Message, *supra* note 47, at 6, 29.

private investment in these developed countries.<sup>86</sup> The Kennedy administration believed, however, that the United States continued to have an interest in promoting investment in underdeveloped countries. Thus, the Administration proposed to allow deferral to continue for U.S. companies operating through subsidiaries in underdeveloped countries that were not tax haven corporations.<sup>87</sup>

### **3. Efficient Allocation of Resources and Equitable Treatment of U.S. Taxpayers**

The Kennedy Administration argued that deferral encouraged U.S. businesses to make investment decisions that were not beneficial to the U.S. economy. The Administration presented evidence to show that artificially stimulated investment in developed countries led to few additional net exports and therefore did not significantly affect the creation of new jobs in the United States, while direct investment in the United States significantly benefitted U.S. employment.<sup>88</sup> The Administration noted that U.S. investment in the countries of Latin America and other less developed countries generated a higher level of U.S. exports and thus was more beneficial to U.S. employment.<sup>89</sup> The Administration maintained that, to the extent deferral encouraged companies to base investment decisions solely on the tax benefits available, it interfered with the free market's efficient allocation of international resources.<sup>90</sup>

The Kennedy Administration also maintained that its proposal to end deferral was necessary to achieve greater equity among U.S. taxpayers.<sup>91</sup> Those U.S. taxpayers that operated abroad through foreign subsidiaries, and thus obtained the benefits of deferral, gained a significant tax advantage over U.S. taxpayers that operated their businesses exclusively in the United

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<sup>86</sup> President's Tax Message, supra note 47, at 7, 17, 29.

<sup>87</sup> Id. at 7.

<sup>88</sup> 1962 Hearings before the Senate, supra note 61, at 100-01. The Kennedy Administration provided figures indicating that, under the most favorable assumptions, a dollar's worth of investment in Europe generated 10 cents worth of capital equipment exports, and hence, had the effect on employment equal to 10 cents invested in the United States while a dollar invested directly in the U.S. generated 40 cents worth of continuing production. Id. at 100.

<sup>89</sup> Id.

<sup>90</sup> President's Tax Message, supra note 47, at 6-7; 1962 Hearings before the Senate, supra note 61, at 103.

<sup>91</sup> Id. at 6.

States.<sup>92</sup> The Administration therefore maintained that deferral was akin to a special subsidy to U.S. taxpayers operating in foreign countries.<sup>93</sup>

The Kennedy Administration took the position that, to encourage resources to be allocated efficiently and to treat taxpayers equitably, the tax policy of the United States must be based on the concept of tax neutrality. As explained in a report prepared by the Treasury and submitted to the Senate in conjunction with the testimony of Douglas Dillon, Secretary of the Treasury, in April, 1962, hearings before the Senate Finance Committee:

One of the most fundamental of the guiding principles in American income taxation is that there should be equality in tax treatment of similar groups of taxpayers. Applied to corporations, this principle must be interpreted to mean that the income of any branch or subsidiary of an American corporation operating overseas should as far as possible be subject to the same corporate income tax rates as the income of any branch or subsidiary operating at home.

Justification of this basic principle, as a principle, is made on two grounds: (1) it is 'fair' or 'equitable'; and (2) it promotes the most efficient possible allocation of our own and world resources.<sup>94</sup>

The Kennedy Administration recognized that, where tax rates differ between countries, two alternative types of tax neutrality are possible.<sup>95</sup> Under capital export neutrality, the foreign income of a U.S. company is taxed at U.S. rates so that the U.S. company pays at least the U.S. rate on its income whether it invests at home or abroad. Capital export neutrality thus eliminates tax as an investment factor.<sup>96</sup> Under capital import neutrality, the foreign income of the U.S. company is taxed only at foreign rates, thus allowing the American investor abroad to be compete under the same tax burden as foreign-owned companies. The Kennedy Administration conceded that the two types of neutrality could not be achieved simultaneously, but believed that capital export neutrality was a more important goal because it achieved the policy objectives of equity and allowing the free market to control investment decisions.<sup>97</sup>

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<sup>92</sup> President's Tax Message, supra note 47, at 6, 29.

<sup>93</sup> 1962 Hearings before the Senate, supra note 61, at 103.

<sup>94</sup> 1962 Hearings before the Senate, supra note 61, Exhibit III, at 177.

<sup>95</sup> President's Tax Message, supra note 47, at 30.

<sup>96</sup> Id.

<sup>97</sup> Id. See also 1961 Hearings before the House, supra note 53, at 348.

#### **4. Complexity**

The Administration repeatedly expressed the position that its proposals were only intended to discourage tax motivated foreign investment and not legitimate overseas operations. As noted by Secretary Dillon in hearings before the Senate: “[W]e are concerned only with artificial tax inducements to invest abroad. We do not wish to impede such investment beyond removing these special preferences.”<sup>98</sup>

Nevertheless, the Administration advocated an end to deferral for all of the income of U.S.-owned foreign subsidiaries operating in developed countries because it believed that a more narrowly targeted provision could not adequately address every possible use of a tax haven corporation without undue complexity.<sup>99</sup> In his statements in hearings before the House Ways and Means Committee in May of 1961, Secretary Dillon acknowledged that a proposal directed only at tax havens would address many of the Administration’s concerns but noted the difficulty of drafting narrowly targeted anti-deferral provisions:

With the situation in Europe, we find that the possibilities are pretty well myriad and we think you would have to develop a very complex body of law which would probably have to be changed rather frequently in the light of experience to keep up with the legal ingenuity of those who wish to make use of these tax havens.<sup>100</sup>

The Administration considered its broader proposal to be a simpler and more comprehensive way to eliminate tax incentives to defer income through tax haven arrangements while not significantly affecting companies operating in high-tax countries for which the foreign tax credit would neutralize the tax effect of ending deferral.<sup>101</sup>

#### **C. Arguments Against Ending Deferral on Tax Haven Income**

Certain members of both the House Ways and Means Committee and the Senate Finance Committee attached dissenting or alternative views to the House and Senate Reports accompanying H.R. 10650. While some Senators acknowledged that the bill, as modified by the

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<sup>98</sup> 1962 Hearings before the Senate, supra note 61, at 102.

<sup>99</sup> 1961 Hearings before the House, supra note 53, at 322.

<sup>100</sup> Id. at 345.

<sup>101</sup> Id. at 322, 343.

Senate, was less far reaching than the original House version of the bill,<sup>102</sup> both Senate and House minority views had similar concerns about fundamental aspects of the bill as it applied to controlled foreign corporations. The following is a summary of their arguments.

### **1. Competitiveness of U.S.-Owned Firms and the Importance of Foreign Investment**

The primary objection to the measure to end deferral for certain income of controlled foreign corporations, as expressed by both the House and Senate minority views, was that the measure would interfere with the ability of U.S.-owned corporations to compete with foreign-owned corporations in the world market.<sup>103</sup> Opponents of the measure argued that, to be competitive, U.S.-owned firms must operate under the same tax rules as foreign-owned corporations.<sup>104</sup> Opponents contended that no foreign government imposed tax on undistributed profits of foreign corporations.<sup>105</sup> Conflicting representations were made during the hearings about whether foreign-owned corporations could use tax haven corporations to benefit from deferral.<sup>106</sup> However, opponents of the measure maintained that, even if U.S.-owned firms

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<sup>102</sup> See Additional Views of Senator Eugene McCarthy on H.R. 10650, S. Rep. No. 1881, 87<sup>th</sup> Cong., 2d Sess. 353-54 (1962) (Additional Views of Senator McCarthy).

<sup>103</sup> See, e.g., Separate Views of the Republicans on H.R. 10650, H.R. Rep. No. 1447, 87<sup>th</sup> Cong., 2d Sess. B23-24 (1962) (Separate Views of House Republicans); Further Views of Hon. Thomas B. Curtis, H.R. Rep. No. 1447, 87<sup>th</sup> Cong., 2d Sess. B29, B30, B33 (Views of Representative Curtis); Additional Views of Senator McCarthy, at 353-54; Dissenting Views of Senators Frank Carlson, Wallace F. Bennett, John Marshall Butler, Carl T. Curtis, and Thruston B. Morton on Section 11- Foreign Source Income, H.R. 10650, as Amended by Senate Finance Committee, S. Rep. No. 1881, 87<sup>th</sup> Cong., 2d Sess. 359, 370 (1962) (Dissenting Views of Senators).

<sup>104</sup> See Separate Views of House Republicans, supra note 103, at B23.

<sup>105</sup> See Separate Views of House Republicans, supra note 103, at B23-24; Dissenting Views of Senators, supra note 103, at 370. While the Kennedy Administration did not dispute this point, it argued that most of the developed countries, either through controls on foreign investment, e.g., France, or by treating the foreign corporation as a resident for tax purposes, e.g., Germany and the U.K., effectively prevented their nationals from taking advantage of deferral. See 1962 Hearings before the Senate, supra note 61, at 102 ; 1961 Hearings before the House, supra note 53, at 323.

<sup>106</sup> See Separate Views of House Republicans, supra note 103, at B25 (tax treaties and favorable treatment for dividends fosters the use of Swiss marketing subsidiaries by European competitors of American firms); 1961 Hearings before the House, supra note 53, at 303, 349 (remarks by Secretary Dillon acknowledging that foreign-owned corporations used structures involving tax haven corporations far less than American-owned corporations).

conducted more tax haven operations than foreign-owned businesses, any competitive advantage they gained was appropriate.<sup>107</sup> Contrary to the position of the Administration that foreign investment by U.S. business had little positive impact on U.S. employment and on the balance of payments, opponents argued that exports were favorable to the balance of payments and stimulated the economy, both creating jobs for U.S. workers and resulting in a dollar return in excess of the amount invested abroad.<sup>108</sup>

Opponents also expressed concern that the anti-deferral measure reversed longstanding U.S. foreign policy that encouraged private investment abroad,<sup>109</sup> and maintained that foreign assistance continued to be necessary to prevent further aggression from Communist regimes.<sup>110</sup>

## **2. Provision Should Not Apply to Avoidance of Foreign Tax**

Another criticism of the measure was that, because tax haven corporations often were used to avoid foreign income taxes, the measure, which would have the effect of preventing foreign tax avoidance, would increase the revenue of foreign governments more than that of the United States. It was argued that the United States was not justified in “taxing income earned by a foreign corporation on transactions occurring outside of the United States merely because of

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<sup>107</sup> See 1961 Hearings before the House, supra note 53, at 349 (remarks of Representative Byrne).

<sup>108</sup> See Views of Representative Curtis, supra note 103, at B31; Additional Views of Senator McCarthy, supra note 102, at 353; Dissenting Views of Senators, supra note 103, at 358. In an exhibit presented in conjunction with Secretary Dillon’s testimony before the Senate Finance Committee, Treasury challenged evidence presented by particular companies that foreign investment by U.S. businesses had a positive effect on U.S. employment and the balance of payments. Treasury argued that this evidence was flawed because (1) it represented the behavior of a single company; (2) the data on capital outflow often included only purchases of stock in a foreign company and did not necessarily include net increases in inter-company accounts; (3) the data did not measure sales by foreign subsidiaries abroad that displace actual or potential U.S. exports; (4) the data included investment in both developed and underdeveloped countries; and (5) the inflows and outflows being compared, the outflow of new capital and the inflow from dividends and export receipts for a given period, did not relate to each other because the dividends and export receipts were generated by investment over several years. See 1962 Hearings before the Senate, supra note 61, at 173-74.

<sup>109</sup> See Separate Views of House Republicans, supra note 103, at B21-22 (The provision “would destroy more than 15 years of effort on the part of prior administrations, both Democrat and Republican, to promote and expand the opportunity for American business in the world market as an integral part of the U.S. foreign policy.”)

<sup>110</sup> See Dissenting Views of Senators, supra note 103, at 361.

American shareholders,”<sup>111</sup> and that avoidance of foreign taxes should not be of concern to the United States.<sup>112</sup>

### 3. Constitutional and Treaty Issues

Opponents of the anti-deferral provision questioned the constitutionality of imposing a tax on the undistributed income of a foreign corporation.<sup>113</sup> Opponents also expressed concern that the proposal would cause the United States to violate its treaty obligations with foreign governments.<sup>114</sup>

### 4. Complexity and Potential Unintended Consequences

Opponents argued that the provision would cause administrative difficulties and would be unnecessarily complex and burdensome for taxpayers.<sup>115</sup> Opponents also questioned some of the technical aspects of the provision. For example, opponents argued that, if U.S. shareholders were being currently taxed on a deemed paid amount, they would want an actual distribution, which may conflict with the interests of the foreign shareholders.<sup>116</sup>

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<sup>111</sup> Separate Views of House Republicans, supra note 103, at B24.

<sup>112</sup> See Id. at B25.

<sup>113</sup> See Id. at B21; Views of Representative Curtis, supra note 103, at B34; Additional Views of Senator McCarthy, supra note 102, at 354; Dissenting Views of Senators, supra note 103, at 375-85. Two memoranda were submitted to the House Ways and Means Committee during the hearings on the Administration’s proposal. The first, by the Joint Committee on Taxation, took the position that the provision was not constitutional, relying on Eisner v. Macomber, 252 U.S. 189 (1920). See 1961 Hearings before the House, supra note 53, at 311. The second, by the Treasury Department, distinguished Eisner v. Macomber and argued that case law supported taxing controlling shareholders on the undistributed earnings of a corporation where necessary to prevent tax avoidance. See Id. at 313.

<sup>114</sup> See Separate Views of House Republicans, supra note 103, at B27; Additional Views of Senator McCarthy, supra note 102, at 354; Dissenting Views of Senators, supra note 103, at 384-86.

<sup>115</sup> See Separate Views of House Republicans, supra note 103, at B25-27; Views of Representative Curtis, supra note 103, at B34; Dissenting Views of Senators, supra note 103, at 363-65.

<sup>116</sup> See Separate Views of House Republicans, supra note 103, at B26, Dissenting Views of Senators, supra note 103, at 382.

Opponents expressed concern that the provision would bring about unintended consequences that would negatively impact the U.S. economy. For example, it was argued that, because, in any case, the U.S. shareholder would pay tax on the undistributed earnings of its foreign subsidiary at a rate at least equal to the U.S. rate, the provision invited foreign countries to increase their taxes on this income to match the U.S. rate. The foreign taxes credits generated would then “soak up” any residual U.S. tax on the income.<sup>117</sup> Opponents also contended that tax haven earnings should be encouraged because they generated more revenue for the United States when finally repatriated. Unlike high-taxed earnings for which there is little or no residual U.S. tax after foreign taxes are credited, the low-taxed earnings from tax havens would yield a residual U.S. tax.<sup>118</sup> Additionally, opponents argued that the provision would encourage U.S. investors to shift to minority positions in foreign firms causing the United States to lose export benefits it derived from U.S.-controlled firms, such as the use of U.S. manufacturers.<sup>119</sup>

#### **D. Subpart F Targets Tax Haven Operations**

##### **1. Tax Haven Deferral**

President Kennedy’s anti-deferral plan had contained two proposals: the elimination of tax deferral privileges in developed countries; and the elimination of tax haven deferral privileges in all countries. While Congress accepted the Kennedy Administration’s second proposal, agreeing that tax haven abuses provided an inappropriate tax incentive for U.S. businesses to move capital abroad and should be curtailed,<sup>120</sup> it rejected the President’s first proposal to end deferral for U.S. businesses operating in developed countries.<sup>121</sup> Because the final legislation incorporates only the

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<sup>117</sup> See Additional Views of Senator McCarthy, supra note 102, at 354; Dissenting Views of Senators, supra note 103, at 370, 382.

<sup>118</sup> See Separate Views of House Republicans, supra note 103, at B24-25.

<sup>119</sup> See Dissenting Views of Senators, supra note 103, at 371.

<sup>120</sup> See 108 Cong. Rec. 17752 (1962) (remarks of Senator Kerr) (“[T]his bill is beneficial in that it will stop the drain on our investment which is artificially induced by the low tax rates it is possible to obtain through the use of tax haven subsidiaries.”).

<sup>121</sup> 1962 House Report, supra note 46, at 57; 1962 Senate Report, supra note 70, at 79. As noted by Senator Kerr during Senate floor debates:

The administration has requested that we end deferral of U.S. tax for U.S.-controlled foreign corporations. This bill does not adopt this principle nor achieve this objective. Instead, the foreign income provisions of the bill are aimed at a much more limited objective, which should be acceptable to all – an ending of tax haven abuses.

tax haven deferral proposal, to understand the scope and purpose of subpart F, it is necessary to clarify what the Kennedy Administration and Congress included within the concept of tax haven deferral.

“Tax haven deferral privileges” could be distinguished from “tax deferral privileges in developed countries,” the target of the President’s first proposal, because tax deferral in developed countries could have been obtained by taxpayers that were conducting normal business operations through non-tax motivated transactions. Commenting on his first proposal, the ending of deferral in developed countries, the President stressed that:

Many American investors properly made use of this deferral in the conduct of their foreign investment. Though changing conditions now make continuance of the privilege undesirable, such change of policy implies no criticism of the investors who utilize this privilege.<sup>122</sup>

Tax haven deferral, however, was deferral that was not justified on business grounds but was maintained for tax avoidance purposes. Referring to tax haven deferral, the President’s Tax Message noted that, “[t]he undesirability of continuing deferral is underscored where deferral has served as a shelter for tax escape through the unjustifiable use of tax havens such as Switzerland.”<sup>123</sup>

Tax haven deferral included deferral obtained to avoid either U.S. or foreign taxes. The type of transactions that the President’s proposal and Committee Reports identified as giving rise to tax haven deferral were “artificial arrangements” between related corporations that “exploit the multiplicity of foreign tax systems and international agreements in order to reduce sharply or eliminate completely their tax liabilities both at home and abroad.”<sup>124</sup> The Senate Finance Committee reported that:

In the case of foreign income, your committee has been primarily concerned with ending tax haven abuses; namely, devices to avoid either the United States or

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108 Cong. Rec. 17750 (1962).

<sup>122</sup> President’s Tax Message, supra note 47, at 6.

<sup>123</sup> Id.

<sup>124</sup> The President’s Tax Message, supra note 47, at 6. This portion of the President’s Tax Message was quoted in both the House and Senate Reports. See 1962 House Report, supra note 46, at 57; 1962 Senate Report, supra note 70, at 78-79.

foreign taxes which could be expected to be imposed under normal business operating conditions.<sup>125</sup>

Finally, tax haven deferral was identified by the way income was earned, rather than by whether income was earned by a corporation organized in a country regarded as a tax haven. President Kennedy's proposal, and the final subpart F legislation, identify "forms of activities, such as trading, licensing, insurance, and others, that typically seek out tax haven methods of operation."<sup>126</sup> The Kennedy Administration did not attempt to define the term "tax haven" other than by example, e.g., Switzerland. Most types of tax haven income described in subpart F, as originally enacted, shared two common elements. The income was derived (1) from sources outside the controlled foreign corporation's country of incorporation, and (2) from transactions with related persons.

## **2. Subpart F Attempts to Preserve Competitiveness of U.S. Businesses**

Congress accepted the arguments made during the hearings that the President's broad proposal would discourage U.S. businesses from investing abroad, which investment was necessary to stimulate U.S. exports, and would place U.S.-owned businesses at a competitive disadvantage with foreign-owned businesses.<sup>127</sup> Although both the House and the Senate favored a regime that specifically targeted tax haven operations, the Senate went further than the House bill in protecting what it perceived to be legitimate foreign operations.<sup>128</sup> Thus, the legislation, as enacted, reflects an attempt to target artificial arrangements that created tax incentives for capital to move outside the United States while being narrow in application to address concerns about the competitiveness of U.S. business in the foreign market.

## **IV. Specific Provisions of 1962 Legislation**

### **A. CFC, U.S. Shareholder, and Current Inclusion Rules**

Senate amendments narrowed the class of foreign corporations subject to the rules of subpart F based on a Treasury proposal that responded to complaints that the rules reached

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<sup>125</sup> 1962 Senate Report, supra note 70, at 2. See also 108 Cong. Rec. 17750–51 (1962) (remarks of Senator Kerr) (describing tax haven abuses as "attempts to avoid U.S. or foreign taxes by the use of artificial corporate devices or selection of countries for incorporation for tax rather than business purposes.").

<sup>126</sup> President's Tax Message, supra note 47, at 7. See also 1962 House Report, supra note 46, at 57; 1962 Senate Report, supra note 70, at 79 (quoting from President's Tax Message).

<sup>127</sup> 1962 House Report, supra note 46, at 57; 1962 Senate Report, supra note 70, at 83.

<sup>128</sup> See 108 Cong. Rec. 17751 (1962) (remarks of Senator Kerr).

“situations where ownership was widely scattered and no U.S. group was in effective control.”<sup>129</sup> As enacted, subpart F defined a controlled foreign corporation (CFC) as a foreign corporation more than 50 percent of the total combined voting power of which was owned, actually (directly or indirectly) or constructively, by U.S. shareholders.<sup>130</sup> A “U.S. shareholder” was a specifically defined term meaning a U.S. person that owned, directly, indirectly or constructively, 10 percent or more of the voting power of the foreign corporation.<sup>131</sup> As enacted, the rules applied only to U.S. shareholders that owned 10 percent of the voting power, direct or indirectly.<sup>132</sup> That is, constructive ownership was not taken into account for purposes of determining the amount of the inclusion.

A Senate amendment narrowed the House bill’s definition of controlled foreign corporation. The House bill would have taken into account all U.S. ownership, not just 10 percent owners, in determining whether the greater than 50 percent threshold was satisfied.<sup>133</sup> The House bill also would have made the current inclusion rules apply to U.S. persons that owned 10 percent of the value of the corporation regardless of the amount of voting stock they owned.<sup>134</sup>

As enacted, subpart F required a U.S. shareholder of a CFC to include currently in gross income his pro rata share of three different amounts: (1) the subpart F income for the taxable year; (2) the previously excluded subpart F income withdrawn from investment in less developed countries for the taxable year; and (3) the foreign corporation’s increase in earnings invested in U.S. property for the taxable year.<sup>135</sup> The amount of subpart F income subject to current inclusion was limited to the earnings and profits of the CFC less accumulated deficits since 1959,

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<sup>129</sup> Senate Committee on Finance, 87<sup>th</sup> Cong., 2d Sess., Draft of Statutory Language, with Accompanying Explanation, of Amendments Proposed by the Secretary of the Treasury on May 10, 1962, to Sections 13, 15, 16, and 20 of H.R. 10650, at 3 (Comm. Print 1962) (1962 Explanation of Treasury Draft).

<sup>130</sup> I.R.C. § 957(a). All section references in this discussion are to the Internal Revenue Code as in effect during the year of enactment of the provision described.

<sup>131</sup> I.R.C. § 951(b).

<sup>132</sup> I.R.C. § 951(a)(1).

<sup>133</sup> Both the House and Senate versions of the bill were narrower than the original Treasury proposal, which would have subjected 10 percent shareholders of newly formed foreign corporations to current inclusion rules regardless of the percentage of U.S. ownership of the foreign corporation. 1961 Hearings before the House, supra note 53, at 261.

<sup>134</sup> 1962 Senate Report, supra note 70, at 240.

<sup>135</sup> I.R.C. § 951(a)(1)(A) and (B).

not otherwise offset.<sup>136</sup> Earnings and profits could also be reduced by deficits of other foreign corporations in the same chain of ownership.<sup>137</sup> To prevent double taxation, actual distributions were excluded from income to the extent they were paid out of earnings and profits attributable to amounts that had previously been included in the gross income of the U.S. shareholder under subpart F.<sup>138</sup>

## **B. Two Categories of Subpart F Income: Income from Insuring U.S. Risks and Foreign Base Company Income**

Subpart F income was defined to include two general categories of income: (1) income from insuring U.S. risks, and (2) foreign base company income.

### **1. Income from Insuring U.S. risks**

Congress targeted income from insuring U.S. risks because of its concern that certain insurance income was being diverted through foreign subsidiaries to avoid U.S. taxation.<sup>139</sup> In 1959, legislation was enacted that, for the first time in many years, taxed insurance companies on underwriting income.<sup>140</sup> Congress became aware that insurance companies were attempting to avoid this tax by reinsuring their policies, or placing the initial policies, with their foreign subsidiaries.<sup>141</sup> To address this problem, Congress included income from insuring or reinsuring U.S. risks within the definition of subpart F income if the associated premiums exceeded 5 percent of total premiums.<sup>142</sup> Certain income from cross-insurance arrangements also was included within the definition of subpart F income to prevent taxpayers from entering into arrangements to avoid these rules.<sup>143</sup> A special definition of CFC, which used a 25 percent rather than 50 percent threshold for control, was added to prevent insurance companies from attempting to decontrol to prevent the application of the subpart F insurance income rules.<sup>144</sup>

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<sup>136</sup> I.R.C. § 952(c).

<sup>137</sup> I.R.C. § 952(d).

<sup>138</sup> I.R.C. § 959.

<sup>139</sup> 1962 House Report, supra note 46, at 58.

<sup>140</sup> Life Insurance Company Income Tax Act of 1959, Pub. L. No. 86-69, 73 Stat. 112.

<sup>141</sup> 1962 Senate Report, supra note 70, at 81.

<sup>142</sup> I.R.C. §§ 952(a)(1) and 953.

<sup>143</sup> I.R.C. § 953(a)(1)(B).

<sup>144</sup> 1962 Senate Report, supra note 70, at 82. See I.R.C. § 957(b).

## 2. Foreign Base Company Income

The foreign base company income rules of subpart F were directed at tax haven arrangements that were designed “to avoid either U.S. tax or tax imposed by the foreign country” by exploiting a “multiplicity of foreign tax systems.”<sup>145</sup> Foreign base company income consisted of three categories of income: foreign personal holding company income, foreign base company sales income, and foreign base company services income.<sup>146</sup>

### a. Foreign Personal Holding Company Income

Foreign personal holding company income generally included income from portfolio types of investments and other passive investment income.<sup>147</sup> Congress believed that ending deferral for this type of income would not interfere with competitiveness of U.S. businesses operating abroad.<sup>148</sup> Nevertheless, following a Treasury proposal,<sup>149</sup> Congress sought to carve out from this category income that was neither passive income nor tax haven-type income.<sup>150</sup>

Congress determined that the following types of investment income were not passive income, and therefore should be excluded from foreign personal holding company income: (1) rents and royalties received from an unrelated person and derived in the active conduct of a trade or business, and (2) dividends, interest and certain gains derived in the conduct of a banking business or derived from investments made by an insurance company of its unearned premiums or reserves.<sup>151</sup>

Congress also determined that dividends, interest, rents and royalties received by a CFC from a related person generally should be excluded from foreign personal holding company income if this income was not “tax haven” type income,<sup>152</sup> that is, if it was earned under

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<sup>145</sup> See 1962 House Report, supra note 46, at 58 (describing foreign base company sales income).

<sup>146</sup> I.R.C. § 954(a).

<sup>147</sup> I.R.C. § 954(c).

<sup>148</sup> 1962 Senate Report, supra note 70, at 83.

<sup>149</sup> See 1962 Explanation of Treasury Draft, supra note 129, at 1-2.

<sup>150</sup> 1962 Senate Report, supra note 70, at 83.

<sup>151</sup> I.R.C. § 954(c)(3).

<sup>152</sup> See 1962 Explanation of Treasury Draft, supra note 129, at 1-2 (describing proposal for related person exceptions to foreign personal holding company income that were adopted by Senate amendments).

circumstances that did not take advantage of two or more foreign tax systems to artificially lower the tax rate.<sup>153</sup> Thus, the foreign personal holding company income rules contained two same country exceptions applicable to related party payments. The first exception excluded dividends and interest from foreign personal holding company income that were received from a related person organized under the laws of the same country as the recipient CFC if the related person had a substantial part of its assets used in a trade or business located in that country.<sup>154</sup> Through this exception, Congress sought to treat foreign corporations organized in the same country in a manner similar to a U.S. consolidated group.<sup>155</sup> The second exception excluded rents and royalties that were received from a related person for the use of property within the CFC's country of incorporation.<sup>156</sup>

The foreign personal holding company rules also contained a third related party exception intended to exclude interest payments between two related financial institutions engaged in normal business transactions.<sup>157</sup> The interest was excluded if both financial institutions conducted business predominately with unrelated persons.

#### **b. Foreign Base Company Sales Income**

The foreign base company sales income provisions were intended to curtail the use of tax havens to siphon off sales profits of a related corporation to obtain a lower rate of tax for this income.<sup>158</sup> Congress was primarily concerned with situations in which the U.S. parent or a related U.S. or foreign corporation manufactured the product that the tax haven subsidiary sold (either as principal or commission agent).<sup>159</sup> Thus, the rules focused on purchases or sales transactions involving related persons where the manufacturing and selling functions were separated into two different taxing jurisdictions.<sup>160</sup>

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<sup>153</sup> See 108 Cong. Rec. 18598 (1962) (remarks of Senator Kerr) (the same country exceptions were included in the bill because all corporations in a single country receive the same tax treatment).

<sup>154</sup> I.R.C. § 954(c)(4)(A).

<sup>155</sup> See 1962 Senate Report, *supra* note 70, at 83 (“Your committee saw no reason for taxing the U.S. shareholders on dividends received by a CFC from a related party where the U.S. shareholder would not have been taxed if he owned the stock of the related party directly.”).

<sup>156</sup> I.R.C. § 954(c)(4)(C).

<sup>157</sup> 1962 Senate Report, *supra* note 70, at 83. See I.R.C. § 954(c)(4)(B).

<sup>158</sup> 1962 House Report, *supra* note 46, at 58.

<sup>159</sup> 1962 Senate Report, *supra* note 70, at 84.

<sup>160</sup> *Id.*

Foreign base company sales income was defined as income (including commissions) derived from the purchase of personal property from, or on behalf of, a related person and its sale to any person or the purchase of personal property from any person and its sale to, or on behalf of, a related person where the property was both manufactured and sold for use outside the CFC's country of incorporation.<sup>161</sup> The tax haven abuses with which Congress primarily was concerned involved mere paper corporations or corporations that performed minimal functions. Thus, language in the committee reports makes clear that Congress intended to exclude sales income from subpart F income if the CFC performed a significant amount of manufacturing (as distinguished from minor assembly or packaging) with respect to the product that it sold.<sup>162</sup>

Congress also expanded the foreign base company sales income rules to cover branch operations. Congress was concerned that the separation of selling and manufacturing activities could also be accomplished by having the CFC form a branch in a tax haven or incorporate in the tax haven and form a branch in another country and locate either the sales or manufacturing function in the branch.<sup>163</sup> In certain circumstances (for example, where the CFC's country of incorporation and the country where the branch was located both used a territorial system of taxation) the tax effect would be the same as if the branch were a separate subsidiary organized in that country. The foreign base company sales income rules thus contained a branch rule that treated the income attributable to branch operations as foreign base company sales income when the branch operations had substantially the same effect as if the branch were a separate subsidiary. Congress gave the Treasury regulatory authority to determine the specific circumstances under which the branch rule would apply.<sup>164</sup>

### **c. Foreign Base Company Services Income**

The foreign base company services income provisions, like the foreign base company sales income provisions, were intended to end deferral where a tax haven subsidiary was used to separate a portion of the active business income of the parent or a related corporation and move it to a low-tax jurisdiction. Congress was specifically concerned about the use of a tax haven

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<sup>161</sup> I.R.C. § 954(d)(1).

<sup>162</sup> 1962 Senate Report, supra note 70, at 84; 1962 House Report, supra note 46, at 62. Although the intent of Congress to exclude income from the sale of a property manufactured by the CFC is not specifically reflected in the statutory language, treasury regulations contain a manufacturing exception to the foreign base company sales income rules based upon this legislative history. See Treas. Reg. § 1.954-3(a)(4).

<sup>163</sup> 1962 Senate Report, supra note 70, at 84.

<sup>164</sup> See I.R.C. § 954(d)(2). Those regulations are contained in Treas. Reg. § 1.954-3(b).

subsidiary to separate services from manufacturing activity.<sup>165</sup> Senate amendments added the foreign base company services income provisions in response to Treasury's concern that, without them, a serious gap would exist in the foreign base company rules.<sup>166</sup>

Foreign base company services income was defined as income derived in connection with the performance of technical, managerial, engineering, architectural, scientific, skilled, industrial, commercial, or similar services performed for or on behalf of a related person outside the CFC's country of incorporation.<sup>167</sup> Because Congress was concerned about the separation of services and manufacturing activities, it excluded from the definition of foreign base company services income, income arising from services directly related to, and performed prior to, the sale of property that was manufactured by the CFC or income arising from services directly related to an offer or effort to sell such property.

#### **d. Exclusions from Foreign Base Company Income**

Subpart F contained special rules that allowed for the reduction or exclusion of foreign base company income.

##### **(1) Investments in Less Developed Countries**

Consistent with the Kennedy Administration's original proposal, the new legislation provided limited deferral for certain investments in less developed countries. Foreign base company income was reduced by dividends, interest and net gains from qualified investments in less developed countries to the extent these amounts were reinvested in qualified investments in less developed countries.<sup>168</sup> Conversely, U.S. shareholders were required to include in gross income their pro rata share of the amounts withdrawn from investments in less developed countries for the year.<sup>169</sup>

##### **(2) Shipping Income**

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<sup>165</sup> 1962 Senate Report, *supra* note 70, at 84.

<sup>166</sup> 1962 Explanation of Treasury Draft, *supra* note 129, at 2.

<sup>167</sup> I.R.C. § 954(e).

<sup>168</sup> I.R.C. § 954(b)(1).

<sup>169</sup> I.R.C. § 954(a)(1)(A)(ii).

The subpart F rules also excluded from foreign base company income amounts derived in connection with the use of any aircraft or vessel in foreign commerce.<sup>170</sup> Congress allowed deferral to continue for this type of income because it believed that a U.S.-owned maritime fleet and airlines operating abroad were in the interest of national defense.<sup>171</sup>

**e. Other Special Rules**

The subpart F rules provided that if foreign base company income was less than 30 percent of the gross income of the CFC, none of the income was foreign base company income (de minimis exception) and, if foreign base company income exceeded 70 percent of gross income, all of the income of the CFC (less deductions) was foreign base company income (full inclusion rule).<sup>172</sup> Senate amendments had raised the de minimis percentage from 20 to 30 percent and had lowered the full inclusion percentage from 80 to 70 percent.

A special rule also provided an exception for CFCs not availed of to reduce taxes. Under this rule, foreign base company income did not include any item of income if it was established to the satisfaction of the Treasury that, with respect to this income, creating the CFC did not have the effect of substantially reducing income or similar taxes.<sup>173</sup>

**C. Investments in U.S. Property**

In addition to insurance income and foreign base company income, the subpart F rules also required a U.S. shareholder to include in gross income his pro rata share of the CFC's increase in earnings invested in U.S. property.<sup>174</sup> "U.S. property" included tangible property located in the United States, stock of a domestic corporation and obligations of a U.S. person, and the right to use in the United States a patent, copyright, etc.<sup>175</sup> In enacting this provision, Congress recognized that bringing earnings back to the United States through U.S. investments was substantially equivalent to paying a dividend to the U.S. shareholder.<sup>176</sup> Certain property was specifically excepted from the definition of U.S. property, for example, investments in U.S. bank

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<sup>170</sup> I.R.C. § 954(b)(2).

<sup>171</sup> 1962 Senate Report, supra note 70, at 85.

<sup>172</sup> I.R.C. § 954(b)(3).

<sup>173</sup> I.R.C. § 954(b)(4).

<sup>174</sup> See I.R.C. §§ 951(a)(1)(B), 956.

<sup>175</sup> I.R.C. § 956(b).

<sup>176</sup> 1962 Senate Report, supra note 70, at 88.

accounts and certain loans arising in connection with the sale or processing of property, because Congress determined that these types of investments were “normal commercial transactions without intention to permit the funds to remain in the United States indefinitely.”<sup>177</sup>

The House bill contained a broader rule that, in addition, would have required U.S. shareholders to include in income their pro rata share of the corporation’s increase in earnings invested in property that was not necessary for the active conduct of the trade or business of the CFC. A Senate amendment eliminated this provision following a Treasury recommendation that noted the difficulty in determining whether earnings were invested in the same trade or business and certain other technical difficulties.<sup>178</sup>

#### **D. Minimum Distribution Rules**

Subpart F income was not taxed to the U.S. corporate shareholders if the CFC (or specified group of related CFCs) met a schedule of minimum distributions of earnings and profits.<sup>179</sup> The higher the effective foreign tax rate on the income, the lower the minimum distribution that was required to avoid a subpart F inclusion. When the effective foreign tax rate was 47 percent or more, no minimum distribution was required. A Senate amendment added this provision to give relief from the subpart F provisions where the foreign tax, combined with the U.S. tax paid on the distributed income, was not substantially below the U.S. tax rate.<sup>180</sup>

#### **E. Export Trade Corporation**

Foreign base company income of an export trade corporation was reduced to the extent this income consisted of export trade income, subject to certain limitations.<sup>181</sup> The amount of foreign base company income that could be deferred was also limited to the amount of income invested in export trade assets. A Senate amendment added this relief provision to encourage export trade by giving limited deferral for corporations selling products abroad that were produced in the United States as long as the income for which deferral was allowed was used to expand the export trade business.<sup>182</sup>

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<sup>177</sup> Id.

<sup>178</sup> 1962 Explanation of Treasury Draft, supra note 129, at 3.

<sup>179</sup> I.R.C. § 963.

<sup>180</sup> 1962 Senate Report, supra note 70, at 88.

<sup>181</sup> I.R.C. § 970.

<sup>182</sup> 1962 Senate Report, supra note 70, at 90-91.

## **F. Foreign Tax Credit**

The subpart F rules allowed a U.S. shareholder to obtain a foreign tax credit with respect to its subpart F inclusion to the same extent it would have been allowed a foreign tax credit upon an actual distribution.<sup>183</sup> Thus, generally the credit was available to a corporate U.S. shareholder that satisfied certain stock ownership rules. Individuals, however, could also obtain a foreign tax credit under these rules if they elected to be taxed at corporate rates.<sup>184</sup> Congress intended this provision to give individuals the assurance that their tax burdens would be no heavier than if they had invested in a domestic corporation doing business abroad.<sup>185</sup>

## **V. Significant Amendments to Subpart F Since 1962 Act**

### **A. Overview**

Congress rejected the Kennedy Administration's broad anti-deferral approach, attempting, instead, to identify specific types of transactions that created artificial tax incentives to move capital abroad. This targeted approach has resulted in a high level of complexity. As subsequent administrations have sought to continue the process of specifically identifying tax haven transactions, the number of categories of subpart F income has grown from 2 to 5. The number of subcategories of foreign base company income has grown from 3 to 5. Four new categories of foreign personal holding company income have been added and several of the existing categories of foreign personal holding company income have been expanded. Certain rules have been added and later removed, such as section 956A, which required a U.S. shareholder to include in income currently its pro rata share of the CFC's excess passive assets. In addition, Congress added a new anti-deferral regime, the passive foreign personal holding company (PFIC) regime, which overlapped to some extent with the subpart F regime. New rules were thus required to govern the interaction of the PFIC rules with subpart F. As Congress has sought to address concerns about competitiveness, the number and complexity of the exceptions and special rules has also grown, such as the recent temporary provisions for active financing income.

Congress, at times, has targeted tax haven transactions to raise revenue. For example, Congress expanded the scope of subpart F in 1975 when it also enacted a series of tax reduction measures designed to alleviate the high rate of unemployment and declining rate of economic growth. In 1986, when Congress decreased the tax rate, it amended subpart F by increasing the number of categories of subpart F income, thereby expanding the tax base. Congress added the

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<sup>183</sup> I.R.C. § 960.

<sup>184</sup> I.R.C. § 962.

<sup>185</sup> 1962 Senate Report, supra note 70, at 92.

956A provisions in 1993, as part of a revenue raising package, when the United States was experiencing a budget deficit.

In addition, Congress has viewed tax deferral as a tax benefit that may be removed when taxpayers engage in certain activity such as participation in an international boycott or making certain illegal payments.

## **B. Amendments to Subpart F**

The amendments to subpart F since 1962 are described in detail below.

### **1. Tax Reform Act of 1969**

#### **a. Revision of Exception from Foreign Base Company Income**

The Tax Reform Act of 1969<sup>186</sup> revised the exception under which an item of income was excluded from foreign base company income if it was established that creation of the CFC in the country in which it was incorporated did not have the effect of substantially reducing taxes with respect to the income. The revised rule was a two-pronged test that focused on “purpose” rather than “effect.” Under the revised rule, foreign base company income did not include income if it was established that neither the creation or organization of the CFC in the particular country nor the transaction giving rise to the income had as one of its significant purposes a substantial reduction of taxes.<sup>187</sup> The revised rule recognized that foreign law may require a CFC to dispose of assets, the gains from which are not taxed under foreign law but which would have been taxed under U.S. law.<sup>188</sup> The formation of the CFC in that country would have the effect, though not the purpose, of reducing taxes.

### **2. Tax Reduction Act of 1975**

The Tax Reduction Act of 1975<sup>189</sup> (1975 Act) was enacted to respond to certain economic conditions in the United States. In 1974, the United States experienced a sharp decline in economic activity together with a high unemployment rate.<sup>190</sup> The 1975 Act contained provisions

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<sup>186</sup> P.L. No. 91-172, 83 Stat. 718 (1969).

<sup>187</sup> I.R.C. § 954(b)(4).

<sup>188</sup> S. Rep. No. 552, 91<sup>st</sup> Cong., 1<sup>st</sup> Sess., reprinted in 1969-3 C.B. 423, 606-607.

<sup>189</sup> P.L. No. 94-12, 89 Stat. 26 (1975).

<sup>190</sup> S. Rep. No. 36, 94<sup>th</sup> Cong., 1<sup>st</sup> Sess. 5 (1975). Figures presented by the Senate Finance Committee indicated that in 1974 the decline in real GNP from the previous year was the largest

that Congress hoped would “check the drastic downward slide in our economy and . . . restore a rate of economic growth that [would] . . . move [the United States] . . . closer to full employment.”<sup>191</sup> The 1975 Act primarily contained a series of tax reduction measures.

The Senate Finance Committee had proposed an amendment that would have imposed the current inclusion rules of subpart F on U.S. persons that owned a one percent or greater interest in a foreign corporation that was owned more than 50 percent by U.S. persons. The conference report substituted for this Senate amendment “a number of specific measures which substantially expand the extent to which foreign subsidiaries of U.S. corporations are subject to current U.S. taxation on tax haven types of income under the . . . subpart F rules of the Code.”<sup>192</sup> The following is a list of the measures substituted by the conference report.

**a. Repeal of Minimum Distribution Exception**

The 1975 Act repealed the minimum distribution rule under which the U.S. shareholder could avoid a subpart inclusion if the CFC (or related group) met a schedule of minimum distributions.

**b. Repeal of Less Developed Country Exception**

The 1975 Act repealed the exclusion for interest, dividends and gain derived from certain investments in less developed countries.

**c. Repeal of Shipping Income Exception and Addition of Foreign Base Company Shipping Income Exception**

The 1975 Act repealed the rule that excluded shipping income from foreign base company income. The 1975 Act also expanded the definition of foreign base company income by adding a new category, foreign base company shipping income. Foreign base company shipping income was income from the use or lease of any aircraft or vessel in foreign commerce or from the sale of any aircraft or vessel used in foreign commerce.<sup>193</sup> Shipping income that was reinvested in shipping operations was excluded from this rule.<sup>194</sup>

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since 1946 and the rate of unemployment was the highest since 1941. *Id.* at 5-6.

<sup>191</sup> *Id.* at 5.

<sup>192</sup> H.R. Conf. Rep. No. 120, 94<sup>th</sup> Cong., 1<sup>st</sup> Sess. 70.

<sup>193</sup> I.R.C. § 954(f).

<sup>194</sup> I.R.C. § 954(b)(2).

**d. Amendment to De Minimis Exception**

The 1975 Act modified the de minimis rule, which excluded all of the income of a CFC from current inclusion under subpart F income if less than 30 percent of its gross income was subpart F income, by lowering the threshold from “30 percent” to “10 percent.”<sup>195</sup>

**3. The Tax Reform Act of 1976**

The Tax Reform Act of 1976<sup>196</sup> (1976 Act) contained several provisions regarding the tax treatment of foreign income. The Joint Committee explained the general principles that guided Congress:

Congress believed that it is necessary to strike a delicate balance between encouraging the free flow of capital across national borders and making sure that the tax laws do not provide excessive incentives for foreign investment instead of investment in the United States.<sup>197</sup>

In the 1976 Act, Congress refined and narrowed the definitions of certain categories of income subject to current inclusion under subpart F and added two new categories of subpart F income.

**a. Investments in U.S. Property**

The 1976 Act narrowed the rules of section 956, which taxed to U.S. shareholders the amount of the increase in earnings of the CFC invested in “U.S. property.” U.S. property included stock or debt of a U.S. person and tangible property located in the United States, with certain exceptions. Congress determined that a broad definition of the term had “a detrimental effect upon our balance of payments by encouraging foreign corporations to invest their profits abroad.”<sup>198</sup>

The 1976 Act provided two new exceptions to the definition of U.S. property. The first exception excluded stock or debt of a domestic corporation if the U.S. shareholder owned less

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<sup>195</sup> I.R.C. § 954(b)(3).

<sup>196</sup> P.L. No. 94-455, 90 Stat. 1520 (1976).

<sup>197</sup> Staff of the Joint Committee on Taxation, General Explanation of the Tax Reform Act of 1976 (H.R. 10612, 94<sup>th</sup> Congress, P.L. No. 94-455) 4 (Joint Comm. Print 1976) (1976 Blue Book).

<sup>198</sup> S. Rep. No. 938, 94<sup>th</sup> Cong., 2d Sess. 226 (1976) (1976 Senate Report).

than 25 percent of the stock of the domestic corporation.<sup>199</sup> Congress believed that treating stock or debt of an unrelated corporation as U.S. property would discourage foreign corporations from temporarily investing their working capital in U.S. obligations, causing them, instead, to favor foreign investments, contrary to the purposes of subpart F.<sup>200</sup> The second exception excluded moveable drilling rigs when used on the U.S. continental shelf.<sup>201</sup> Congress believed that including this property in the definition of U.S. property acted as “a disincentive to explore for oil in the United States.”<sup>202</sup>

**b. Repeal of Exclusion for Earnings of Less Developed Country Corporations for Purposes of Section 1248**

Section 1248, which contained rules for treating gain on the sale of stock of a CFC as a dividend, excluded earnings accumulated by a less developed country corporation from dividend treatment. The 1976 Act repealed this exception because Congress questioned the effectiveness of this provision in encouraging investment in less developed countries. Congress believed that an incentive to invest in such countries should be provided in a manner in which the economic costs could be measured more accurately.<sup>203</sup>

**c. Exclusion from Subpart F of Certain Earnings of Insurance Companies**

As enacted, subpart F excluded from foreign personal holding company income the income of a foreign insurance company derived from the investment of unearned premiums or reserves that were necessary for the proper conduct of its business. The 1976 Act expanded this exception to apply also to income derived from the investment of surplus of a foreign insurance company if the surplus had to be retained to satisfy state insurance solvency requirements.<sup>204</sup>

**d. Shipping Profits of Foreign Corporations**

Foreign base company shipping income, as enacted by the 1975 Act, included shipping income without distinguishing whether the income was derived from shipping activities conducted in or outside the foreign corporation’s country of incorporation. Congress determined that, to be

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<sup>199</sup> I.R.C. § 956(b)(2)(F).

<sup>200</sup> 1976 Senate Report, *supra* note 198, at 226.

<sup>201</sup> I.R.C. § 956(b)(2)(G).

<sup>202</sup> 1976 Senate Report, *supra* note 198, at 226.

<sup>203</sup> 1976 Senate Report, *supra* note 198, at 228.

<sup>204</sup> I.R.C. § 954(c)(3)(C).

consistent with the other foreign base company rules, shipping income should not be treated as tax haven income when the shipping activities were conducted between two points within the country where the vessel was registered and the CFC was incorporated.<sup>205</sup>

**e. Two New Categories of Subpart F Income**

The 1976 Act added two new categories of subpart F income. Subpart F income had previously included only foreign base company income and insurance income. The first new category was income from overseas operations in connection with which there had been an agreement to participate in an international boycott.<sup>206</sup> The second category was the amount equal to illegal bribes, kickbacks and other payments to an employee of any government.<sup>207</sup> Congress added these provisions, together with provisions denying foreign tax credit and Domestic International Sales Corporation (DISC) benefits for these activities. Congress determined that, like the foreign tax credit and DISC provisions, the deferral of earnings of U.S.-owned foreign subsidiaries was a tax benefit that should not be made available to taxpayers participating in international boycotts or making illegal payments to government officials.<sup>208</sup> Thus, Congress ended deferral on the earnings of a CFC to the extent they were attributable to boycott participation or an illegal payment.

**4. Tax Equity and Fiscal Responsibility Act of 1982**

**a. Foreign Base Company Oil Related Income**

The Tax Equity and Fiscal Responsibility Act of 1982<sup>209</sup> added a new category of foreign base company income called foreign base company oil related income. This provision treated the foreign oil related income of a CFC as subpart F income if it was derived from a country other than the country in which the oil and gas was extracted or consumed.<sup>210</sup> Congress enacted this provision because it was concerned that multinational oil companies earned significant revenues from activities performed after the oil had been extracted, such as the transporting, “shipping, refining, trading and retail sales of the petroleum.”<sup>211</sup> Congress determined that “because of the

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<sup>205</sup> 1976 Senate Report, *supra* note 198, at 230-31.

<sup>206</sup> I.R.C. § 952(a)(3).

<sup>207</sup> I.R.C. § 952(a)(4).

<sup>208</sup> 1976 Blue Book, *supra* note 197, at 282, 288-89.

<sup>209</sup> P.L. No. 97-248, 96 Stat. 324 (1982).

<sup>210</sup> I.R.C. § 954(g).

<sup>211</sup> S. Rep. No. 494, 97<sup>th</sup> Cong., 2d. Sess. 149-150 (1982).

fungible nature of oil and because of the complex structures involved, oil income is particularly suited to tax haven type operations.”<sup>212</sup> Congress was concerned that U.S. oil companies paid little or no U.S. tax on the high revenue of their foreign subsidiaries.<sup>213</sup> Accordingly, Congress ended deferral with respect to foreign oil related income.

## **5. Tax Reform Act of 1984**

### **a. Related Party Factoring Income**

The Tax Reform Act of 1984<sup>214</sup> (1984 Act) added a provision that treated related person factoring income (i.e., any income arising from a trade or service receivable that the CFC acquired, directly or indirectly, from a related person) as interest on a loan to the obligor under the receivable. Thus, under this provision, factoring income would be treated as foreign personal holding company income for subpart F purposes.<sup>215</sup> The 1984 Act also amended the definition of U.S. property to include any trade or service receivable acquired from a related U.S. person.<sup>216</sup>

Congress recognized that when a factor purchased a receivable at a discount and then collected on the receivable, the difference between the amount paid and the amount collected was functionally the equivalent of interest and that this factoring income could easily be shifted to a tax haven, contrary to the purposes of subpart F. As noted in the Senate Report accompanying the 1984 Act:

The purpose of subpart F of the Code is to enforce capital export neutrality by preventing the shifting of earnings to a jurisdiction having no natural business nexus with the income and where the income will not be taxed. Otherwise, there would be an incentive to shift earnings into tax havens and away from the United States. Factoring income is financing income that can easily be shifted from one country to another even where the country in which the income is finally earned has no economic nexus with the underlying transaction.<sup>217</sup>

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<sup>212</sup> Id. at 150.

<sup>213</sup> Id.

<sup>214</sup> P.L. No. 98-369, 98 Stat. 494 (1984).

<sup>215</sup> I.R.C. § 864(d).

<sup>216</sup> I.R.C. § 956(b)(3).

<sup>217</sup> S. Rep. No. 169 (Vol. I), 98<sup>th</sup> Cong., 2d Sess. 348 (1984).

Congress also determined that factoring transactions could also be used to accomplish a tax-free repatriation of low-taxed foreign profits, thus avoiding section 956, which subjects to current inclusion a CFC's increase in earnings invested in U.S. property.

**b. Insurance of Related Parties**

Insurance income, as a category of subpart F income, was limited to income from the insurance of U.S. risks. Thus, income from the insurance of related party risks outside the United States was not subpart F insurance income. Congress was concerned that CFCs were able to “improperly shift income to tax havens” through related party insurance transactions.<sup>218</sup> The 1984 Act therefore amended the foreign base company services income rules to specifically treat insurance services as performed where the risks were located, instead of where the administrative or investment services were performed, when the primary insured was a related person.<sup>219</sup> Income from insuring related party risks therefore was foreign base company services income when the risks were located outside the CFC's country of incorporation even if the administrative or investment services were performed within that country.

**c. Coordination of Subpart F with Other Rules**

The 1984 Act changed the order of applying the subpart F regime and the foreign personal holding company regime.<sup>220</sup> Prior to the 1984 Act, the foreign personal holding company regime had priority of application to the extent the two regimes overlapped. This rule created ambiguity about whether amounts to which the foreign personal holding company regime did not apply could be subpart F income. The 1984 Act changed the rules to give the subpart F regime priority over the foreign personal holding company income regime.<sup>221</sup>

The 1984 Act also added a rule coordinating subpart F and section 1248. When a U.S. shareholder recognized gain on the sale of stock of the CFC that was treated as a dividend under section 1248, the earnings and profits of the foreign corporation were not reduced as they would have been upon an actual dividend distribution. Thus, these earnings were subject to taxation again when distributed. The new rule provided that the amount treated as a dividend under section 1248 would be treated as an amount that had been previously taxed under subpart F.<sup>222</sup> Thus, under the subpart F rules, the amount would not be subject to tax again when distributed.

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<sup>218</sup> *Id.* at 383.

<sup>219</sup> I.R.C. § 954(e).

<sup>220</sup> I.R.C. §§ 551-558.

<sup>221</sup> I.R.C. § 951(d).

<sup>222</sup> I.R.C. § 959(e).

## **6. Tax Reform Act of 1986**

The Tax Reform Act of 1986<sup>223</sup> (1986 Act) enacted a comprehensive revision of the Internal Revenue Code, including a set of amendments to the subpart F rules.<sup>224</sup> The general policy guiding Congress in amending subpart F was addressed in the Committee reports to the 1986 Act:

It has long been the policy of the United States to impose current tax when a significant purpose of earning income through a foreign corporation is the avoidance of tax. Such a policy serves to limit the role that tax considerations play in the structuring of U.S. person's operations and investments. Because movable income earned through a foreign corporation could often be earned through a domestic corporation instead, the committee believes that a major motivation of U.S. persons in earning such income through foreign corporate vehicles often is the tax benefit expected to be gained thereby. The committee believes that it is generally appropriate to impose current U.S. tax on such income earned through a controlled foreign corporation, since there is likely to be limited economic reason for the U.S. person's use of a foreign corporation. The committee believes that by eliminating the U.S. tax benefits of such transactions, U.S. and foreign investment choices are placed on a more even footing, thus encouraging more efficient (rather than more tax-favored) uses of capital.<sup>225</sup>

The 1986 Act narrowed the exceptions to subpart F income, and added to the definition of subpart F income types of income that Congress considered to be particularly susceptible to manipulation.<sup>226</sup>

### **a. Changes to Foreign Personal Holding Company Income Rules**

The 1986 Act amended the foreign personal holding company income rules to target the types of income that “may sometimes be earned through a foreign corporation in a tax haven

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<sup>223</sup> P.L. No. 99-514, 100 Stat. 2085 (1986).

<sup>224</sup> Staff of the Joint Committee on Taxation, 100<sup>th</sup> Cong., 1<sup>st</sup> Sess., General Explanation of the Tax Reform Act of 1986 (H.R. 3838, 99<sup>th</sup> Congress, P.L. No. 99-514) 9 (Joint Comm. Print 1987) (1986 Blue Book).

<sup>225</sup> H.R. Rep. No. 426, 99<sup>th</sup> Cong., 1<sup>st</sup> Sess. 391 (1985) (1986 House Report). See also S. Rep. No. 313, 99<sup>th</sup> Cong., 2d Sess. 363 (1986) (1986 Senate Report).

<sup>226</sup> Id. at 366.

country that bears limited substantive economic relation to the income. . . .”<sup>227</sup> Congress determined that “continued deferral of U.S. tax on such income encourages the movement of the income abroad at the U.S. Treasury’s expense.”<sup>228</sup>

**(1) Expansion of Definition of Foreign Personal Holding Company Income**

The 1986 Act amended, or added to foreign personal holding company income, the following four subcategories of income.

**(a) Net Gains on Sales of Property That Does Not Generate Active Income**

Prior to the 1986 Act, foreign personal holding company income included gain from the sale or exchange of stock and securities, in addition to the underlying income from this property. However, gain from the sale of other types of investment property was not foreign personal holding company income. To remove this inconsistency and to create a more logical approach to the treatment of gains under the foreign personal holding company rules,<sup>229</sup> Congress amended the rules to provide that foreign personal holding company income included net gains from the disposition of non-inventory property that gave rise to foreign personal holding company income (other than amounts excluded under the active rents and royalties exception) or that did not give rise to income.<sup>230</sup>

**(b) Net Commodities Gains**

Prior to the 1986 Act, foreign personal holding company income included net gains from futures transactions in any commodity. This provision excluded gains by a producer, processor, merchant or handler of a commodity if they arose from certain bona fide hedging transactions. Congress determined that net gains of passive investors from not only futures contracts, but also other commodities contracts should be included in foreign personal holding company income. Congress recognized, however, that commodities transactions constituted an integral part of the active business of a producer, processor, merchant or handler of commodities.<sup>231</sup> Thus, Congress added an exception for transactions that occurred in the active business of a corporation

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<sup>227</sup> *Id.* at 363.

<sup>228</sup> *Id.*

<sup>229</sup> *Id.* at 364.

<sup>230</sup> I.R.C. § 954(c)(1)(B).

<sup>231</sup> 1986 Senate Report, *supra* note 225, at 364.

substantially all of whose business was that of an active producer, processor, merchant, or handler of commodities.<sup>232</sup> This exception was intended to apply only to corporations actively engaged in the commodities business as opposed to a corporation whose primary activity was engaging in financial transactions, such as trading commodities futures.<sup>233</sup>

### **(c) Net Foreign Currency Exchange Rate Gains**

The 1986 Act added, as a new category of foreign personal holding company income, net currency gains attributable to section 988 transactions (transactions in nonfunctional currency).<sup>234</sup> The 1986 Act also added an exception for hedging and other transactions related to the business needs of a CFC. When subpart F was enacted, in 1962, currency exchange rates generally were fixed. However, when floating exchange rates began in the early 1970s, taxpayers began to realize foreign currency gains and losses.<sup>235</sup> Congress added this category because it determined that currency gains and losses easily could be routed through a tax haven CFC.<sup>236</sup>

### **(d) Income Equivalent to Interest**

The 1986 Act also added as a new category of foreign personal holding company income, income equivalent to interest.<sup>237</sup> Congress sought to prevent taxpayers from avoiding subpart F on passive interest-type income earned offshore that did not fit within the definition of traditional interest income.<sup>238</sup>

## **(2) Repeal of Banking Exception**

The 1986 Act repealed certain exceptions to the foreign personal holding company income rules for interest, dividends and gains earned by banks and insurance companies but left a narrow exception for export financing interest.<sup>239</sup> Congress determined that these exceptions had provided excessive opportunity for interest, dividends and gains earned by banks and insurance companies to be routed through tax havens because the types of activities conducted by banks and

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<sup>232</sup> I.R.C. § 954(c)(1)(C).

<sup>233</sup> 1986 Senate Report, supra note 225, at 367.

<sup>234</sup> I.R.C. § 954(c)(1)(D).

<sup>235</sup> 1986 Senate Report, supra note 225, at 364.

<sup>236</sup> Id.

<sup>237</sup> I.R.C. § 954(c)(1)(E).

<sup>238</sup> 1986 Blue Book, supra note 224, at 967.

<sup>239</sup> I.R.C. § 954(c)(2)(B).

insurance companies could be easily be located in any jurisdiction.<sup>240</sup> Congress noted that the proliferation of U.S.-controlled banking and insurance companies in tax havens supported its conclusion.<sup>241</sup> Congress determined that dividends, interest and gains on stock and securities were so inherently manipulable that it was inappropriate to allow deferral regardless of the business of the corporation,<sup>242</sup> except in the case of export financing interest. A Senate amendment that would have allowed the banking exception to continue to apply with respect to bona fide active banking, financing, and similar operations,<sup>243</sup> was rejected.<sup>244</sup>

### (3) Narrowing of Related Person Exception

The 1986 Act narrowed the exception for certain dividends, interest, rents and royalties received from related persons. Under the new rules, interest, rent and royalty payments would not qualify for the exception to the extent that the payments reduced the subpart F income of the payor.<sup>245</sup>

#### b. Repeal of Reinvestment Exclusion for Shipping Income

The 1986 Act repealed the rule that excluded shipping income from subpart F income if it was reinvested in shipping operations. Congress determined that the exclusion was not appropriate as a matter of tax policy because no justification existed for treating shipping income more favorably than other types of subpart F income.<sup>246</sup> Further, Congress questioned whether the interests of the United States were served by promoting investments in foreign-flag shipping operations, which were seldom taxed by foreign governments.<sup>247</sup>

Congress also was concerned that a taxpayer could obtain indefinite deferral of tax for certain income earned outside the jurisdiction of any country, such as income from activities in

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<sup>240</sup> 1986 House Report, supra note 225, at 393.

<sup>241</sup> Id.

<sup>242</sup> Id.

<sup>243</sup> See 1986 Senate Report, supra note 225, at 368.

<sup>244</sup> See H.R. Conf. Rep. No. 841, 99<sup>th</sup> Cong., 2d Sess. II-613, 616 (1986) (1986 Conference Report).

<sup>245</sup> I.R.C. § 954(c)(3)(B).

<sup>246</sup> 1986 House Report, supra note 225, at 394-395.

<sup>247</sup> Id. at 395.

space or on the ocean floor, when it earned that income through a foreign corporation.<sup>248</sup> Accordingly, Congress expanded the definition of foreign base company shipping income to include income from space or ocean activity.<sup>249</sup>

**c. Expanded Definition of Insurance Income**

The 1986 Act broadened the definition of insurance income for subpart F purposes. Under prior law, insurance income was defined as income of the CFC from insuring or reinsuring U.S. risks. Further, foreign base company services income included income from insuring the risks of a related person outside the CFC's country of incorporation. The new provision defined insurance income to include income from insuring or reinsuring risks located outside the CFC's country of incorporation whether or not the risks were of a related person.<sup>250</sup> Congress expanded the definition of insurance income for subpart F purposes because "[i]nsurance income generally represents the type of inherently manipulable income at which subpart F is aimed, since such income can frequently be routed through a corporation formed in any convenient jurisdiction."<sup>251</sup>

The 1986 Act also added a new category of subpart F insurance income called related person insurance income that applied to widely held captive insurance companies.<sup>252</sup> Congress was concerned that the insurance income of captive foreign insurance companies (companies formed to insure the risks of their owners) escaped the subpart F rules because the U.S. ownership of these companies was often widely dispersed so that these companies did not fall within the definition of a CFC.<sup>253</sup> To address this problem, Congress created a special set of rules, including a broader definition of "U.S. shareholder" and "controlled foreign corporation," for purposes of taking into account captive insurance income.<sup>254</sup>

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<sup>248</sup> *Id.*

<sup>249</sup> I.R.C. § 954(f).

<sup>250</sup> I.R.C. § 953.

<sup>251</sup> 1986 House Report, *supra* note 225, at 395.

<sup>252</sup> I.R.C. § 953(c).

<sup>253</sup> 1986 Blue Book, *supra* note 224, at 968.

<sup>254</sup> I.R.C. § 953(c)(1).

**d. Restriction on Use of Accumulated Deficits and Repeal of Chain Deficit Rule**

Subpart F income is limited to current year earnings and profits. Under prior law, to determine subpart F income, accumulated deficits of the CFC could reduce current year earnings and profits. Further, earnings and profits of the CFC could be reduced by current deficits of another CFC in the chain. Congress determined that the both of these deficit rules allowed CFCs to shelter too much income from current taxation.<sup>255</sup> In the case of the chain deficit rule, a loss anywhere in the chain could prevent the current taxation of subpart F income earned elsewhere in the chain even if the loss were in a non-subpart F category or did not relate to the subpart F income.<sup>256</sup> Similarly, under the accumulated deficit rule, prior year deficits of the CFC in a non-subpart F or unrelated income category could prevent the current taxation of subpart F income.<sup>257</sup> Congress was concerned that under the accumulated deficit rule taxpayers could shelter passive investment income from the subpart F rules by moving those passive investments to a CFC with prior year deficits.<sup>258</sup> The 1986 Act amended the accumulated deficit rules to provide that an accumulated deficit could reduce subpart F income only to the extent the deficit arose from the same qualified activity as the activity giving rise to the income to be offset.<sup>259</sup> The 1986 Act defined a qualified activity to include any activity giving rise to certain specified types of subpart F income.<sup>260</sup> The 1986 Act also repealed the chain deficit rule.

**e. Thresholds for Imposition of Current Tax under Subpart f**

**(1) De Minimis and Full Inclusion Rules**

The 1986 Act amended the de minimis and full inclusion rules, under which none of the income of CFC was treated as foreign base company income if less than 10 percent of its gross income was foreign base company income and all of its income was treated as foreign base company income if more than 70 percent of its gross income was foreign base company income. Congress considered the 10 percent de minimis threshold to be too high, allowing a substantial

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<sup>255</sup> 1986 Blue Book, supra note 224, at 972.

<sup>256</sup> Id.

<sup>257</sup> Id.

<sup>258</sup> 1986 Conference Report, supra note 244, at II-623.

<sup>259</sup> I.R.C. § 952(c).

<sup>260</sup> Qualified activities were activities that gave rise to foreign base company shipping income, foreign base company oil related income, subpart F insurance income or, in the case of a qualified financial institution, foreign personal holding company income. I.R.C. § 952(c)(1)(B)(iii).

amount of tax haven income to escape tax.<sup>261</sup> The new de minimis rule substituted “the lesser of 5 percent of gross income or one million dollars” for the old 10 percent threshold. In addition, Congress amended the de minimis and full inclusion rules to apply to subpart F insurance income as well as foreign base company income.<sup>262</sup>

## **(2) Exception for Foreign Corporations Not Used to Reduce Taxes**

The 1986 Act amended the rule that excluded income from foreign base company income based on a test that focused on whether a “significant purpose” of the transaction was substantially to reduce taxes. The 1986 Act replaced this subjective test with an objective test. Under the objective test, an item of income was excluded from foreign base company income and insurance income if it was established that the income was subject to an effective rate of foreign income tax greater than 90 percent of the maximum U.S. corporate rate.<sup>263</sup> Congress intended this new rule to be simpler to apply and to counterbalance provisions of the 1986 Act that broadened the categories of subpart F income.<sup>264</sup> Congress determined that, where no U.S. tax advantage was gained by routing the income through a foreign corporation, no policy of subpart F justified the current inclusion of income.<sup>265</sup>

## **(3) Expansion of Definition of Controlled Foreign Corporation**

Under prior law, whether U.S. shareholders possessed the requisite greater than 50 percent ownership of a foreign corporation was determined entirely upon voting power. Congress determined that these rules were susceptible to manipulation, particularly when the U.S. shareholder owned less than 50 percent of the voting power but held a majority of the value of the corporation in nonvoting stock.<sup>266</sup> Congress amended the definition of CFC by adding a value test in addition to the voting power test for purposes of determining stock ownership.<sup>267</sup>

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<sup>261</sup> 1986 Senate Report, *supra* note 225, at 373.

<sup>262</sup> I.R.C. § 954(b)(3).

<sup>263</sup> I.R.C. § 954(b)(4).

<sup>264</sup> 1986 Blue Book, *supra* note 224, at 983.

<sup>265</sup> *Id.*

<sup>266</sup> 1986 Senate Report, *supra* note 225, at 371.

<sup>267</sup> I.R.C. § 957(a).

#### **(4) Definition of Related Person**

Many of the provisions of subpart F based current inclusion on whether the CFC was engaged in a transaction with, or was receiving income from, a related person. A “related person” included an individual, partnership, trust or estate that controlled the CFC or a corporation that controlled the CFC, was controlled by the CFC, or was controlled by the same persons that controlled the CFC. Control was defined as greater than 50 percent ownership. In the case of a corporation, ownership was measured by voting power. Congress determined that these rules allowed the easy avoidance of related person status.<sup>268</sup> Congress also was concerned that income that would be subpart F income if received by the CFC from a subsidiary corporation would escape subpart F if received from a controlled partnership.<sup>269</sup> The 1986 Act included a controlled partnership, trust or estate within the definition of “related person.” The 1986 Act also amended the definition of control to mean 50 percent or greater ownership and, in the case of a corporation, defined control in terms of both voting power and value.<sup>270</sup>

#### **f. Passive Foreign Investment Company Regime**

The 1986 Act also added a new anti-deferral regime to supplement existing anti-deferral provisions (subpart F, the personal holding company rules, the foreign personal holding company rules, the foreign investment company rules, and the accumulated earnings tax). Because existing anti-deferral provisions applied only where U.S. persons held a controlling interest in the foreign corporation, U.S. persons could continue to get the benefits of deferral by investing outside the United States through non U.S.-controlled foreign corporations. Congress believed that U.S. persons who invested in passive assets through foreign corporations should not gain a tax advantage over U.S. investors in domestic investment companies.<sup>271</sup> Accordingly, Congress enacted the passive foreign investment company (PFIC) provisions.

A PFIC was defined as any foreign corporation if 75 percent or more of its gross income for the taxable year consisted of passive income or if 50 percent or more of the average value of

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<sup>268</sup> 1986 Senate Report, supra note 225, at 372.

<sup>269</sup> Id. This problem was highlighted by MCA, Inc. v. Commissioner, 685 F.2d 1099 (9<sup>th</sup> Cir. 1982), in which royalties paid by a partnership to its controlling CFC partner were excluded from subpart F income under the active rents and royalties exception. The active rents and royalties exception did not apply to rent or royalty payments received from a related person. Because the controlled partnership did not come within the definition of “related person,” the taxpayer was able to take advantage of this exception.

<sup>270</sup> I.R.C. § 954(d)(3).

<sup>271</sup> 1986 Blue Book, supra note 224, at 1023.

its assets consisted of assets that produced passive income.<sup>272</sup> A foreign corporation that was a PFIC could also be a CFC. Congress created two sets of taxing mechanisms for PFICs. The first set of rules applied to PFICs for which the taxpayer made a qualified electing fund (QEF) election. Each U.S. person that owned any stock in a QEF was required to include currently in gross income his share of the QEF's ordinary earnings and net capital gain. To take into account U.S. investors that had insufficient liquidity to meet their tax liability and insufficient control to compel a dividend distribution, U.S. investors in a QEF could also elect to defer payment of U.S. tax, subject to an interest charge, on undistributed amounts.<sup>273</sup> A coordination rule provided that amounts that would be currently included in the U.S. shareholder's gross income under both subpart F and the QEF provisions were to be included in gross income only under subpart F. The second set of rules required U.S. investors in PFICs that were not QEFs to pay U.S. tax, together with an interest charge based on the value of tax deferral, when the shareholder disposed of the stock or received an excess distribution. This rule was intended to take into account U.S. investors who were unable to obtain sufficient information from the foreign corporation to compute their annual tax liability.<sup>274</sup>

## **7. Technical and Miscellaneous Revenue Act of 1988**

The Technical and Miscellaneous Revenue Act of 1988<sup>275</sup> (1988 Act) made a number of changes to subpart F, most of which were technical corrections to, or clarifications of, amendments made by the 1986 Act.

### **a. Modifications to Subpart F Insurance Income Rules**

The 1988 Act made a number of technical corrections to the subpart F insurance income rules as amended by the 1986 Act. Most of the changes related to the special rules for captive insurance companies.

### **b. Modifications to Foreign Personal Holding Company Income Category**

The 1988 Act expanded the definition of foreign personal holding company income to include the excess of gains over losses from the sales or exchanges of interests in trusts,

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<sup>272</sup> I.R.C. § 1296 (currently § 1297).

<sup>273</sup> 1986 Blue Book, *supra* note 224, at 1023.

<sup>274</sup> *Id.*

<sup>275</sup> P.L. 100-647, 102 Stat. 3342 (1988).

partnerships and REMICs.<sup>276</sup> The 1988 Act also clarified that losses from the sale or exchange of inventory property could not offset foreign personal holding company income, consistent with the rule that gains from the sale or exchange of inventory property were not included in foreign personal holding company income.<sup>277</sup> The 1988 Act also provided a new hedging exception for regular dealers. Under this exception, gains and losses arising out of a bona fide hedging transaction reasonably necessary to the conduct of the business of being a dealer in such property were excluded from foreign personal holding company income.<sup>278</sup>

**c. Accumulated Deficits**

The 1988 Act modified the 1986 Act accumulated deficit rule, under which, at the U.S. shareholder level, accumulated deficits of a CFC could offset current year subpart F income if both the deficit and the subpart F income arose out of the same qualified activity. The 1988 Act expanded the definition of qualified activity to include an activity giving rise to foreign base company sales income and foreign base company services income and, in the case of a qualified insurance company or qualified financial institution, foreign personal holding company income.<sup>279</sup>

**d. Addition of Modified Chain Deficit Rule**

The 1988 Act added a new chain deficit rule, to replace the old chain deficit rule that had been repealed by the 1986 Act. The new chain deficit rule, like the new accumulated deficit rule, was a narrow rule that allowed overall current deficits of another corporation in the same chain of ownership and organized in the same country as the CFC to offset the subpart F income of the CFC if the deficit and the subpart F income arose from the same qualified activity.<sup>280</sup> The new chain deficit rule was intended to address the problem that Congress noted with the old rule, that a loss could have offset subpart F income in the chain although it might have arisen in a non-subpart F income category and had no relation to the income that it offset.<sup>281</sup>

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<sup>276</sup> I.R.C. § 954(c)(1)(B)(ii).

<sup>277</sup> I.R.C. § 954(c)(1)(B).

<sup>278</sup> I.R.C. § 954(c)(2)(C).

<sup>279</sup> I.R.C. § 952(c)(1)(B)(iii).

<sup>280</sup> I.R.C. § 952(c)(1)(C).

<sup>281</sup> Staff of the Joint Committee on Taxation, Description of the Technical Corrections Act of 1988 (H.R. 4333 and S. 2238) 282 (Joint Comm. Print 1988) (1988 Blue Book).

**e. Computations of Earnings and Profits**

The 1988 Act added rules regarding the computation of current earnings and profits of a CFC. These rules prevented the use of certain accounting methods that accelerated the recognition of earnings and profits.<sup>282</sup> Because subpart F income is limited to current earnings and profits, the provision was intended to reduce “the possibility that tax haven income will go untaxed.”<sup>283</sup>

**f. Other Technical Corrections**

The 1988 Act also made certain technical corrections to the 1986 Act (1) to clarify that the withdrawal of previously excluded subpart F income from qualified shipping reinvestments are taxed only once,<sup>284</sup> and (2) to change the threshold for control in the definition of “related person” back to “more than 50 percent”, to conform it to the definition of control for CFCs.<sup>285</sup>

**8. Revenue Reconciliation Act of 1989**

**a. Conforming Taxable Year of U.S. Shareholder and Controlled Foreign Corporation**

The Revenue Reconciliation Act of 1989<sup>286</sup> added a provision that generally required the taxable year of the CFC to conform to the majority U.S. shareholder year.<sup>287</sup>

**9. Omnibus Budget Reconciliation Act of 1993**

The Omnibus Budget Reconciliation Act of 1993<sup>288</sup> (1993 Act) was a comprehensive set of measures designed to reduce the deficit.<sup>289</sup> The provisions affecting CFCs were part of a revenue raising package.

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<sup>282</sup> I.R.C. § 952(c)(3).

<sup>283</sup> 1988 Blue Book, *supra* note 281, at 284.

<sup>284</sup> I.R.C. § 955(a)(2)(A).

<sup>285</sup> I.R.C. § 954(d)(3).

<sup>286</sup> P.L. No. 101-239, 103 Stat. 2106 (1989).

<sup>287</sup> I.R.C. § 898.

<sup>288</sup> P.L. No. 103-66, 107 Stat. 312 (1993).

<sup>289</sup> H.R. Rep. No. 111, 103d Cong., 1<sup>st</sup> Sess. 1 (1993) (1993 House Report).

**a. Deferral Ended for Excess Passive Assets**

The 1993 Act added a new section 956A, which required a U.S. shareholder to include currently in gross income his pro rata share of the CFC's accumulated earnings invested in excess passive assets. Excess passive assets were determined as the excess of the quarterly average of passive assets over 25 percent of the quarterly average of total assets for the taxable year. Congress determined that such a rule was necessary to restrict the benefits of deferral where CFCs accumulated excess quantities of earnings and profits and did not reinvest them in active business assets.<sup>290</sup> The House Report explains:

The committee is aware that the deferral of U.S. tax on income of U.S. persons earned through foreign corporations may tend to favor foreign investment over U.S. investment, and can provide an incentive to engage in certain tax-haven activities. The committee understands that prior enactments that permit deferral of U.S. tax on most types of active business income derived through controlled foreign corporations have been justified as enhancing the competitiveness of U.S.-owned business operations abroad. In fact, Congress referred to such concerns in rejecting the President's proposal to eliminate all deferral in the Revenue Act of 1962. The committee believes, however, that deferral of U.S. tax on accumulated active business profits is not necessary to maintain the competitiveness of business activities conducted by controlled foreign corporations where such accumulated profits are held in the form of excessive accumulations of passive assets.<sup>291</sup>

**b. Modifications to Section 956 and 959**

The 1993 Act also modified section 956 (investments in U.S. property) to require the amount included under section 956 to be computed as the lesser of the (1) U.S. shareholder's pro rata share of the U.S. property held by the CFC (reduced by prior year section 956 inclusions) or (2) the U.S. shareholder's pro rata share of applicable earnings of the CFC. For this purpose, the U.S. property held by the CFC was no longer determined at year end but instead was an average amount based on quarterly determinations, similar to section 956A.<sup>292</sup>

The 1993 Act also modified the rules applicable to previously taxed subpart F income. New ordering rules were added to coordinate section 956 and section 956A and a new rule was added that required actual distributions during the year to be taken into account before amounts

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<sup>290</sup> *Id.* at 691.

<sup>291</sup> *Id.* (footnote omitted).

<sup>292</sup> I.R.C. § 956(a).

that would be included under section 956 or section 956A.<sup>293</sup> Thus, such distributions would not be treated as made out of earnings and profits previously included in the U.S. shareholder's gross income under section 956 or section 956A (although such distributions could be treated as made out of earnings and profits previously taxed as subpart F income).

**c. Modification to PFIC Rules Affecting CFCs**

**(1) Measurement of Assets**

For purposes of testing a foreign corporation for PFIC status under the asset test (which treats an entity as a PFIC if the ratio of passive assets to total assets is at least 50 percent) assets were measured based on value. The 1993 Act amended this rule for PFICs that were also CFCs to require that the asset test be applied based on the adjusted basis of the assets.<sup>294</sup> This amendment recognized that, unlike investment funds, CFCs generally did not hold marketable assets.<sup>295</sup> The 1993 Act also provided that, for purposes of the asset test, the adjusted basis of total assets of the CFC was increased to take into account certain research and experimental expenditures and certain payments for the use of intangible property that is licensed to the CFC.<sup>296</sup>

**(2) Treatment of Previously Taxed PFIC Inclusions**

The 1993 Act added a coordination rule for CFCs that were also PFICs under which any current inclusion under the QEF rules was treated as an inclusion in the U.S. shareholder's gross income under subpart F for purposes of the previously taxed income rules of subpart F.<sup>297</sup> Thus, earnings and profits attributable to amounts currently included under the QEF rules would not be taxed again when actually distributed.

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<sup>293</sup> I.R.C. § 959(f).

<sup>294</sup> I.R.C. § 1296(a) (deleted by the Taxpayer Relief Act of 1997).

<sup>295</sup> 1993 House Report, *supra* note 289, at 692.

<sup>296</sup> I.R.C. § 1297(e) (currently §1298(e)).

<sup>297</sup> I.R.C. § 1293(c).

## **10. Small Business Job Protection Act of 1996**

### **a. Repeal of Section 956A**

The Small Business Job Protection Act of 1996 repealed section 956A.<sup>298</sup> Congress determined that section 956A added an undue layer of complexity to the subpart F rules and imposed substantial administrative burdens.<sup>299</sup> Congress also determined that, although section 956A was enacted to restrict the benefits of deferral for CFCs accumulating passive assets abroad, it operated to provide an incentive to invest abroad. Congress determined that the provision encouraged foreign corporations to engage in costly, non-economic transactions, such as acquiring otherwise unneeded foreign assets to reduce their percentage of passive assets.<sup>300</sup>

## **11. Taxpayer Relief Act of 1997**

The Taxpayer Relief Act of 1997<sup>301</sup> (1997 Act) contained a set of tax reduction, tax simplification and technical corrections provisions. This legislation was originally proposed by the House pursuant to the Fiscal Year 1998 Budget Resolution which was the result of the Balanced Budget Agreement between Congress and the President.<sup>302</sup>

### **a. Expansion of Categories of Foreign Personal Holding Company Income and Dealer Exception**

The 1997 Act added two new categories of foreign personal holding company income: (1) income from notional principal contracts, and (2) payments in lieu of dividends.<sup>303</sup> Congress determined that income from notional principal contracts and stock lending transactions was economically equivalent to the types of income that were currently included in foreign personal holding company income.<sup>304</sup>

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<sup>298</sup> P.L. No. 104-188, §1501, 110 Stat. 1755 (1996).

<sup>299</sup> H.R. Rep. No. 586, 104<sup>th</sup> Cong., 2d Sess. 128-129 (1996).

<sup>300</sup> *Id.* at 129.

<sup>301</sup> P.L. No. 105-34, 111 Stat. 788 (1997).

<sup>302</sup> H.R. Rep. No. 148, 105<sup>th</sup> Cong., 1<sup>st</sup> Sess. 308 (1997) (1997 House Report).

<sup>303</sup> I.R.C. § 954(c)(1)(F) and (G).

<sup>304</sup> 1997 House Report, *supra* note 302, at 543.

The 1997 Act also added an expanded dealer exception from foreign personal holding company income.<sup>305</sup> Prior to the 1997 Act, the foreign personal holding company provisions contained no dealer exception for financial instruments referenced to commodities. The new dealer exception specifically included dealers in financial instruments referenced to commodities.

**b. Dividend Treatment for Sale of Lower-Tier CFCS and Adjustments to Basis of Stock**

The 1997 Act added two new provisions to make the rules for taxing dispositions of stock of a CFC by an upper-tier CFC conform to those applicable to dispositions of such stock by a U.S. shareholder. The first provision treated a CFC's gain from the sale of stock of a lower-tier foreign corporation as a dividend to the same extent it would have been so treated under section 1248 if the CFC were a U.S. shareholder.<sup>306</sup> The dividend income would be subpart F income to a same-country upper-tier CFC because the exception for same country dividends, under section 954(c)(3)(A)(i), did not apply. For purposes of the foreign tax credit rules, the inclusion in the U.S. shareholder's gross income, based on this dividend income, would be characterized by reference to the nature of the income of the lower-tier foreign corporation.

The second provision added basis adjustment rules applicable to an upper-tier CFC's basis in the stock of a lower-tier CFC to parallel the rules that increased a U.S. shareholder's basis in the stock of a first-tier CFC when the subpart F income is earned and decreased the basis when previously taxed income was distributed.<sup>307</sup>

**c. Section 1248 Dividend Treated as Distribution**

The 1997 Act added a provision that treated the U.S. shareholder's section 1248 dividend as a distribution with respect to the stock, for purposes of the rules that reduced a mid-year purchaser's subpart F inclusion by distributions with respect to the stock received by another person during the year.<sup>308</sup>

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<sup>305</sup> I.R.C. § 954(c)(2)(C).

<sup>306</sup> I.R.C. § 964(e).

<sup>307</sup> I.R.C. § 961.

<sup>308</sup> I.R.C. § 951(a)(2).

**d. Extension of Indirect Foreign Tax Credit to Sixth Tier**

The 1997 Act extended the application of the indirect foreign tax credit to taxes paid by certain fourth-, fifth- and sixth-tier foreign corporations.<sup>309</sup> Under prior law, the application of the indirect tax credit was limited to the first three tiers of foreign corporations. Congress intended this provision to give relief to certain taxpayers that were reorganizing, or deciding not to purchase foreign corporations, because of the limitations of the foreign tax credit.<sup>310</sup>

**e. Exception from Definition of U.S. Property for Securities and Commodities Dealers**

The 1997 Act amended the rules pertaining to a CFC's investment in U.S. property. The 1997 Act added two new exceptions from the definition of U.S. property for certain transactions entered into by securities dealers or commodities dealers in the ordinary course of business.<sup>311</sup>

**f. PFIC - CFC Overlap**

The 1997 Act added a provision that generally treated a PFIC that is also a CFC as not a PFIC with respect to the U.S. shareholders of the CFC.<sup>312</sup> The rule applied for the portion of the shareholder's holding period after December 31, 1997, during which the corporation was a CFC and the shareholder was a U.S. shareholder. If the PFIC was not treated as a qualified electing fund (QEF) with respect to the shareholder, the shareholder did not get the benefit of this overlap provision unless it first made an election to pay tax and interest charge with respect to the unrealized appreciation in the stock or the accumulated earnings of the corporation. Congress added this provision to reduce the complexity caused by the interaction of these two anti-deferral regimes.<sup>313</sup>

**g. Temporary Exception for Active Banking, Financing or Insurance Income**

The 1997 Act added a temporary exception from foreign personal holding company income for certain income derived in the active conduct of a banking, financing or similar business

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<sup>309</sup> I.R.C. § 960(a)(1).

<sup>310</sup> 1997 House Report, supra note 302, at 528.

<sup>311</sup> I.R.C. § 956(c)(2)(J) and (K).

<sup>312</sup> I.R.C. § 1297(e).

<sup>313</sup> 1997 House Report, supra note 302, at 533.

if the CFC was predominately engaged in the active conduct of such business and for income derived from certain investments of a qualifying insurance company with respect to risks located within the CFC's country of incorporation.<sup>314</sup> Congress authorized the Treasury to prescribe regulations under which dividends, interest, income equivalent to interest, rents or royalties received from a related person were subject to look-through treatment for purposes of these provisions. The 1997 Act also added a temporary exception from foreign base company services income for certain income derived from services in connection with the active conduct of a banking, financing, insurance or similar business.<sup>315</sup>

These exceptions applied only for the tax year of a CFC that began within the 1998 calendar year. These exceptions were added because Congress was concerned that the repeal, by the Tax Reform Act of 1986, of certain foreign personal holding company income exceptions applicable to the income of banks and insurance companies caused income that was neither passive nor highly moveable to be treated as subpart F income.<sup>316</sup>

President Clinton attempted to cancel these temporary exceptions for active banking, financing and insurance income by exercising his authority under the Line Item Veto Act.<sup>317</sup> The President gave as reasons for his cancellation that the provisions would have reinstated rules that had been repealed by the Tax Reform Act of 1986 without adequately addressing the concerns that led to their repeal and that the provisions "would have decreased Federal receipts, would have allowed the tax-haven abuses that previously existed, and would have provided preferential tax treatment to a limited group of taxpayers."<sup>318</sup> These provisions were reinstated, however, after the Supreme Court held that the cancellation procedures in the Line Item Veto Act were unconstitutional.<sup>319</sup>

## **12. The Tax and Trade Relief Extension Act of 1998**

The Tax and Trade Relief Extension Act of 1998<sup>320</sup> (1998 Act) added a set of temporary provisions that extended and modified the 1997 Act's temporary exceptions for active banking,

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<sup>314</sup> I.R.C. § 954(h).

<sup>315</sup> I.R.C. § 954(e)(2).

<sup>316</sup> S. Rep. No. 33, 105<sup>th</sup> Cong., 1<sup>st</sup> Sess. 89-90 (1987).

<sup>317</sup> 110 Stat. 1200, 2 U.S.C. § 691 *et seq.* (1994 ed., Supp. II).

<sup>318</sup> Cancellation No. 97-1, Cancellation of Limited Tax Benefit, Report Pursuant to the Line Item Veto Act, P.L. 104-130, 62 Fed. Reg. 43266 (1997).

<sup>319</sup> See Clinton v. City of New York, 524 U.S. 417 (1998).

<sup>320</sup> P.L. No. 105-277, 112 Stat. 2681 (1998).

financing and insurance income. The 1998 Act temporary provisions, originally in effect only for the tax year of a CFC that began within the 1999 calendar year, subsequently were extended to apply to taxable years of a CFC beginning after December 31, 1998 and before January 1, 2002.<sup>321</sup> The 1998 Act modifications added certain substantial activity and nexus requirements.

**a. Exception from Foreign Personal Holding Company Income for Certain Active Banking and Financing Income**

The 1998 Act extended and modified the 1997 Act exception for income derived in the active conduct of a banking or financing business.<sup>322</sup> The 1998 Act tightened these rules by adding a substantial activity requirement. As modified, the exception applied to the qualified banking or financing income of an eligible CFC. An eligible CFC was a CFC that was predominately engaged in the active conduct of a banking, financing or similar business and conducted substantial activity with respect to that business.<sup>323</sup> The 1998 Act provided differing rules for determining whether a CFC satisfied the “predominately engaged” requirement for CFCs in the banking business, the securities business or the lending or finance business.<sup>324</sup>

If the CFC was an eligible CFC, its qualified banking or financing income was excluded from foreign personal holding company income. Qualified banking or financing income was defined to impose a nexus requirement which insured that substantially all of the activities in connection with the transactions were conducted by the CFC or qualified business unit (QBU) in its home country and that the home country’s tax laws treated the income as earned in that country.<sup>325</sup>

**b. Insurance Income**

The 1998 Act added a temporary provision that modified the definition of subpart F insurance income.<sup>326</sup> Under prior law, insurance income, generally, was income from insuring risks located outside the CFC’s country of incorporation. Under the new temporary definition, insurance income included any insurance income except exempt insurance income. Exempt insurance income was defined as income derived by a qualifying insurance company that was

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<sup>321</sup> See Ticket to Work and Work Incentives Improvement Act of 1999, P.L. No. 106-170, § 503(a), 113 Stat.1860.

<sup>322</sup> I.R.C. § 954(h). See H.R. Rep. No. 825, 105<sup>th</sup> Cong., 2d Sess. 1558 (1998).

<sup>323</sup> I.R.C. § 954(h)(2).

<sup>324</sup> I.R.C. § 954(h)(2)(B).

<sup>325</sup> I.R.C. § 954(h)(3)(A).

<sup>326</sup> I.R.C. § 953(a)(2) and (e).

attributable to the issuing of an exempt contract by the CFC (or its qualifying insurance company branch) and that was treated as earned by the CFC or branch in the home country of the CFC or branch under that country's tax laws.<sup>327</sup> An "exempt contract" was an insurance or annuity contract issued with respect to non-U.S. risks.<sup>328</sup> The terms "qualifying insurance company," "qualifying insurance company branch" and "exempt contract" were defined to ensure that the CFC has a business nexus with the country in which it was incorporated, or in which its branch was located and regulated, and that a certain portion of its income was earned from insurance contracts involving unrelated persons.

**c. Exception from Foreign Personal Holding Company Income for Investments of Insurance Income**

The 1998 Act also added temporary rules to extend and modify the 1997 Act exception from foreign personal holding company income for income from certain investments of an insurance company.<sup>329</sup> The modifications corresponded to the temporary amendments to the subpart F insurance income rules. Using the same definitions for "qualifying insurance company," "qualifying insurance company branch" and "exempt contract" as under the temporary insurance income rules, the 1998 Act excluded investment income derived by a qualifying insurance company (or qualifying insurance company branch) if the investment income was received from a unrelated person and derived from investments made by the CFC or branch of its reserves (or a certain percentage of surplus) allocable to exempt contracts. Thus, unlike the 1997 Act temporary rule, which based the exclusion on whether the investment income was earned in connection with risks located in the home country of the CFC, the 1998 Act temporary rule allowed investment income earned on the insurance of certain cross border risks to be excluded if the insurance company or its branch satisfied certain nexus requirements with the home country.

**d. Exception for Securities Dealers**

The 1997 Act had added a general dealer exception that excluded certain gains from foreign personal holding company income. The 1998 Act added a new temporary dealer exception that excluded from foreign personal holding company income certain interest or dividend (or equivalent) income derived by a securities dealer that was attributable to activities of the dealer in its country of incorporation.<sup>330</sup>

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<sup>327</sup> I.R.C. § 953(e)(1).

<sup>328</sup> I.R.C. § 953(e)(2).

<sup>329</sup> I.R.C. § 954(i).

<sup>330</sup> I.R.C. § 954(c)(2)(C)(ii).

**e. Sale of Assets of an Active Financing Business**

Generally, foreign personal holding company income includes gains from the sale of property that gives rise to dividends, interest, rents, etc. The 1998 Act added a new temporary exception from foreign personal holding company income for gains from the sale of property that gave rise to income excluded from subpart F income under one of the 1998 Act temporary exceptions applicable to securities dealers or to active banking or financing income or insurance income.<sup>331</sup>

**f. Exceptions from Foreign Base Company Services Income**

As under the 1997 Act, the 1998 Act included a corresponding exception from foreign base company services income for services directly related to a transaction entered into by the CFC that gave rise to income excluded from subpart F income under one of the 1998 Act temporary exceptions.<sup>332</sup>

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<sup>331</sup> I.R.C. § 954(c)(1)(B).

<sup>332</sup> I.R.C. § 954(e)(2).

## **PART 2. FEDERAL TAX ENTITY CLASSIFICATION**

### **I. Background**

Since the Revenue Act of 1913,<sup>333</sup> the Internal Revenue Code has provided different tax regimes for individuals, corporations,<sup>334</sup> partnerships,<sup>335</sup> and trusts and estates.<sup>336</sup> The manner in which an entity is taxed thus has turned on how it is classified for federal tax purposes. In many countries, domestic entities are formed under national business statutes that regulate the form in which enterprises may carry on a business. Their national tax statutes tax different types of entities by referencing the classes of entities described in the business statute. In the United States, with a number of very limited exceptions, e.g., national banks, there are no national business statutes governing the formation of entities and, accordingly, federal tax law has never been able to rely on a uniform business law definition of “corporation.” Rather, business entities are formed under a plethora of state laws, only some of which unambiguously describe “corporations” or “partnerships.” Thus, federal tax law has sought to develop its own entity classification rules.

The term “partnership” is defined in section 7701(a)(2) of the Code to include “a syndicate, group, pool, joint venture, or other unincorporated organization, through or by means of which any business, financial operation, or venture is carried on, and which is not, within the meaning of this title, a trust or estate or a corporation . . . .” Section 7701(a)(2) defines the term “partner” to include “a member in such a syndicate, group, pool, joint venture, or organization.” These definitions have remained virtually unchanged since they were first enacted in the Revenue

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<sup>333</sup> Revenue Act of 1913, ch. 16, 38 Stat. 114.

<sup>334</sup> Section II.G. of the Revenue Act of 1913 provided that “the normal tax hereinbefore imposed upon individuals likewise shall be levied, assessed, and paid annually upon the entire net income arising or accruing from all sources during the preceding calendar year to every corporation, joint-stock company or association, and every insurance company . . . .” For a detailed discussion of the history of entity classification in the United States prior to 1996, see Patrick Hobbs, Entity Classification: The One Hundred-Year Debate, 44 Cath. U.L. Rev. 437 (1995).

<sup>335</sup> Section II.D. of the Revenue Act of 1913 provided that “any persons carrying on business in partnership shall be liable for income tax only in their individual capacity, and the share of the profits of a partnership to which any taxable partner would be entitled if the same were divided, whether divided or otherwise, shall be returned for taxation and the tax paid . . . .”

<sup>336</sup> Although § II.D. of the Revenue Act of 1913 required trustees, executors and others acting in a fiduciary capacity “to make and render a return of the net income of the person for whom they act,” and, in this capacity, subjected them to all the provisions that applied to individuals, it was not until the Revenue Act of 1916, Ch. 463, § 2(b), 39 Stat. 756, that the tax law specifically referred to the income received by “estates” and “trusts.”

Act of 1932.<sup>337</sup> Congress added these definitions to address the uncertainty existing under prior law about how certain business organizations, such as syndicates, would report income. As noted in the House report accompanying the 1932 Act, “[t]he bill does away with this uncertainty by placing all joint ventures, syndicates, pools, and similar organizations which do not constitute associations or trusts, in the category of partnerships.”<sup>338</sup>

The term “corporation” is defined in section 7701(a)(3) of the Code to include “associations, joint stock companies, and insurance companies.” This definition, unmodified, derives from the Revenue Act of 1918.<sup>339</sup> Congress did not provide a definition of the term “association” and the legislative history provides no specific guidance other than to suggest that the term includes entities in addition to those incorporated under state law.<sup>340</sup> The scope of this term has been a source of continuing controversy in the entity classification area.

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<sup>337</sup> See Revenue Act of 1932, Pub. L. No. 154, § 1111(a)(3), 47 Stat. 169.

<sup>338</sup> H.R. Rep. No. 708, 72d Cong., 1<sup>st</sup> Sess. 53 (1932).

<sup>339</sup> See Revenue Act of 1918, Pub. L. No. 254, § 1, 40 Stat. 1075. Legislation prior to the Revenue Act of 1917 treated a “corporation” as separate from a “joint stock company or association, or insurance company.” See § II.G.(a) of the Revenue Act of 1913. See also Hobbs, *supra* note 334, at 450-51 (contending that Congress originally understood “association” to be synonymous with “joint stock company”).

<sup>340</sup> The following exchange between Representative William Borland and Representative John Garner, during debates on the Revenue Act of 1918, is often cited to demonstrate that Congress had no precise understanding of the term “association”:

Mr. BORLAND. The word ‘corporation’ ordinarily means a legal entity.

Mr. GARNER. I know, but we have changed it. We have undertaken to determine what a corporation is by stating specifically what it includes, and we say that it includes an association. Now, if you want to go to the dictionary and find out the definition of association, well and good. I think it means a number of people, whether organized under law or voluntarily.

56 Cong. Rec. 10418 (1918), reprinted in J.S. Seidman, *Seidman’s Legislative History of Federal Income Tax Laws 1938-1861*, 893 (1938). See *O’Neill v. United States*, 410 F.2d 888, 893-94 (6<sup>th</sup> Cir. 1969) (quoted language came in the midst of a discussion over deductions for charitable contributions).

## II. Morrissey, the Changing Resemblance Test and the Kintner Regulations

During the 1920s and 1930s, the Treasury Department issued regulations that defined the term “association” broadly enough to include unincorporated entities, such as business trusts.<sup>341</sup> In Morrissey v. Commissioner,<sup>342</sup> decided in 1935, the Supreme Court upheld the Treasury’s broad regulatory authority in the area of entity classification as well as the position reflected in its regulations. The Morrissey Court held that a trust formed to develop and operate golf courses was taxable as an association. The Morrissey case is significant because it developed an approach to entity classification that would come to be known as the “resemblance test.” Under this approach, the Morrissey Court considered those features of a trust created to carry on a business enterprise that would make the trust analogous to a corporation: the ability to hold title to property; centralized management; continuity of life upon death of an owner; a structure that facilitates the transferability of beneficial interest; and limited liability.<sup>343</sup> The Court determined that the business trust at issue was an association because it possessed these features.<sup>344</sup>

When Morrissey was decided, taxpayers generally sought to avoid corporate status because it subjected income to two levels of taxation. After Morrissey, however, some taxpayers began to discover certain tax advantages in being taxed as corporations. For example, corporations could set up tax-deferred pension plans, which were particularly advantageous at a time when individual tax rates were significantly higher than corporate rates.<sup>345</sup> Professionals that were unable to incorporate under local law formed unincorporated associations that were structured to be taxed as associations under the Morrissey resemblance test. In the 1954 case of

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<sup>341</sup> See Art. 1502, Regulation No. 45, T.D. 3146 (1920) (associations and joint stock companies include certain common law trusts and other organizations that do business in an organized capacity); Art. 1504, Regulation No. 65, T.D. 3640 (1924) (reflecting decision of Hecht v. Malley, 265 U.S. 144 (1924), by treating operating trusts as associations, regardless of degree of beneficiaries’ control, where beneficiaries’ activities included more than collecting funds and making payments to beneficiaries); Art. 21-23, Regulation 64, T.D. 4575 (1935) (trust treated as an association if it is an arrangement conducted for profit where capital is supplied by beneficiaries and the trustees are in effect the managers of the arrangement, whether or not beneficiaries appoint or control trustees).

<sup>342</sup> 296 U.S. 344 (1935).

<sup>343</sup> Id. at 359.

<sup>344</sup> Id. at 360.

<sup>345</sup> See Kurzner v. United States, 413 F.2d 97, 101 (5<sup>th</sup> Cir. 1969). See also Hobbs, supra note 334, at 481-83.

United States v. Kintner,<sup>346</sup> the Ninth Circuit considered whether an unincorporated professional association formed for the practice of medicine and surgery could be taxed as an association and, hence, whether its pension plan would qualify for tax-deferred benefits under the Code. In this case, the government argued against corporate status, taking the position that a professional association could not be taxed as an association because under local law a corporation could not engage in the practice of medicine.<sup>347</sup> In taking this position, however, the government faced the difficulty of distinguishing its own regulations, which broadly interpreted the definition of association, as well the case of Pelton v. Commissioner,<sup>348</sup> which decided, in the government's favor, that a clinic organized for the practice of medicine was taxable as an association although state law did not permit a corporation to practice medicine. The Kintner court rejected the government's argument and held that under Morrissey and Pelton, as well as under the Treasury regulations, the association should be taxed as a corporation.

In 1960, in response to Kintner and subsequent cases upholding corporate tax treatment for unincorporated medical associations,<sup>349</sup> the Treasury issued new entity classification regulations.<sup>350</sup> These regulations, which came to be known as the Kintner regulations, adopted an approach to entity classification similar to the resemblance test set forth in Morrissey. The Kintner regulations identified six corporate characteristics. If an unincorporated organization possessed more corporate than non-corporate characteristics, it was taxable as an association. In distinguishing between a trust and a corporation, characteristics common to both trusts and corporations were ignored. Thus, only two of the six factors were used to differentiate corporations from trusts: (1) the presence of associates; and (2) the objective to carry on business and divide the gains therefrom. Similarly, in distinguishing between a partnership and a corporation, characteristics common to both partnerships and corporations were ignored. Thus, four factors distinguished a corporation from a partnership: (1) continuity of life; (2) centralization of management; (3) limited liability; and (4) free transferability of interests. If an unincorporated entity possessed more than two of the four factors it would be classified as an association taxable as a corporation.

The Kintner regulations effectively provided that an entity formed under a state statute corresponding to the Uniform Partnership Act would not be taxed as an association because it

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<sup>346</sup> 216 F.2d 418 (9<sup>th</sup> Cir. 1954).

<sup>347</sup> Id. at 421.

<sup>348</sup> 82 F.2d 473 (7<sup>th</sup> Cir. 1936).

<sup>349</sup> See Galt v. United States, 175 F.Supp. 360 (N.D. Tex. 1959); Foreman v. United States, 232 F.Supp. 134 (S.D. Fla. 1964).

<sup>350</sup> Treas. Reg. §§ 301.7701-1 to -11, T.D. 6503, 1960-2 C.B. 409.

would not possess continuity of life, centralization of management or limited liability.<sup>351</sup> Thus, professional associations could not qualify as associations under the Kintner regulations. The Kintner regulations also provided that local law would govern in determining whether the legal relationships satisfied the standards of the regulations.<sup>352</sup> In response to the Kintner regulations, taxpayers successfully lobbied state legislatures to allow professional groups to be incorporated.<sup>353</sup>

To address the proliferation of state statutes allowing professional incorporation, the Treasury issued new amendments to the Kintner regulations in 1965, including a new paragraph to address professional service organizations.<sup>354</sup> The 1965 amendment de-emphasized local law and defined the corporate characteristics in such a way that a professional corporation generally could not satisfy them. These regulations were invalidated by many courts,<sup>355</sup> and, in 1970, the IRS issued guidance indicating that it would treat entities formed under state professional corporation statutes as associations.<sup>356</sup>

### **III. General Changes in the Entity Classification Rules since 1962**

#### **A. Growth in Tax Shelters**

A significant trend in federal tax law since the enactment of subpart F in 1962 has been the increasing use of partnerships and other passthrough entities as forms of carrying on business. A number of non-tax considerations have motivated taxpayers to conduct business through partnerships, including the flexibility permitted in arrangements between the partners. However, tax considerations have also played a large part. The formation of limited partnerships increased rapidly during the 1970s and early 1980s when they were used as tax shelters, providing the

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<sup>351</sup> See Treas. Reg. §§ 301.7701-2(b)(3); 301.7701-2(c)(4); 301.7701-2(d)(1) (1960).

<sup>352</sup> Treas. Reg. § 301.7701-1(c) (1960).

<sup>353</sup> See Hobbs, supra note 334, at 489 & n.321 (noting that, by 1963, more than 30 states had enacted legislation allowing for incorporation of professional groups).

<sup>354</sup> See Treas. Reg. § 301.7701-2(h) (1965), T.D. 6797, 1965-1 C.B. 553.

<sup>355</sup> See, e.g., Kurzner v. United States, 413 F.2d 97 (5<sup>th</sup> Cir. 1969); O'Neill v. United States, 410 F.2d 888 (6<sup>th</sup> Cir. 1969).

<sup>356</sup> Rev. Rul. 70-101, 1970-1 C.B. 278. The invalid portions of these 1965 regulations were revoked in 1977. See T.D. 7515, 1977-2 C.B. 482 (revoking Treas. Reg. §§ 301.7701-2(a)(5), (h)).

passive investor with deductions and credits to offset other income.<sup>357</sup> The government's attempt to curtail tax shelter abuses by classifying the limited partnerships as associations was unsuccessful because the Kintner regulations contained provisions that made it difficult for limited partnerships to qualify as associations.<sup>358</sup> In 1986, Congress addressed tax shelter abuses by enacting provisions to limit the tax benefits available to passive investors.<sup>359</sup>

## B. LLCs

Partnerships also became an increasingly popular form of conducting business after the Tax Reform Act of 1986 repealed the General Utilities rule reflected in the Code,<sup>360</sup> thus causing gain to be recognized at the corporate level on the distribution or sale of appreciated corporate assets.<sup>361</sup> As more taxpayers desired to do business in passthrough form, they sought entities that would combine the advantages of a corporation, e.g., limited liability, with those of a partnership, e.g., one level of federal tax. The most important vehicle for achieving these aims, and the catalyst for the "check-the-box" regulations, discussed, infra, has been the Limited Liability Company (LLC). LLCs provide limited liability protection but were designed to qualify for classification as partnerships under the Kintner regulations because they lack two of the four characteristics that distinguish a corporation from a partnership.

Although the IRS issued proposed regulations in 1980 that would have denied partnership status to LLCs,<sup>362</sup> it withdrew these proposed regulations in 1983 and announced that it would

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<sup>357</sup> See 1986 Blue Book, supra note 224, at 210 (discussion of tax shelter abuses in the early 1980s).

<sup>358</sup> See Treas. Reg. §§ 301.7701-2(b), (c)(4), (d) and (e). See also Larson v. Commissioner, 66 T.C. 159 (1976) (treating real estate tax shelter as partnership under Kintner regulations). In 1977, the Treasury issued proposed regulations that would have classified tax shelter limited partnerships as associations, but withdrew these regulations two days later. See Prop. Treas. Reg. §§ 301.7701-301.7703, 42 Fed. Reg. 1038 (1977); 42 Fed. Reg. 1489 (1977) (withdrawal).

<sup>359</sup> See I.R.C. § 469 (limiting passive activity losses and credits and treating an interest in a limited partnership as presumptively passive); I.R.C. § 465 (extension of at-risk rules to the activity of holding real property).

<sup>360</sup> See I.R.C. §§ 311, 336 and 337.

<sup>361</sup> See Bruce N. Davis and Steven R. Lainoff, U.S. Taxation of Foreign Joint Ventures, 46 Tax L. Rev. 165, 179 (1991) ("Foreign Joint Ventures") (discussing planning techniques involving partnerships after repeal of General Utilities rule).

<sup>362</sup> Prop. Treas. Reg. § 301.7701-2(a), 45 Fed. Reg. 75709 (1980).

conduct a study of the issues in this area.<sup>363</sup> The first state LLC statute was enacted by Wyoming in 1977<sup>364</sup> and considered in Revenue Ruling 88-76,<sup>365</sup> which held that an LLC formed under the Wyoming LLC statute would be classified as a partnership for federal tax purposes. Subsequently, every other state has passed an LLC statute<sup>366</sup> and the entities formed under many of these state laws have been held to be partnerships by the IRS.<sup>367</sup>

### C. Single Member Entities

Special entity classification issues have arisen with respect to entities that have only one owner. While courts have long held that an entity incorporated under state law with a single stockholder is a corporation for tax purposes,<sup>368</sup> courts originally were reluctant to treat an unincorporated entity with a single owner as an association for tax purposes.<sup>369</sup>

In the 1943 case of Lombard Trustees, Ltd. v. Commissioner,<sup>370</sup> the Ninth Circuit held that a trust with a single beneficiary was taxable as an association. In that case, however, the trust had several trustees that were associated in the business. Thus, it was unclear whether the holding of that case was based on the activities of the trustees.<sup>371</sup>

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<sup>363</sup> Announcement 83-4, 1983-2 I.R.B. 31. See Foreign Joint Ventures, supra note 361, at 171-172 (proposed regulations withdrawn in response to severe pressure from private bar).

<sup>364</sup> Wyoming Limited Liability Company Act, Wyo. Stat. §§ 17-15-101 to-136 (1977).

<sup>365</sup> 1988-2 C.B. 360.

<sup>366</sup> See Bruce P. Ely and Christopher R. Grissom, 98 STN 216-17 The LLC/LLP Scorecard, 98 State Tax Notes 216-17 (Nov. 9, 1998) (1998 LLC/LLP Scorecard) (list of state LLC statutes).

<sup>367</sup> For a list of revenue rulings upholding partnership status for entities created under state LLC statutes, see Hobbs, supra note 334, at 517 n.521. Many of these revenue rulings, including Rev. Rul. 88-76, were obsoleted after the issuance of the check-the-box regulations, discussed infra. See Rev. Rul. 98-37, 1998-2 C.B. 133.

<sup>368</sup> See Moline Properties v. Commissioner, 319 U.S. 436 (1943); Burnet v. Commonwealth Improvement Co., 287 U.S. 415 (1932).

<sup>369</sup> See Knoxville Truck Sales and Service, Inc. v. Commissioner, 10 T.C. 616 (1948) (after corporate charter of single owner corporation was revoked entity was held not to be an association taxable as a corporation because it lacked associates).

<sup>370</sup> 136 F.2d 22 (9<sup>th</sup> Cir. 1943).

<sup>371</sup> See Knoxville Truck Sales and Service, Inc. v. Commissioner, 10 T.C. at 621-22 (trustees in Lombard acted as directors of a corporation and thus trust resembled a corporation).

From July through October of 1977, the IRS issued several private letter rulings classifying certain foreign organizations with single owners.<sup>372</sup> These rulings all concluded that the foreign organizations lacked “associates with an objective to conduct business and divide the gain therefrom” and therefore could not be classified as associations or partnerships. Some of the rulings also specifically determined that the organizations could not be classified as trusts.<sup>373</sup> Instead, the rulings concluded that the foreign organizations would be treated as “an integral part” of the sole owner for tax purposes. In November of 1977, the IRS withdrew each of these private letter rulings, citing Rev. Rul. 77-214<sup>374</sup> for the position that the rulings were “not in accord with the views of the Service concerning the proper classification of foreign organizations that have only one beneficial owner.”<sup>375</sup> Subsequently, in February of 1978, the IRS issued further guidance that, on a prospective basis, classified each of these foreign organizations as an association taxable as a corporation.<sup>376</sup>

In the 1980 case of Hynes v. Commissioner,<sup>377</sup> the Tax Court held that a trust with a single beneficiary that was carrying on a business for profit had the corporate characteristics of “associates” and an objective to carry on business for “joint” profit under the Kintner regulations and was therefore properly classified as an association taxable as a corporation. The Tax Court

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<sup>372</sup> See Priv. Ltr. Rul. 77-43-060 (July 28, 1977) (classifying a German GmbH); Priv. Ltr. Rul. 77-43-077 (July 29, 1977) (classifying a French societe a responsabilite limitee); Priv. Ltr. Rul. 77-47-083 (Aug. 26, 1977) (classifying a German GmbH); Priv. Ltr. Rul. 77-48-038 (Aug. 31, 1977) (classifying a German limited liability company); Priv. Ltr. Rul. 78-02-012 (Oct. 11, 1977) (classifying a Brazilian limited liability company). For a discussion of these private letter rulings, see New York State Bar Association, Tax Section, Report on Foreign Entity Characterization for Federal Income Tax Purposes, 35 Tax L. Rev.167, 202-203 (1980).

<sup>373</sup> See Priv. Ltr. Rul. 77-43-060; Priv. Ltr. Rul. 77-48-038.

<sup>374</sup> 1977-1 C.B. 408 (looking to German law to determine that the GmbH had associates and an objective to carry on business and divide the gains therefrom and applying “single interest” theory to find other corporate characteristics in classifying as an association a German GmbH owned by two domestic subsidiaries, each of which was wholly owned by the same corporate parent).

<sup>375</sup> See Priv. Ltr. Rul. 78-06-062 (Nov. 11, 1977) (withdrawing PLR 77-43-060); Priv. Ltr. Rul. 78-06-056 (Nov. 11, 1977) (withdrawing PLR 77-43-077); Priv. Ltr. Rul. 78-06-055 (Nov. 11, 1977) (withdrawing PLR 77-47-083); Priv. Ltr. Rul. 78-06-057 (Nov. 11, 1977) (withdrawing PLR 77-48-038); Priv. Ltr. Rul. 78-06-058 (Nov. 11, 1977) (withdrawing PLR 78-02-012).

<sup>376</sup> See Priv. Ltr. Rul. 78-21-147 (Feb. 28, 1978); Priv. Ltr. Rul. 78-21-125 (Feb. 28, 1978); Priv. Ltr. Rul. 78-21-134 (Feb. 28, 1978); Priv. Ltr. Rul. 78-21-142 (Feb. 28, 1978); Priv. Ltr. Rul. 78-21-143 (Feb. 28, 1978).

<sup>377</sup> 74 T.C. 1266 (1980).

specifically noted that in reaching its holding it did not treat the trustees as associates.<sup>378</sup> Instead, the Tax Court determined that “where there is a single owner, the regulations are not intended to require multiple associates or a sharing of profits among them.”<sup>379</sup> Thus, under Hynes, a trust carrying on a business for profit could never be taxable as a trust because it would always possess the two characteristics that distinguish an association from a trust.

On August 5, 1985, the IRS issued Gen. Couns. Mem. 39,395, which considered how to classify a trust with a single beneficiary that was formed to conduct business for profit. Following Hynes, Gen. Couns. Mem. 39,395 determined that the entity could not be treated as a trust. In examining the four corporate characteristics that distinguish a corporation from a partnership, Gen. Couns. Mem. 39,395 determined that the entity could not be taxed as an association because it lacked continuity of life and limited liability. Further, Gen. Couns. Mem. 39,395 determined that Hynes could not be interpreted to consider a single member entity to have associates in the partnership sense. Thus, because the entity lacked associates, it could not be taxed as a partnership. Gen. Couns. Mem. 39,395 concluded that, because the trust could not be classified for tax purposes as a corporation, a partnership or a trust, the beneficiary should be treated as making investments through an agent, the trustee.

In a 1992 memorandum opinion, Barnette v. Commissioner,<sup>380</sup> the Tax Court considered whether an entity organized as a GmbH under German law was taxable as a wholly owned subsidiary or a branch of its parent. The court reasoned that since the absence of “associates” and an objective to carry on a business for “joint” profit are common to both one-man corporations and sole proprietorships, these characteristics would be ignored in determining whether the GmbH possessed a preponderance of the remaining four corporate characteristics under the Kintner regulations. The court in Barnette determined that the GmbH possessed more corporate than non-corporate characteristics and therefore was taxable as an association.<sup>381</sup>

Based on Hynes and Barnette and certain IRS guidance,<sup>382</sup> some commentators questioned whether certain foreign or domestic business entities, such as LLCs, that had a single owner could

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<sup>378</sup> Id. at 1280.

<sup>379</sup> Id. The Tax Court determined that because the trust clearly had five of the six corporate characteristics, it would be taxable as an association. Id. at 1286. See Gen. Couns. Mem. 38,707 (May 1, 1981) (IRS will follow Hynes).

<sup>380</sup> T.C. Memo. 1992-371, 63 TCM (CCH) 3201 (1992).

<sup>381</sup> 63 TCM at 3201-12.

<sup>382</sup> See Gen. Couns. Mem. 39,395 (Aug. 5, 1985); Priv. Ltr. Rul. 85-33-003 (May 7, 1985). But see PLRs cited supra in note 375 and 376 (revoking PLRs that treated single member entities as branches and treating such entities as separate corporations).

be classified as an integral part of the entity that owned them.<sup>383</sup> Commentators reasoned that the entity is carrying on a business and therefore it cannot be a trust. It lacks free transferability of interests, and continuity of life and therefore cannot be a corporation. Further, it does not have two partners and, therefore, does not have “associates and an objective to carry on a business and divide the gains therefrom.” Thus, it cannot be a partnership. Since it cannot be a separate entity it must be simply a branch or division of its owner. Whether a single member LLC could be so treated under the Kintner regulations, however, was never specifically addressed by the IRS.

#### **IV. Specific Changes in the Entity Classification Rules for Foreign Entities since 1962**

Although the entity classification rules generally have been applied consistently to both foreign and domestic entities, one area in which application of the rules has diverged has been in the classification of entities that are incorporated (or similarly constituted) under a local incorporation statute (or similar law). Courts have long followed the principle that an entity organized as a corporation under U.S. state law will be treated as a corporation for federal tax purposes without the necessity of applying a corporate resemblance test<sup>384</sup> and in 1970, the IRS affirmed this position when it conceded the status of entities formed under state professional corporation statutes as associations.<sup>385</sup>

At that time, the IRS took a similar position with respect to entities formed under foreign law. On November 13, 1970, the IRS issued Gen. Couns. Mem. 34,376, which determined that an entity incorporated under the laws of Nigeria, a country whose concept of “incorporated” was substantially similar to the U.S. concept, would be treated as a corporation for federal tax purposes without regard to whether it met the standards of the Kintner regulations. On April 6, 1973, the IRS issued Gen. Couns. Mem. 35,294, which went further to conclude that a

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<sup>383</sup> See, e.g., Jill Darrow, Limited Liability Companies and S Corporations: Deciding Which is Optimal and Whether to Convert to LLC Status, 48 Tax Law. 1 (Fall, 1994); Francis Wirtz and Kenneth Harris, Tax Classification of the One Member Limited Liability Company, 59 Tax Notes 1829 (June 28, 1993).

<sup>384</sup> See, e.g., O’Neill v. United States, 410 F.2d 888 (6<sup>th</sup> Cir. 1969) (entity incorporated under state law is a corporation for federal tax purposes whether or not it satisfies corporate resemblance test); Knoxville Truck Sales & Services, Inc. v. Commissioner, 10 T.C. 616 (1948) (before corporate charter was revoked entity was taxable as a corporation although it did not have the essential characteristics of an association).

<sup>385</sup> Rev. Rul. 70-101, 1970-1 C.B. 278 (professional service organizations formed under state corporate statutes will be treated as corporations for tax purposes). See also Gen. Couns. Mem. 39,693 (Jan. 22, 1988) (citing Rev. Rul. 70-101 to support statement that Service generally confers automatic corporate status on organizations formed under designated domestic corporate statutes, bypassing application of Kintner regulations).

Colombian SRL, which was not “incorporated” under U.S. principles, was nevertheless automatically treated as a corporation for federal tax law purposes because it was a separate juridical person under Colombian law. Gen. Couns. Mem. 35,294 relied on the 1933 Supreme Court case of Puerto Rico v. Russell & Co.,<sup>386</sup> which held that a Puerto Rican sociedad en comandita was taxable as an association because the sociedad was regarded as a legal person under civil law, although not “incorporated” in the common law sense.

In Rev. Rul. 73-254,<sup>387</sup> the IRS appeared to limit the position taken in Gen. Couns. Mem. 35,294, holding that the classification of an unincorporated foreign entity was determined under the Kintner regulations, apparently without regard to whether the entity was regarded as a separate juridical person under the laws of the foreign country. Rev. Rul. 73-254 provided that, for purposes of applying the Kintner regulations, the local law of the foreign country would be applied to determine the legal relationships of the members and their interests in the assets. In an attachment to Gen. Couns. Mem. 35,294, dated July 16, 1973,<sup>388</sup> the IRS tried to reconcile its holding with the holding of Rev. Rul. 73-254. The attachment reasoned that an entity that was considered a separate juridical person under the relevant foreign law (even if the entity was not considered “incorporated” under that law) would have the attributes of an association taxable as a corporation, and therefore the Kintner regulations would be applied only to organizations that were not considered separate juridical entities under relevant foreign law.<sup>389</sup> In 1976, however, the IRS revoked Gen. Couns. Mem. 35,294, concluding that a foreign entity would be classified under the Kintner regulations unless it was “considered ‘incorporated’ as that term is used at common law.”<sup>390</sup>

Following this narrower position, Rev. Rul. 77-214 applied the four factor test in the Kintner regulations to determine that a German GmbH was taxable as an association. The ruling specifically noted that the GmbH at issue was a juridical person but that, under German law, a GmbH could assume the characteristics of an association or a partnership depending on its memorandum of association. Thus, it could not be automatically treated as a partnership or corporation for federal tax purposes.

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<sup>386</sup> 288 U.S. 476 (1933).

<sup>387</sup> 1973-1 C.B. 613.

<sup>388</sup> 1973 IRS GCM LEXIS 262, at \*11 (July 16, 1973).

<sup>389</sup> See Id. at \*16-\*17.

<sup>390</sup> Gen. Couns. Mem. 36,910 (Nov. 4, 1976).

In 1988, the IRS revoked prior GCMs that gave automatic corporate status to foreign incorporated entities.<sup>391</sup> Shortly thereafter, it issued Rev. Rul. 88-8,<sup>392</sup> which specifically held that all foreign entities are considered to be unincorporated organizations and therefore must always be classified by application of the four factor test of the Kintner regulations. Rev. Rul. 88-8 considered how to classify a U.K. unlimited company. The ruling noted that the entity was formed under Great Britain's "corporation" statute. Nevertheless, the ruling held that the entity was classified as a partnership for federal tax purposes because it lacked the corporate characteristics of limited liability and free transferability of interests.

By requiring all foreign corporate entities to be classified under the Kintner regulations, Rev. Rul 88-8 facilitated the creation of hybrid entities, i.e., entities that are treated as pass-through entities under the laws of one taxing jurisdiction and as taxable entities under the laws of another taxing jurisdiction. Many foreign limited liability entities that were treated as separate entities under foreign law could qualify as partnerships under the four factor test of the Kintner regulations with sufficient alterations to their organizational documents. For example, German law allowed for the possibility of incorporating partnership-type features, such as restrictions on free transferability of interests, in the organizational documents of a GmbH.<sup>393</sup>

Hybrid entities have been favored by tax planners because they provide greater flexibility in structuring international operations.<sup>394</sup> Practitioners have noted that inconsistent foreign and U.S. treatment can provide opportunities for worldwide tax reduction.<sup>395</sup> The business advantages of being in foreign corporate solution can be retained while obtaining the benefits of pass-through status for U.S. purposes, such as the ability to flow losses through to the U.S. parent, certain foreign tax credit benefits and the ability to avoid certain provisions of subpart F.<sup>396</sup>

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<sup>391</sup> Gen. Couns. Mem. 39,693 (Jan. 22, 1988).

<sup>392</sup> 1988-1 C.B. 403.

<sup>393</sup> See Rev. Rul. 77-214 (German law contains optional provision that can be modified by memorandum of association so that GmbH can assume characteristics of a corporation or partnership). The Limitada, which can be formed under the laws of many civil law countries, and the Dutch C.V. are also examples of entities that are separately taxable under foreign law but can be structured to qualify as a partnership for U.S. tax purposes.

<sup>394</sup> See Ronald Harvey, Michael Burke and Susan Shapiro, Uses of Hybrid Entities in the International Arena, 70 Tax Notes 215 (1996) (Hybrid Entities).

<sup>395</sup> See Foreign Joint Ventures, supra note 361, at 173.

<sup>396</sup> See Hybrid Entities, supra note 394, at 218-222 (discussing planning techniques involving hybrid entities under foreign tax credit rules and subpart F).

In MCA Inc. v. United States,<sup>397</sup> partnership status was sought for U.S. tax purposes to take advantage of certain exceptions to subpart F, as in effect prior to 1987. The taxpayer in MCA Inc. was able to establish entities in 29 foreign countries that were taxable as separate entities under local law, but whose organizational documents were intentionally drafted to allow the entities to qualify as partnerships under the four factor test of the Kintner regulations. In MCA Inc., the taxpayer sought to use this structure to take advantage of an exception to subpart F for certain income received by a CFC from an unrelated person. The taxpayer claimed that the partnerships controlled by the CFC from which the CFC received payments were not related persons.<sup>398</sup>

## V. Promulgation and Purpose of the Check-the-Box Regulations

In 1996, the IRS and Treasury issued regulations that replaced the entity classification rules of the Kintner regulations with a new set of rules that generally made entity classification elective.<sup>399</sup> These regulations have come to be known as the “check-the-box” regulations.

The check-the-box regulations provide that whether an organization will be recognized as a separate entity is determined based on federal tax law and does not depend on local law tax classifications.<sup>400</sup> An organization that is a separate entity can be either a trust or a business entity. The regulations provide a list of business entities that will be treated as per se corporations, including entities incorporated under a federal or state statute, joint stock companies, insurance companies, banks, and certain business entities formed under foreign law.<sup>401</sup>

Under the check-the-box regulations, a business entity that is not a per se corporation can choose its classification.<sup>402</sup> If the entity has at least two members it can elect to be classified as either a partnership or an association. If it has only a single member it can elect to be classified as an association or disregarded as an entity separate from its owner. To minimize the need for

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<sup>397</sup> 685 F.2d 1099 (9<sup>th</sup> Cir. 1982).

<sup>398</sup> Prior to 1986, a controlled partnership was not treated as a related person with respect to a CFC, although a corporation controlled by the CFC would have been so treated. See I.R.C. § 954(d)(3) as in effect prior to 1987. The Ninth Circuit held that the entities were taxable as partnerships and therefore were not related persons. Thus, the subpart F exception applied. In 1986, Congress amended subpart F to treat controlled partnerships as related persons with respect to a CFC. See Tax Reform Act of 1986, Pub. L. No. 99-514, § 1221(e), 100 Stat. 2553.

<sup>399</sup> See T.D. 8697, 61 Fed. Reg. 66584 (Dec. 18, 1996).

<sup>400</sup> Treas. Reg. § 301.7701-1.

<sup>401</sup> Treas. Reg. § 301.7701-2(b).

<sup>402</sup> Treas. Reg. § 301.7701-3(a).

elections, the regulations provide default categories.<sup>403</sup> For newly formed domestic entities, the default category is a partnership if there are at least two members, and a disregarded entity if there is a single member. For newly formed foreign entities, the default category is based on whether the members have limited liability. If all of the members have limited liability, the entity will be treated as an association. If not, it will be treated as a partnership or disregarded entity, depending on whether it has more than one owner. The default category for existing entities was the status they claimed prior to the effective date of the regulations.

These new regulations were promulgated because entity classification under the old rules effectively had become elective in many cases.<sup>404</sup> The check-the-box regulations thus formalized this process in an attempt to provide administrative simplification.<sup>405</sup> The regulations greatly simplified the entity classification process, eliminating the need for a factual analysis under the Kintner regulations. Further, the regulations resolved certain issues, for example, that a single member LLC could be treated as an integral part of the entity that owned it, an issue that was never specifically addressed under the Kintner regulations.

The regulations have also had the effect of increasing planning opportunities, however. Prior to the issuance of the check-the-box regulations, taxpayers generally were able to plan into a specific entity classification, but the process was expensive, time consuming and often lacked certainty.<sup>406</sup> Because the check-the-box regulations greatly facilitated this process, these regulations have allowed taxpayers greater flexibility to use entity classification to achieve specific results under the Code. The ease with which entity classification can now be achieved and the specific sanction of the disregarded entity classification have created a new set of issues. In the international context, these issues have principally related to whether taxpayers should be able to create hybrid entities to take advantage of inconsistent foreign and U.S. tax treatment and whether the check-the-box regulations can undermine substantive tax law in certain circumstances to produce inappropriate tax results.

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<sup>403</sup> Treas. Reg. § 301.7701-3(b).

<sup>404</sup> 61 Fed. Reg., at 66584.

<sup>405</sup> See 61 Fed. Reg., at 66584 (new regulations replace old rules with “a much simpler approach”). See also Notice 95-14, 1995-1 C.B. 297, 298 (The purpose of allowing taxpayers to elect entity classification “is to simplify the rules in order to reduce the burdens on both the taxpayers and the Service”). Most states have adopted rules that allow LLCs to elect entity classification, in conformity with the check-the-box regulations. See 1998 LLC/LLP Scorecard, supra note 366.

<sup>406</sup> See Hybrid Entities, supra note 394.

## **APPENDIX B**

### **SURVEY OF QUANTITATIVE ECONOMIC STUDIES THAT EXAMINE THE INTERNATIONAL MOBILITY OF CAPITAL**

To forecast how a change in the subpart F foreign-to-foreign related party rules<sup>1</sup> would affect the global allocation of capital, it is necessary to know how readily international capital flows respond to changes in the after-tax rates of return at home and abroad. For example, if capital flows are very responsive to changes in the rates of return, the foreign-to-foreign related party rules, by raising the effective rate of tax on foreign investment, might prevent substantial capital outflows from the United States. In that case, weakening or eliminating these rules may cause capital to flow from the United States to foreign countries and, consequently, reduce investment and production in the United States.

At this time, however, there is little consensus among economists about the degree of international capital mobility. Several empirical microeconomic studies suggest that capital flows respond fairly readily to changes in the rates of return, at least within multinational companies. However, a number of macroeconomic studies suggest that international capital flows have relatively little effect on a nation's aggregate capital supply.

The purpose of this appendix is to survey economic articles on international capital mobility. Three bodies of literature are discussed. The first two bodies of literature are composed of empirical microeconomic studies. The third body of literature is composed of macroeconomic studies. The first body of literature examines the decision of U.S. multinationals to invest in one foreign country over another. This body of literature suggests that capital is fairly mobile internationally. It finds evidence that the distribution of foreign investment of U.S. multinationals is influenced by inter-country differences in tax rates. The second body of literature examines the decision of multinationals to invest in the United States or abroad. This body of literature also supports the notion of capital mobility. It presents evidence that suggests that the after-tax rates of return influence whether U.S. multinationals invest in the United States or overseas. The third body of literature, however, suggests that capital may be relatively immobile internationally, at least in the aggregate.

#### **I. Taxes and U.S. Direct Investment Abroad, Suggestive Evidence of Capital Mobility**

The first body of literature, composed of empirical microeconomic studies, contains evidence that suggests that, between foreign subsidiaries of U.S. multinational companies, capital flows freely across national borders. Although these studies do not examine the issue of capital

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<sup>1</sup> The term "foreign to foreign related party rules" is defined in Chapter 3, Section IV.A.

mobility explicitly, the evidence they present suggests that U.S. multinationals respond fairly readily to changes in after-tax rates of return on foreign capital. If capital were immobile internationally, there should be no identifiable relationship between after-tax rates of return in foreign countries and foreign investment by U.S. multinationals.

This section provides detailed summaries of five papers in this body of literature. Brief summaries of these papers can be found in Table 1. The first three (Cummins and Hubbard<sup>2</sup>, Grubert and Mutti<sup>3</sup>, and Hines and Rice<sup>4</sup>) all find that the aggregate distribution of foreign investment by U.S. multinationals is influenced by inter-country differences in taxes. Specifically, U.S. multinationals tend to invest more in countries with low tax burdens than in countries with high-tax burdens. Altshuler, Grubert, and Newlon<sup>5</sup> find that the influence of taxes on investment has risen over time, at least among manufacturing affiliates of U.S. multinational corporations. Altshuler and Hubbard<sup>6</sup> also find that U.S. companies with foreign subsidiaries consider U.S. deferral rules when deciding how much to invest overseas. Table 1 contains brief summaries of these five papers.

Cummins and Hubbard<sup>7</sup> study the relationship between home country taxes, host country taxes and outbound foreign direct investment by subsidiaries of U.S. multinational firms operating in high-tax countries. Their analysis is based on data from a panel containing annual observations for between 282 and 632 foreign subsidiaries over the period from 1980 to 1991. Using these data, they construct two versions of a model that characterizes the relation between a foreign subsidiary's demand for capital and other variables. In the first version, taxes are ignored. The second version controls for differences in both home and host country taxes. Their results imply that the second model provides a better characterization of a subsidiary's demand for capital.

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<sup>2</sup> Jason G. Cummins and R. Glenn Hubbard, The Tax Sensitivity of Foreign Direct Investment: Evidence from Firm-Level Panel Data, in The Effects of Taxation on Multinational Corporations (Martin Feldstein, James R. Hines Jr., and R. Glenn Hubbard eds., 1995).

<sup>3</sup> Harry Grubert and John Mutti, Taxes, Tariffs, and Transfer Pricing in Multinational Corporate Decision Making, 73 *Rev. of Econ. & Stat.* 285 (1991).

<sup>4</sup> James R. Hines, Jr. and Eric M. Rice, Fiscal Paradise: Foreign Tax Havens and American Business, 109 *Q. J. of Econ.* 149 (1994).

<sup>5</sup> Rosanne Altshuler, Harry Grubert, and T. Scott Newlon, Has U.S. Investment Abroad Become More Sensitive to Tax Rates? (Nov. 14-15, 1997) (unpublished paper prepared for the National Bureau of Economic Research International Taxation Conference).

<sup>6</sup> Rosanne Altshuler and R. Glenn Hubbard, The Effect of the Tax Reform Act of 1986 on the Location of Assets in Financial Services Firms (February 19, 1999) (unpublished paper prepared for the American Enterprise Institute Seminar Series in Tax Policy).

<sup>7</sup> Cummins and Hubbard, supra note 2.

Thus, they find that foreign subsidiaries of U.S. multinationals account for inter-country differences in corporate income taxes when deciding how much to invest. The authors use the results to predict that a change in a host country tax rate that raises a subsidiary's cost of capital by 0.10 will also decrease the subsidiary's ratio of foreign direct investment to capital by 0.05.<sup>8</sup> Alternatively, Hines<sup>9</sup> shows that Cummins and Hubbard's results imply that an increase in host country taxes that causes a subsidiary's after-tax cost of capital to increase by 1 percent will reduce annual investment by that subsidiary by 1 to 2 percent.<sup>10</sup>

Grubert and Mutti<sup>11</sup> examine the relationship between average effective tax rates in host countries and the stock of net plant and equipment of foreign manufacturing affiliates of U.S. multinationals in such countries. They examine 1982 data, aggregated by jurisdiction, for a sample of 33 countries. In 1983, the effective tax rates in some of the countries, such as Canada, exceeded the comparable U.S. rate. In others, such as Ireland, the effective tax rate was less than the comparable U.S. rate. The authors estimate the parameters of an equation that explains the aggregate demand for capital by U.S. multinational manufacturers in a host country as a function of that country's gross domestic product, per capita gross domestic product, the tariff rate, and the country's average effective tax rate. Their results imply that higher host-country taxes discourage investment by U.S. manufacturing companies. The authors use their results to predict that if the tax rate in a host country were to decline such that the after-tax rate of return were to rise by 1 percent (for a given pretax return), then the stock of net plant and equipment of majority owned U.S. manufacturing affiliates in that country would increase by 1.96 percent.

Hines and Rice<sup>12</sup> build on the work of Grubert and Mutti. They examine aggregate U.S. foreign direct investment in real capital (plant and equipment) in all industries (not just manufacturing) and consider a wider selection of countries. Their analysis is based on 1982 data, aggregated by country, for a sample of 41 countries. In some countries, such as France and Canada, the average effective tax rate exceeded the comparable U.S. rate in 1982. Rates in other countries, such as the Cayman Islands and the Bahamas, were significantly below the comparable U.S. rate. To study the relationship between the stock of net plant and equipment of foreign affiliates of U.S. companies and average effective tax rates, the authors estimate the parameters of

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<sup>8</sup> The ratio of foreign direct investment to capital measures how the amount of capital acquired within a specified period compares to total capital.

<sup>9</sup> James R. Hines, Tax Policy and the Activities of Multinational Corporations, in Fiscal Policy: Lessons from Economic Research, (Alan J. Auerbach ed., 1997).

<sup>10</sup> Note that these predictions are based on data for only foreign countries with high tax rates and, as a result, may not apply to investment in low-tax countries.

<sup>11</sup> Grubert and Mutti, supra note 3.

<sup>12</sup> Hines and Rice, supra note 4.

an equation that characterizes the relationship between the demand for capital in a foreign country by U.S. companies and the tax rate and gross domestic product in that country. They control for variation in gross domestic product (GDP) because economists generally believe that the demand for investment is greater in countries with relatively high levels of aggregate output than in countries with relatively low levels of output. Similar to Grubert and Mutti, Hines and Rice find that aggregate U.S. direct investment is lower in foreign countries with higher tax rates.<sup>13</sup> Their results suggest that if the tax rate in a host country were to decline such that the after-tax rate of return rose by 1 percent (given a constant pretax rate of return), then the stock of net plant and equipment of U.S. affiliates in that country would increase by 2.3 percent. Thus, Hines and Rice project that foreign direct investment in real capital is more sensitive to changes in taxes than suggested by Grubert and Mutti.<sup>14</sup>

Altshuler, Grubert, and Newlon<sup>15</sup> extend the literature further by considering whether the distribution of U.S. foreign direct investment became more sensitive to inter-country differences in tax rates over time. Their interest in this question stems from two factors. First, production appears to be becoming more globally integrated over time. In addition, during the 1980s, corporate taxes fell in several countries including Canada, the United States, the United Kingdom, France, Belgium, and the Netherlands. To study this question, they examine data on real capital (inventory, plant, and equipment) of foreign manufacturing affiliates of U.S. multinationals, aggregated by country, for a sample of 58 countries for 1984 and 1992. There are two advantages to studying data that spans more than a single year period. First, the authors can control for unobservable characteristics, such as risk and political instability, which influence investment and are specific to individual countries. In addition, they can test whether the responsiveness of investment to taxes changed between 1984 and 1992. Their results suggest that the sensitivity of investment to taxes increased over time. Specifically, they infer from their estimates that if a foreign country had reduced its tax rate such that the after-tax rate of return rose by 1 percent in 1984, investment in real capital in manufacturing affiliates of U.S.

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<sup>13</sup> Hines and Rice estimated a non-linear relationship between investment and changes in the tax rate, i.e., they believed that U.S. direct investment was more responsive to changes in low tax rates than high tax rates. They chose to analyze their findings at the mean tax rate.

<sup>14</sup> Note that the data set used by Hines and Rice (1994) contained more observations for countries with low tax rates than were contained in the Grubert and Mutti (1991) data set. This may explain partly why Hines and Rice found investment to be more sensitive to taxes than Grubert and Mutti. In their paper, Grubert and Mutti found evidence that suggested that a 1 percentage point decrease in a low tax rate in a given country would encourage more investment than a one percentage point decrease in a high tax rate in the same country. In other words, according to their findings, a decrease in the tax rate from 5 percent to 4 percent should encourage more investment in a given country than an decrease in the tax rate from 35 percent to 34 percent.

<sup>15</sup> Altshuler, Grubert, and Newlon, supra note 5.

multinationals in that country would have risen by 1.75 percent. In contrast, they infer that a tax cut that would have led to the same increase in the after-tax rate of return in 1992 would have stimulated a much larger increase in investment in manufacturing affiliates in that country (2.77 percent as opposed to 1.75 percent).

Finally, Altshuler and Hubbard<sup>16</sup> study the impact of the amendments made by the Tax Reform Act of 1986<sup>17</sup> (1986 Act) to the deferral rules of subpart F on the relationship between investment in foreign financial subsidiaries of U.S. multinationals and average effective tax rates in foreign countries.<sup>18</sup> For their analysis, the authors examine data, aggregated by country, for a sample of 32 countries in 1984, 1992, and 1994. Because the 1986 Act repealed deferral for financial service income earned overseas, thus subjecting financial services income to current U.S. tax at the U.S. shareholder level, the authors conjecture that the local tax rate in a foreign country should have had smaller impact on overseas investment by foreign subsidiaries in that sector after 1986. To study the effect of the 1986 Act, they estimate the parameters of an equation that characterizes the value of assets in foreign subsidiaries of U.S. companies in a given host country as a function of both the average effective tax rate and the gross domestic product in that country in 1984, 1992, and 1994. Their results are consistent with their conjecture. They find that, in 1984, the aggregate value of assets in financial subsidiaries of U.S. multinationals was higher in foreign countries with low tax rates than in countries with high tax rates. In contrast, they find that differences in foreign tax rates did not affect the levels of assets in financial subsidiaries of U.S. multinationals after the 1986 Act, in 1992 and in 1994.

The five studies covered in this section reflect only recent research on the relationship between foreign tax rates and investment overseas by U.S. multinationals. However, the central finding -- foreign taxes affect the distribution of foreign direct investment of U.S. multinationals -- is consistent with that of earlier work.<sup>19</sup>

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<sup>16</sup> Altshuler and Hubbard, *supra* note 6.

<sup>17</sup> Pub. L. No. 99-514, 100 Stat. 2553.

<sup>18</sup> Note that many multinationals in the financial sector are organized in branch form rather than in subsidiary form. However, the authors did not take into account the impact of the policy change on branches. They examined only investment data for subsidiaries.

<sup>19</sup> Bond, Boskin and Gale, and others that conducted research in this area during the 1980s, are discussed in the Hines article, *Tax Policy and the Activities of Multinational Corporations*. Hines, *supra* note 9. See Eric Bond, *Tax Holidays and Industry Behavior*, 63 Rev. of Econ. & Stat. 88 (1981); Michael Boskin and William G. Gale, *New Results on the Effects of Tax Policy on the International Location of Investment*, in *The Effects of Taxation on Capital Accumulation*, (Martin Feldstein ed., 1987).

## **II. Taxes and the Decision to Invest in the United States or Overseas, Additional Evidence of Capital Mobility**

The empirical evidence discussed in the first section suggests that capital is fairly mobile among foreign countries within U.S. multinational corporations. However, it does not indicate whether capital is mobile within such companies between the United States and foreign countries. A second body of literature provides suggestive evidence in this area. Studies in this second body of literature are briefly summarized in Table 2.

Similar to the papers in the first body of literature, studies in the second body do not address the issue of capital mobility directly. Rather, they examine how changes in the after-tax rate of return impact investment in domestic and foreign subsidiaries of U.S. multinationals. The most current evidence suggests that multinationals invest more overseas and less in the United States when the rate of return overseas increases relative to the rate in the United States. Such evidence lends support to the notion that capital is fairly mobile internationally.

Two studies in this body of literature, Harris<sup>20</sup> and Desai<sup>21</sup>, examine whether U.S. multinationals responded to the 1986 Act by changing the amount they invested in their domestic subsidiaries relative to their foreign subsidiaries. The 1986 Act influenced the after-tax rate of return on U.S. capital in two ways. First, it reduced the U.S. statutory tax rate on corporate income from 45 percent to 34 percent. This reform effectively raised the U.S. return relative to the return in other countries. Second, it eliminated the investment tax credit. This reform effectively lowered the U.S. return. The overall impact of the two changes was to reduce the after-tax rate of return on U.S. capital relative to that in other countries. Since foreign capital was relatively more profitable than U.S. capital following the reforms, both Harris and Desai hypothesized that U.S. multinationals should respond by investing more overseas and less in the United States after 1986.

Harris<sup>22</sup> finds mixed evidence when examining this hypothesis about the impact of the 1986 Act. His analysis consists of two parts. First, he examines the ratio of U.S. investment to global investment by U.S. multinationals during the 1980s. Consistent with the hypothesis that such companies should invest less in the United States and more overseas following the 1986 Act, he finds that the ratio of U.S. investment to global investment of these companies was lower

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<sup>20</sup> David G. Harris, The Impact of U.S. Tax Law Revision on Multinational Corporations' Capital Location and Income-Shifting Decisions, 31 J. of Acct. Res. 111 (1993 Supp.).

<sup>21</sup> Mihir A. Desai, The Substitutability of Foreign and Domestic Capital: Evidence from TRA (1999) (unpublished mimeo Harvard Business School).

<sup>22</sup> Harris, supra note 20.

between 1987 and 1990 than between 1984 and 1986. In the second part of his analysis, he compares the investment behavior of U.S. multinationals with that of both domestic and foreign non-multinationals. The purpose of the comparison is to link the surge in foreign investment by U.S. multinationals with the 1986 Act tax reforms. He reasons that if the investment behavior of non-multinationals over this period differed from that of U.S. multinationals, then the surge in foreign investment could stem from the reforms. For the comparison, he regresses investment in a country by a firm in a given year against the firm's corporate income that year, the interest rate in the country that year, and the value of the firm's assets in the prior year. His results suggest little difference in investment behavior of U.S. multinationals and foreign and domestic non-multinationals. Specifically, over the relevant period, U.S. multinationals neither reduced their U.S. investments by more than U.S. non-multinationals nor invested relatively more overseas than foreign non-multinationals. He interprets the second part of his analysis to suggest that the business cycle, not the 1986 Act, caused the surge in foreign investment.

Desai<sup>23</sup> builds on the work of Harris and finds evidence that suggests a link between the increase in foreign investment and the 1986 Act. His analysis also consists of two parts. First, using aggregate data, he examines annual capital expenditures by U.S. multinationals. Consistent with his expectations that the reforms should have encouraged such companies to invest more overseas after 1986, he finds that the portion of capital expenditures undertaken through majority-owned foreign affiliates grew from 17 percent in 1986 to 22.5 percent of total capital expenditures in 1990.<sup>24</sup> Second, he uses regression analysis to determine if this surge in foreign investment is linked to the 1986 Act. Because the 1986 Act reduced the U.S. corporate tax rate, which caused U.S. multinationals with average foreign tax rates between 34 percent and 46 percent in 1987 to change from excess limitation to excess foreign tax credit status, he argues that this group of multinationals should have reallocated their investment toward lower tax countries following the tax reform. Thus, the relative effective tax rate on foreign investment in lower tax countries for such companies should have been reduced. To test his prediction, using firm-level data on income, assets, and worldwide sales of 373 U.S. multinationals, he estimates the parameters of an equation that characterizes the growth rate of a firm's foreign assets between 1987 and 1990. The results suggest that the surge in foreign investment in the late 1980s is linked to the 1986 Act.

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<sup>23</sup> Desai, *supra* note 21.

<sup>24</sup> The Bureau of Economic Analysis -- the organization responsible for collecting data on U.S. multinational companies -- defines a majority owned affiliate as one in which the combined ownership of all U.S. parents exceeds 50 percent.

Cummins and Hassett<sup>25</sup> study firm-level data to measure whether a multinational enterprise's foreign demand for capital is a substitute for its domestic demand for capital. This is an important question because, if multinationals consider them to be substitutes, they will invest more abroad and less at home when a tax change reduces the cost of foreign capital relative to the cost of domestic capital. For their analysis, the authors develop a model in which multinationals produce output at home and abroad using six inputs: domestic labor, domestic capital, domestic materials, foreign labor, foreign materials, and foreign capital. Using firm-level data on output, labor, capital, and materials for approximately 200 U.S. multinationals between 1980 and 1995, they estimate values for production function parameters. Their results suggest that multinationals consider domestic and foreign capital to be relatively strong substitutes.<sup>26</sup>

### III. Macroeconomic Research on International Capital Mobility

The empirical evidence discussed to this point suggests that capital is fairly mobile among subsidiaries of U.S. multinational companies. However, it does not shed light on the mobility of capital held by other types of investors. For example, the evidence provides no hint as to whether individual U.S. investors or U.S. non-multinational companies adjust their portfolios in response to a change in the rate of return on foreign capital relative to the rate of return on U.S. capital. A third body of economic literature addresses this question indirectly. Specifically, studies in this third body examine whether the aggregate supply of capital in developed countries is mobile across national borders. Their finding that capital is relatively immobile in the aggregate may suggest that capital held by other types of investors is not as mobile as that held by multinational companies. Table 3 contains brief summaries of four articles in this area of the economic literature.

Feldstein and Horioka<sup>27</sup> examine aggregate savings and aggregate investment in OECD countries to determine whether capital at the aggregate level can be considered internationally mobile. The relationship between aggregate investment and national savings is characterized by a

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<sup>25</sup> Jason G. Cummins and Kevin A. Hassett, Structural Estimates of Factor Substitution from Firm-Level Panel Data on Multinational Corporations (Feb. 19, 1999) (unpublished conference paper, Seminar Series in Tax Policy, American Enterprise Institute).

<sup>26</sup> They also provide evidence that suggests that an individual firm may increase investment in both locations when the tax on foreign investment is reduced. This so-called "output effect" would take place because a business would decide to increase the scale of its operations everywhere, although it would expand by more abroad than at home (the substitution effect). Note that, like the other papers discussed in this section, their results only characterize the demand for capital by individual firms.

<sup>27</sup> Martin S. Feldstein and Charles Horioka, Domestic Savings and International Capital Flows, 90 *Econ. J.* 314 (June, 1980).

basic identity in macroeconomics. Specifically, this identity equates aggregate investment with the sum of national savings and the net flow of international investment.<sup>28</sup> Feldstein and Horioka employ this identity to study the international mobility of capital. They conjecture that if capital flows unfettered across national borders, then the net flow of international investment should be either a positive or negative number, rather than zero. In that case, within an individual country national savings should differ from aggregate investment. Conversely, if capital does not flow across national borders, i.e., if capital is immobile internationally, the net flow of international investment should be zero. In that case national savings should equal aggregate investment within a country. To test their hypothesis, the authors examine data on gross domestic savings, gross domestic investment, and gross domestic product in 16 OECD countries between 1960 and 1974. They estimate the coefficients of an equation that characterizes the ratio of gross domestic investment to gross domestic product in a country as a function of a constant and the ratio of gross domestic savings to gross domestic product in that country. They find that domestic investment is highly correlated with domestic savings. Their estimates suggest that, on average, 89 cents of every dollar saved by residents of OECD countries is invested domestically. They interpret this result to imply that capital, in the aggregate, is not very mobile across international borders.

Since Feldstein and Horioka published their work in 1980, several others have studied the relationship between aggregate savings and investment. An incomplete list of such studies

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<sup>28</sup> Aggregate investment is the sum of domestic public and private sector investment. National savings is the sum of domestic public and private sector savings. In a completely closed economy (i.e., one in which capital does not flow in or out of the country) aggregate investment will always equal national savings because all investment within the country will come from national savings. In an economy that is open to two-way capital flows, aggregate investment within the country could be made with national or foreign savings, and aggregate savings from the country could be invested domestically or abroad. Thus national savings will only equal aggregate investment if net foreign investment (i.e. the difference between foreign savings and foreign investment) is zero.

includes: Feldstein<sup>29</sup>, Fieleke<sup>30</sup>, Murphy<sup>31</sup>, Summers<sup>32</sup> and Frankel.<sup>33</sup> All conclude, similar to Feldstein and Horioka, that national savings and national investment levels are highly correlated. However, there is no consensus among macroeconomists that the proper implication of this finding is that capital is relatively immobile internationally.

Many agree with the Feldstein and Horioka interpretation and offer explanations for the meaning of the phrase “relatively immobile internationally.” For example, some suggest that some but not all types of capital are mobile. For example, investments by multinational companies, but not by other types of investors, may be sensitive to changes in after-tax rates of return in foreign countries. Gordon and Bovenberg<sup>34</sup> suggest that, unlike multinationals, individual investors may prefer to invest in their own countries because they tend to be more familiar with, and better able to evaluate, domestic than foreign investments. As a result, they probably do not respond to changes in foreign rates of return.

Others disagree with the Feldstein and Horioka interpretation and offer explanations as to why the net flow of international investment in many OECD countries may approach zero even though capital is mobile internationally. For example, Murphy<sup>35</sup> examines whether Feldstein's and Horioka's findings are linked to an unrealistic assumption about the size of capital markets in individual countries. Specifically, in their analysis, Feldstein and Horioka assume that the capital markets in all countries are small relative to the global capital market as a whole. This, in turn, allows them to assume that neither changes in the supply or demand of capital in a particular country affects world interest rates. To test whether Feldstein and Horioka's findings could be explained by this small country assumption, Murphy develops a framework in which global

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<sup>29</sup> Martin Feldstein, Domestic Saving and International Capital Movements in the Long Run and in the Short Run, 21 Eur. Econ. Rev. 129 (1983).

<sup>30</sup> Norman S. Fieleke, International Lending in Historical Perspective, New Eng. Econ. Rev. 5 (Nov.-Dec., 1982).

<sup>31</sup> Robert G. Murphy, Capital Mobility and the Relationship between Saving and Investment Rates in OECD Countries, 3 J. of Int'l Money & Fin. 327 (1984).

<sup>32</sup> Lawrence H. Summers, Tax Policy and International Competitiveness, NBER Working Paper Number 2007 (August 1986), available at <<http://www.nber.org/pubs.html#papers>>.

<sup>33</sup> Jeffrey A. Frankel, And Now Won/Dollar Negotiations? Lessons from the Yen/Dollar Agreement of 1984 90 (January 1990) (working paper in Economics, University of California at Berkeley).

<sup>34</sup> Roger Gordon and A. Lans Bovenberg, Why is Capital So Immobile Internationally? Possible Explanations and Implications for Capital Income Taxation, 86 Am. Econ. Rev. 1057 (1996).

<sup>35</sup> Murphy, supra note 31.

interest rates can be influenced by changes in either the supply or demand of capital in relatively large countries. While not conclusive, his results suggest that at least a portion of the close correlation between savings and investment found by Feldstein and Horioka may be due to the small country assumption. Similarly, Summers<sup>36</sup> suggests that the correlation between savings and investment is explained by fiscal and monetary policies. Specifically, governments tend to control tax and monetary policies in ways that attempt to maintain a balance between exports and imports of goods and services. It then follows that net foreign investment tends to approach zero.

#### **IV. Conclusion**

There is no consensus among economists about whether the global allocation of investment would be affected much by a change in the subpart F foreign-to-foreign related party rules. The lack of consensus stems primarily from a disagreement about the international mobility of capital. Those who believe that capital flows unfettered across national borders would argue that such a change would significantly affect the global distribution of investment. Specifically, more would be invested in countries in which the relative after-tax rate of return rose and relatively less would be invested in jurisdictions in which the after-tax rate of return fell. In contrast, those who believe capital is relatively immobile internationally would argue that the impact on the global allocation of investment would be small. The three bodies of literature examined in this appendix, when viewed together, suggest that changes in the after-tax rate of return on foreign capital relative to that on U.S. capital might affect investment expenditures of multinational companies significantly and have a relatively small impact on the total amount invested at home or abroad.

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<sup>36</sup> Summers, supra note 32.

**Table 1: Taxes and U.S. direct investment abroad, suggestive evidence of capital mobility**

Study	Data	Results
Cummins and Hubbard (1995)	Firm-level data on U.S. multinationals with subsidiaries in Canada, United Kingdom, Germany, France, Australia, and Japan between 1980 and 1991. Host country and home country tax information.	U.S. multinationals take into account inter-country differences in taxes when determining how to allocate capital among their subsidiaries in relatively high-tax countries.  Forecast: If taxes in a high-tax foreign country change such that a multinational's after-tax cost of capital rises by 1 percent, annual investment in that country by the multinational will fall by 1 to 2 percent.
Grubert and Mutti (1991)	Gross domestic product, population statistics, ad valorem tariff equivalents, host country average effective tax rates, and aggregate U.S. foreign direct investment in manufacturing in a cross section of 33 countries in 1982.	The aggregate distribution of U.S. foreign direct investment in real capital in manufacturing across countries is explained partly by differences in host country average effective tax rates.  Forecast: If the tax rate in a host country declines such that the after-tax rate of return rises by 1 percent, then the stock of net plant and equipment of majority owned U.S. manufacturing affiliates in that country will increase by 1.96 percent.
Hines and Rice (1994)	Gross domestic product, population statistics, average effective tax rates, and aggregate U.S. foreign direct investment in a cross section of 41 countries in 1982.	The aggregate distribution of U.S. foreign direct investment in real capital across countries is explained partly by differences in average effective tax rates.  Forecast: If the tax rate in a host country declines such that the after-tax rate of return rises by 1 percent, then the stock of net plant and equipment of U.S. affiliates in all industries in that country will increase by 2.3 percent.
Altshuler, Grubert, and Newlon (1997)	Data on gross domestic product, population, inflation, average effective tax rates, and book values of depreciable assets of manufacturing CFCs, aggregated by country for a sample of 58 countries in 1984 and 1992. Trade regime classification data for 1987.	The aggregate distribution of investment in real capital in foreign manufacturing affiliates of U.S. multinational companies became more sensitive to differences in average effective tax rates between 1984 and 1992.  Estimates: If the tax rate in a host country in 1984 had declined such that the after-tax rate of return had risen by 1 percent, then the stock of net plant and equipment of U.S. manufacturing affiliates in that country would have increased by 1.75 percent. In contrast, if the tax rate in a host country in 1992 had declined such that the after-tax rate of return had risen by 1 percent, then the stock of net plant and equipment of U.S. manufacturing affiliates in that country would have increased by 2.77 percent.

Altshuler and Hubbard (1999)	Aggregate value of assets of U.S. controlled foreign corporations in financial services and gross domestic product for a cross section of 32 countries in 1984, 1992, and 1994 and host country average effective tax rates.	The aggregate distribution of assets in foreign financial subsidiaries of U.S. multinational companies became less sensitive to differences in host country average effective tax rates following the Tax Reform Act of 1986.
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**Table 2: Taxes and the decision to invest in the United States or overseas, additional evidence of capital mobility**

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Study	Data	Findings
Harris (1993)	Firm-level data on investment, corporate income, and the value of existing assets of 377 U.S. multinationals, 1,965 firms domiciled in America, and 2,114 firms domiciled in foreign countries between 1984 and 1990. Statistics on the U.S. interest rate on Treasury securities and the London inter bank offer rate during the same period.	When examining the decline in U.S. investment by U.S. multinationals in the late 1980s, Harris does not find evidence that links the decline to the Tax Reform Act of 1986.
Desai (1999)	Aggregate annual data from the Bureau of Economic Analysis on capital expenditures and total assets of U.S. multinationals between 1982 and 1993. Firm-level data on income, assets, and worldwide sales of 373 firms between 1987 and 1990. Statistics on foreign tax rates for 1987.	In contrast to the work done by Harris, Desai finds evidence that suggests the surge in foreign investment by U.S. multinationals in the late 1980s is linked to the Tax Reform Act of 1986.
Cummins and Hassett (1999)	Firm-level panel data on output, capital, labor, and materials, of nearly 200 U.S. multinationals between 1980 and 1995.	Domestic and foreign capital are relatively strong substitutes in production by U.S. multinationals.

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**Table 3: International capital mobility**

Study	Data	Empirical finding	Interpretation
Feldstein and Horioka (1980)	Gross domestic savings, gross domestic investment, and gross domestic product data for 16 OECD countries between 1960 and 1974.	On average, a \$1 increase in domestic savings causes an increase in domestic investment of 89 cents.	Capital is relatively immobile internationally.
Gordon and Bovenberg (1996)	No data	Theoretical analysis	Capital is relatively immobile internationally because of asymmetric information.
Murphy (1984)	Gross domestic savings, gross domestic investment, and gross domestic product data for 17 OECD countries between 1960 and 1980.	On average, a \$1 increase in domestic savings causes an increase in domestic investment of 90 cents.	Capital is relatively mobile internationally. High correlation between domestic savings and domestic investment is explained by the fact that some of the capital markets in countries for which data are available are large relative to the global capital market.
Summers (1986)	Gross domestic savings, gross domestic investment, and gross domestic product data for four-year intervals between 1960 and 1983.	A high correlation exists between domestic savings and domestic investment rates.	Capital is relatively mobile internationally. He suggests that the high correlation between domestic savings and domestic investment may be explained by fiscal and monetary policies.

## APPENDIX C

### THE MEASUREMENT OF TAX RATES

This appendix explains how the tax rates referred to in Chapter 3 were measured. Both the concepts and data sources are described. The appendix is organized into three parts, covering the measurement of foreign effective tax rates on the earnings and profits of foreign manufacturing subsidiaries of U.S. multinationals, the measurement of total tax rates on the foreign source income of U.S. manufacturing companies and the tax rate on domestic income of U.S. corporations.

#### **I. Foreign Effective Tax Rates on the Earnings and Profits of Foreign Manufacturing Subsidiaries of U.S. Multinationals**

The effective tax rates shown in Table 1 of Chapter 3 and referred to throughout this paper are tax rates on corporate profits. Foreign effective tax rates are the taxes paid in a given foreign country divided by the economic income earned in that foreign country. The corporations for which we calculate foreign tax rates are those manufacturing subsidiaries reporting on Form 5471, Information Return of U.S. Persons With Respect To Certain Foreign Corporations. Form 5471 is filed by the U.S. parent corporation for each foreign subsidiary that is greater than 10% owned. Tax rates based on these data are the effective foreign tax rates on corporate profits of U.S. subsidiaries in their respective foreign countries. These tax rates provide a measure of the tax on income from investment in a foreign country.<sup>1</sup>

The numerator of the foreign tax rate is from Schedule F of Form 5471, and includes income, war profits, and excess profits taxes paid or accrued. Schedule F includes taxes paid to countries other than the home country of the subsidiary to the extent that other countries' laws or tax treaties give them taxing jurisdiction.<sup>2</sup> In 1994 the foreign taxes on manufacturing subsidiaries of U.S. parents was approximately \$13.8 billion.

The denominator of the tax rate, economic income, is the tax code defined earnings and profits of the firm as reported in Schedule H of Form 5471. In general, these earnings and profits are calculated by the taxpayer by starting with its foreign book income, converting that to U.S. generally accepted accounting principles (GAAP), and then converting the GAAP version of profits to the tax concept of earnings and profits.<sup>3</sup> When these conversions are complete the

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<sup>1</sup> For a variety of reasons these tax rates may differ from the effective tax rates on all corporations (both U.S. owned and others) in a given foreign country.

<sup>2</sup> Section 986 provides the principles for determining taxes that are included in Schedule F.

<sup>3</sup> Section 964 and the regulations thereunder give a detailed description of the adjustments that must be made to foreign book income to arrive at the tax definition of earnings and profits.

earnings and profits that result are a reasonable approximation of economic income. In 1994 the earnings and profits of foreign manufacturing subsidiaries of U.S. parents was approximately \$64.8 billion.

The average effective tax rate across all countries for 1994 is \$13.8 billion divided by \$64.8 billion or approximately the 21 percent shown in the Average Foreign Rate column in Table 1 of Chapter 3.

Country effective tax rates were obtained by dividing the sum of taxes paid or accrued for the subsidiaries located in a country by the sum of earnings and profits for those same subsidiaries. The result is a weighted average of the effective tax rates for the subsidiaries; the weights being the earnings and profits of each subsidiary. Subsidiaries were included in this calculation for the years in which their after-tax earnings and profits were greater than zero. Negative earnings and profits has two unwanted effects on the average tax rates. In a loss year, firms are likely to pay no taxes. Therefore, including loss firms in the tax rate calculation forces the denominator downward, while having no effect on the numerator of the fraction, thus causing average tax rates to be higher than they otherwise would be. In years after the loss, taxable income is forced downward because most countries, like the United States, allow firms to offset taxable income and thus taxes in other years via a carryover of losses. This carryover generally has little effect on U.S. tax law defined earnings and profits. Thus, the inclusion of subsidiaries with loss carryovers may cause the numerator of the tax rate to decrease while having no effect on the denominator, causing the tax rate in the year in which the carryforward is applied to decrease.

It would probably be best to follow a firm through time taking into consideration all of its earnings and profits and all of its taxes over the years in order to calculate a long-term tax rate that would more accurately reflect the average tax cost of doing business in a foreign country. Given the data on foreign subsidiaries currently available that is not possible. Another alternative measurement would exclude both subsidiaries that have current year losses and those that have net operating loss carryovers to the current year. This also is not possible because although subsidiaries with current year losses can be identified, subsidiaries with loss carryovers cannot be identified. Instead, we have chosen to exclude subsidiaries that have an after tax loss from the country tax rate calculation only in the year in which they incur that loss. The exclusion of such firms in the year the losses are incurred causes the country foreign tax rate to be lower than it would be if such firms were included.<sup>4</sup>

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<sup>4</sup> Tax defined earnings and profits that exclude firms that have current year losses have frequently been used in effective tax rate calculation in the economic literature. Recent articles using these tax rates include: Rosanne Altshuler, and R. Glenn Hubbard, The Effect of the Tax Reform Act of 1986 on the Location of Assets in Financial Services Firms, American Enterprise Institute, Conference Paper from Taxation of International Investment : principles and Policies, February

Country effective tax rates are different from statutory rates. The inclusion of firms with loss carryovers is one reason for the difference, but there are other reasons. Economic income in a growing economy is generally larger than taxable income causing the effective tax rate to be lower than the statutory tax rate.<sup>5</sup> Second, the taxes paid or accrued in the numerator of the tax rate are net of any tax credits, causing the effective tax rate to be lower than the statutory rate. Finally, some countries may have laws that allow certain kinds of income to go untaxed. For example, some countries have tax holidays that allow income during a certain period of time to be excluded from taxable income. Such income would be included in economic income causing the effective tax rate to be lower than the statutory rate.

Table 1 of Chapter 3, Country Average Tax Rates Variations Across Countries By Year, Foreign Manufacturing Subsidiaries of U.S. Companies, shows the distribution of average country tax rates that are calculated in the manner described above. The firms included in the calculation are only those that are classified into the manufacturing industries as reported by the taxpayer on Form 5471. Each subsidiary is classified into a country based upon the taxpayer reported country of incorporation. Countries are included separately in the distribution only when there are more than five manufacturing subsidiaries with positive earnings and profits after taxes in that country for every year shown in the table. Countries with less than five subsidiaries were combined into an all other group that was treated like any other country for purposes of calculating the distribution. Generally, the number of subsidiaries operating in each country grows over the years. All firms for which information was available was used to calculate the average country tax rate for a given year, so that a single country may include a different set of firms in each year.

## **II. Average Effective Total Tax Rate on Foreign Source Income of U.S. Manufacturing Companies**

The average effective rate of total tax on foreign source income of U.S. manufacturing companies is calculated by dividing foreign source income, including unrepatriated earnings of subsidiaries, into the sum of foreign taxes, the U.S. tax on foreign source income, and withholding tax paid to foreign governments. The total tax rate differs from the country foreign tax rate because it includes all types of foreign source income in the denominator rather than just earnings and profits and includes all taxes on that income in the numerator rather than just foreign income taxes. For example, the total tax rate calculation includes royalty, interest and services income in

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19,1999; and Roseanne Altshuler, Harry Grubert and T. Scott Newlon, Has U.S. Investment Abroad Become More Sensitive to Tax Rates?, NBER, Working Paper 6383, January 1998.

<sup>5</sup>When preferences in the tax system that are caused by timing differences such as accelerated depreciation cause economic income to be larger than statutory income, economic income will continue to be larger than statutory income as long as investment continues to grow.

the denominator and the foreign withholding taxes and other foreign taxes on that income in the numerator. The total tax rate provides a broader measure of the tax on income from a foreign country than does the country tax rate. The measure presented here is the total tax rate on manufacturing activities.

The measurement of the total tax rate begins with data from Form 1118, Foreign Tax Credit - Corporations. Form 1118 must be filed by U.S. taxpayers that claim a foreign tax credit and includes information concerning the foreign taxes that are eligible for credit as well as foreign source income that must be used in the calculation of the limitation on the use of the credit.<sup>6</sup> In order to limit the measure to manufacturing activities, only data from Form 1118's filed by manufacturing corporations are included in the total tax rate measure.

Taxpayers are required to report foreign taxes and foreign source income in nine separate categories or "baskets" of income. Only income and taxes from the general basket are used in the calculation of the total tax rate presented here. The general basket includes most active income from subsidiaries (other than financial and transportation subsidiaries) including dividends, interest, royalties, services or other types of income and excludes passive activities such as portfolio investments.

In 1994, the general basket of manufacturing corporations included approximately \$55.9 billion in net foreign source income as reported on Schedule B, Part II of Form 1118. This amount includes section 863(b) income. Under section 863(b), half of export income may be treated as foreign source income. Such income is generally not taxed in any foreign jurisdiction and will be excluded from the calculation of the total tax rate. Section 863(b) net income in the general basket for 1994 is approximately \$6.5 billion.<sup>7</sup> This amount is subtracted from net foreign source income in the general basket.

Earnings and profits of foreign subsidiaries as reported on Form 1118 includes either income that is distributed as dividends to the United States or income that is deemed distributed under subpart F, but because of our system of deferral, does not include any retained earnings and profits that are not subpart F income. In order that the total tax rate cover income from all foreign manufacturing activities, including both income taxable in the United States in the current period and income not taxable in the current period but produced in the current period, earnings and profits of foreign subsidiaries (of U.S. manufacturing parents) in all industries except financial

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<sup>6</sup> A description of the data from Form 1118 is in Robin A. Robinson and Sarah E. Nutter, Corporate Foreign Tax Credit, 1994, Internal Revenue Service, Statistics of Income Bulletin 172-230 (Fall 1998).

<sup>7</sup> Net 863(b) income is gross income less definitely allocable deductions for the general basket as reported on Schedule F of Form 1118 and less a part of not definitely allocable deductions as shown on Schedule F.

services and transportation industries are substituted for the gross value of dividends appearing on the Form 1118 of U.S. manufacturing corporations. This adjustment increases net foreign source income by approximately \$39.2 billion. After the adjustment the denominator of the total tax rate fraction is approximately \$88.6 billion for 1994. A corresponding adjustment to taxes is described below.

In 1994, there was approximately \$21.7 billion of foreign taxes in the general basket for U.S. manufacturing firms. Approximately \$5.2 billion of these taxes were carried forward from a previous year. The effective total tax rate should include only taxes on current year's income, so taxes carried forward are subtracted from total foreign taxes.

The U.S. tax on foreign source income is frequently referred to as the residual tax because it is the amount of U.S. tax liabilities remaining after foreign tax credits. The amount of the residual tax in the general basket for manufacturing companies is approximately \$2.9 billion.

As mentioned above, the treatment of export income as foreign source income under section 863(b) results in mismeasurement of foreign source income. It also causes mismeasurement of taxes on that foreign source income. For every dollar of export income treated as foreign source there is \$.35 of mismeasurement of taxes. Approximately \$2.3 billion (or 35% of foreign source income of approximately \$6.5 billion) of taxes must be removed from total taxes to correct this mis-measurement.

It is necessary to replace foreign income taxes on dividends reported in the general basket on Form 1118 with foreign income taxes on all earnings and profits of subsidiaries (except transportation and financial subsidiaries) of manufacturing parents. This corresponds to the adjustment for deferred income described above. The net adjustment is approximately \$6.3 billion.

The average effective total tax rate on foreign source income of U.S. manufacturing firms in 1994 is \$23.4 billion in taxes divided by \$88.6 billion in foreign source income or 26.4 percent.

### **III. The U.S. Tax Rate on Domestic Income of U.S. Manufacturing Corporations**

The calculation of the 1996 average U.S. tax rate, which is referenced in Chapter 3 of this study, is described in this section. The U.S. tax rate is the domestic income of manufacturing firms divided into the U.S. taxes paid on that income. To make the U.S. tax rates on domestic income as close in definition as possible to the foreign and total tax rates, the domestic tax rates are calculated from stockholder reports which provide a measure of the companies' U.S. income similar in concept to earnings and profits reported for foreign subsidiaries on Form 5471.

The stockholder report information used in the calculation of the U.S. tax rates includes corporations with positive domestic net income after taxes. It further includes only the corporations that Compustat has classified into manufacturing industries. However, firms

included in the manufacturing industries may have significant non-manufacturing activities and it is not possible to obtain a domestic net income concept that is limited only to manufacturing activities from the Compustat data.

The denominator of the U.S. tax rate calculation is domestic pre-tax income (compustat mnemonic= pidom) with income from consolidated subsidiaries' common stock not owned by the parent (mii) removed. The numerator is the sum of U.S. federal (txfed) and state and local (txs) taxes. This tax rate calculation has been frequently used in the economic literature<sup>8</sup>. Both federal and state and local taxes are included in the numerator of the tax rate fraction because they are both generally included in the denominator of the foreign tax rate fraction.<sup>9</sup> A part of the taxes included in the numerator may be on foreign source income, but the residual U.S. tax on foreign source income is small relative to total U.S. corporate taxes.

Less than a quarter of manufacturing firms report domestic pre-tax income as compiled by Compustat. Only those firms for which Compustat shows domestic pre-tax income separately have been included in the tax rate calculation. These firms account for approximately 30 percent of positive net income of manufacturing corporations. Using these concepts for 1996, the denominator of the U.S. tax rate is approximately \$151 billion and the numerator (including state and local taxes) is approximately \$47 billion, yielding a tax rate of approximately 31 percent. The state and local taxes are approximately \$6.0 billion, so that the federal corporate tax rate on domestic income is approximately 27 percent.

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<sup>8</sup> In Omer, Molloy and Zieberts, A Measurement of Effective Corporate Tax Rates Using Financial Statement Information, a detailed description of the tax rate calculation is given. Here, the tax rate calculation has been altered to obtain domestic figures.

<sup>9</sup>Non-federal taxes are included in the numerator of the total tax rate as well to the extent that they qualify for foreign tax crediting.

## APPENDIX D

### **SURVEY OF QUANTITATIVE ECONOMIC STUDIES THAT EXAMINE INCOME SHIFTING BY MULTINATIONAL COMPANIES**

Because tax rules and the cost of complying with such rules differ across countries, an incentive often exists for multinational companies to reduce costs by shifting income among their affiliates. For purposes of this appendix, the term income shifting is used to describe arrangements through which income that, from an economic perspective, is considered to be earned in one country, is treated as earned in another country for tax purposes. For example, multinationals may try to maximize income reported in a low-tax country through transfer pricing arrangements or through deductible payments that strip earnings out of a corporation in a high-tax country to a related corporation in a low-tax country. To the extent the tax rules of a country allow such income shifting, or to the extent those tax rules are not strictly and rigorously enforced, a multinational may have an incentive to shift income. By contrast, an increase in compliance costs<sup>1</sup> in a high-tax country should reduce the incentive to shift income by offsetting such tax savings.

When evaluating the revenue impact of a proposed change to the subpart F foreign-to-foreign related party rules, it is necessary to know whether multinational companies actually respond to changes in the incentive to shift income. It is also important to know how much money such companies could shift in response to such a change. If U.S. multinationals were to significantly increase the amount they shifted out of the United States, the impact on U.S. tax revenue could be considerable.

The purpose of this appendix is to survey economic studies on international income shifting. Three bodies of literature are discussed. Studies in the first body provide evidence that suggests U.S. multinational companies shift income in response to differences in tax rules in foreign countries. A few of the studies also estimate the potential magnitude of such shifting. Studies in the second body suggest that reported earnings of U.S. multinationals in a particular country change when the incentive to shift income changes. Studies in the third body of literature suggest that U.S. subsidiaries of foreign companies transfer relatively little income out of the United States. No empirical studies to date have examined whether U.S. multinationals change

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<sup>1</sup> For purposes of this discussion, increased compliance costs in a country generally refer to the increased taxes associated with rigorous enforcement of the tax laws in that country. Rigorous enforcement of the tax laws in a country will likely cause taxpayers to be more cautious in reporting their income and deductions, with the result that more taxable income is likely to be reported in that country.

the amount of income reported in the United States in response to changes in U.S. compliance costs.

### **I. Foreign Tax Rates and Reported Profits: Evidence That Suggests Multinationals Shift Income in Response to Differences in Tax Rules in Foreign Countries**

When the authors conducted research for the studies in the first body of literature, there was no consensus that U.S. multinationals actually shifted income among affiliates. Some believed income shifting was merely a theoretical construct. There was also significant disagreement about the potential magnitude of such shifting. The purpose of these first studies was to document evidence that suggested U.S. multinationals actually shifted income in response to differences in tax rules in foreign countries. Some of the studies also attempted to quantify the magnitude of such shifting.

A similar analytical strategy was employed in all papers. Specifically, the authors conjectured that if income shifting were widely practiced, it then follows that the reported income of subsidiaries located in low-tax jurisdictions should exceed that of similar size subsidiaries in high-tax jurisdictions.

While searching for suggestive evidence of shifting, authors of these studies also addressed indirectly whether both statutory and average effective tax rates influenced reporting strategies of multinationals. Statutory tax rates are the actual rates listed in tax codes. Average effective tax rates are calculated as the ratio of taxes paid to total reported income. Average effective rates are intended to characterize the combined impact of various provisions of a particular tax code. Effective rates are influenced not only by changes in statutory rates but also by changes that affect the tax base (e.g., deductions, and credits) and compliance costs.

Five studies from this body of literature are discussed in this appendix. The first, a paper by Newlon<sup>2</sup>, examines data on unadjusted taxable income and average effective tax rates. He finds that U.S. foreign subsidiaries located in countries with a relatively low average effective tax rate tend to report nearly twice as much income as similar size subsidiaries based in countries with

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<sup>2</sup> T. Scott Newlon, Transfer Pricing and Income Shifting in Integrating Economies (April 3-5, 1997) (unpublished conference paper prepared for the International Seminar in Public Economics on Reform and Harmonization of Company Taxes in the European Union).

a relatively high average effective tax rate. Grubert and Mutti<sup>3</sup>, Hines and Rice<sup>4</sup>, and Harris, Morck, Slemrod, and Yeung<sup>5</sup> also examine the relationship between reported profits and tax rates (both statutory and average effective tax rates), but use regression analysis to control for other factors that might affect profitability in foreign countries, like labor costs and economic growth. They find that reported earnings of foreign subsidiaries tend to be negatively correlated both with foreign statutory tax rates and with average effective foreign tax rates. Grubert and Mutti and Hines and Rice then quantify the amount shifted among affiliates of U.S. multinationals. Rousslang<sup>6</sup> examines the same issue using a slightly different approach. Specifically, he studies after-tax rates of return on capital of foreign affiliates of U.S. multinationals on a company-by-company basis and finds evidence that suggests such firms shift income from countries with a high average effective tax rate to countries with a low average effective tax rate. Table 1 contains brief summaries of these studies.

Newlon<sup>7</sup> examines the relationship between reported income and average effective tax rates by collecting data for 1992, aggregated by country, and calculating three normalized measures of reported income: the ratio of taxable income to assets, the ratio of taxable income to sales, and the ratio of taxable income to equity. Income data are normalized to adjust for differences in subsidiary size. Next, he categorizes the income measures by three classes of average effective tax rates (less than 10 percent, 10 percent to 20 percent, and greater than 20 percent). His findings, shown in table 2, indicate that the unadjusted reported earnings of U.S. affiliates in countries with a low effective tax rate in 1992 were significantly higher than the earnings of similar size affiliates in countries with a high average effective tax rate in that year.

Grubert and Mutti<sup>8</sup> reexamine Newlon's findings. In particular, they question whether reported income tends to be high in low-tax countries, and vice versa, when other factors that affect profitability are taken into account. They also question whether statutory tax rates are a

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<sup>3</sup> Harry Grubert and John Mutti, Taxes, Tariffs, and Transfer Pricing in Multinational Corporate Decision Making, 73 Rev. of Econ. & Stat. 285 (1991).

<sup>4</sup> James R. Hines, Jr. and Eric M. Rice, Fiscal Paradise: Foreign Tax Havens and American Business, 109 Q. J. of Econ. 149 (Feb., 1994).

<sup>5</sup> David G. Harris, Randall Morck, Joel Slemrod, and Bernard Yeung, Income Shifting in U.S. Multinational Corporations, in Studies in International Taxation (Alberto Giovannini, R. Glenn Hubbard, and Joel Slemrod eds., 1993).

<sup>6</sup> Donald J. Rousslang, International Income Shifting by U.S. Multinational Corporations, 29 Applied Econ. 925 (1997).

<sup>7</sup> Newlon, supra note 2.

<sup>8</sup> Grubert and Mutti, supra note 3.

better determinant than effective tax rates of a multinational's incentive to shift income.<sup>9</sup> For their analysis, Grubert and Mutti regress two different reported income measures, the ratio of book income to sales and the ratio of book income to equity, against statutory tax rates and the growth rate of gross domestic product (GDP). GDP growth was included in the regression to control for the likelihood that companies in countries with high-growth rates were more profitable on average than companies in countries with low-growth rates. They also repeat the regression analysis with average effective tax rates rather than statutory tax rates. They examine data on manufacturing affiliates of U.S. multinationals in 33 countries for 1982. Their findings corroborate those of Newlon. Specifically, their findings suggest that affiliates in countries with either a relatively low statutory or a relatively low average effective tax rate tend to report more income than similar size affiliates located in countries with either a relatively high statutory or a relatively high average effective tax rate. Negative correlations between reported income and tax rates are evident even when differences in economic growth are taken into account. The results also indicate that statutory tax rates are slightly better determinants of reported foreign earnings than average effective tax rates.

Hines and Rice<sup>10</sup> also examine the relationship between reported income and average effective tax rates. For their analysis, they regress a non-linear function of aggregate reported profits in different countries against non-linear functions of labor costs, the value of real assets, per capita gross domestic product and average effective tax rates. They include labor costs in the regression to control for the possibility that companies in countries with high wage costs tend to be less profitable than companies that produce in countries with relatively low labor costs. The value of real assets is also included to control for the possibility that larger subsidiaries (those with more assets) tend to earn higher profits than smaller subsidiaries. The authors also used per capita gross domestic product information as a proxy for worker productivity. Subsidiaries in countries with relatively productive workers tend to be more profitable than subsidiaries in countries with less productive workers. The analysis was conducted using data on non-bank majority owned affiliates<sup>11</sup> of U.S. multinationals in 108 countries in 1982. Similar to the findings of the other studies, the results indicated that reported earnings and average effective tax rates are negatively correlated even when differences in labor costs, worker productivity, and subsidiary size are taken into account.

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<sup>9</sup> The difference in statutory rates in two countries is the amount a multinational would save on each dollar it shifted from one country to another.

<sup>10</sup> Hines, Jr. and Rice, supra note 4.

<sup>11</sup> Note the Bureau of Economic Analysis -- the organization responsible for collecting data on U.S. multinational companies -- defines a majority owned affiliate as one in which the combined ownership of all U.S. parents exceeds 50 percent.

Grubert and Mutti<sup>12</sup> and Hines and Rice<sup>13</sup> also use their results to estimate how the amount of income reported as earned by U.S. multinationals might differ in two countries with different tax rates. For example, Grubert and Mutti estimate that if the statutory tax rate in one country is 40 percent and 20 percent in another and the average growth rate of GDP in both countries is 3.94 percent, then reported income in the first country should be about half as much as that reported in the second country. Specifically, reported book income as a fraction of sales of affiliates of U.S. multinationals should amount to only 5.6 percent in the country with the 40 percent tax rate and 12.6 percent in the country with the 20 percent rate. Similarly, Hines and Rice estimate that if the average effective tax rate in one country is one percentage point higher than in another, then reported income of non-bank majority owned affiliates of U.S. multinationals in the first country should be 3 percent less than the amount reported in the other country.

Harris *et al.*<sup>14</sup> also examine the relationship between reported earnings and foreign statutory tax rates, but from a slightly different perspective. They hypothesize that a U.S. multinational with subsidiaries located primarily in high-tax countries should shift less income out of the United States than a similar size U.S. company with subsidiaries located primarily in low-tax countries. If true, this hypothesis implies that a multinational with subsidiaries based primarily in high-tax countries should report more U.S. income and pay more in U.S. taxes than a similar company with subsidiaries based primarily in low-tax countries. To test this hypothesis, the authors analyzed data on 200 randomly selected U.S. multinationals with foreign manufacturing affiliates over the period 1984 to 1988. Like the other studies, the authors used regression analysis to control for non-tax factors that affect profitability, such as research and development expenses, marketing expenses, wage costs, and the cost of capital. The results, which support their hypothesis, indicate that U.S. multinationals with subsidiaries located primarily in countries with a mean statutory tax rate that exceeds the comparable U.S. rate pay more in U.S. taxes over the five-year period than multinationals with subsidiaries based primarily in countries with a mean statutory tax rate that falls below the comparable U.S. rate.

Rousslang<sup>15</sup> examines after-tax rates of return on capital to determine if multinationals tend to shift income from countries with a high average effective tax rate to countries with a low average effective tax rate. The theory of profit maximization implies that, if multinationals shift profits to minimize taxes, after-tax rates of return on capital should be high in countries with low tax rates and low in countries with high tax rates. The after-tax rate of return on capital in a particular subsidiary is equal to the value of the subsidiary's taxable income divided by the value of its assets. If earnings are shifted to that subsidiary, then the after-tax rate of return should be

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<sup>12</sup> Grubert and Mutti, *supra* note 3.

<sup>13</sup> Hines, Jr. and Rice, *supra* note 4.

<sup>14</sup> Harris, Morck, Slemrod, and Yeung, *supra* note 5.

<sup>15</sup> Rousslang, *supra* note 6.

relatively high. Similarly, the return should be relatively low if earnings are not shifted to the subsidiary. To test this theory, Rousssang examines information reported on tax returns in 1988 by U.S. multinational companies about both their assets and their earnings. He found that after-tax rates of return tended to be low for subsidiaries located in countries with a high average effective tax rate and high for subsidiaries located in countries with a low average effective tax rate. Thus, his findings also suggest that multinationals shift income. However, it should be noted that the results could also be explained by risk. If production in low-tax countries tends to be riskier than production in high-tax countries, the after-tax rates of return on capital should systematically be higher in low-tax countries than in high-tax countries.

To summarize, evidence in this body of literature suggests that U.S. multinationals shift income in response to differences in tax rules in foreign countries. Specifically, such companies tend to report high earnings in countries with relatively low tax burdens and low earnings in countries with relatively high tax burdens. Most of the authors also tend to believe that the incentive to shift income is determined primarily by differences in statutory tax rates across countries. However, differences in compliance costs, which result in differences in average effective tax rates, may also influence the amount shifted. Finally, evidence in two of these studies suggests that considerable earnings could be shifted among affiliates. Grubert and Mutti, for example, estimate that twice as much income is reported in one country relative to another if the statutory tax rate in the former is half the size of that in the latter.

## **II. Tax Reforms and Reported Profits: Evidence That Suggests Reported Earnings in a Particular Country Change When the Incentive to Shift Income Changes**

The objective of authors of papers in the second body of literature is to examine whether multinational companies respond to changes in the incentive to shift income. All employ a similar research strategy. They conjecture that if multinationals act on the incentive to shift income, then a policy that reduces the corporate statutory tax rate in a particular country relative to rates in other countries should encourage more income to be shifted to affiliates in that country. This, in turn, should cause reported taxable earnings of affiliates in that country to rise.

While the authors of these papers do not consider the impact of changes in average effective tax rates on shifting strategies of U.S. multinationals, their findings do indicate that there is no obvious income shifting response to a change in the average effective tax rate in a particular country. As background to the discussion in this section, it should be noted that, in theory, the income shifting response should depend on the factors that influence the average effective rate. An average effective tax rate is influenced by changes in the statutory rate, the tax base, and the enforcement of the tax rules. A policy that changes rates or enforcement of the tax rules should theoretically affect income shifting while investment incentives that change the tax base should not. This result may best be demonstrated by example. Suppose the corporate statutory tax rate is increased in country A. Tax credits for investment are introduced, which reduce the tax base. Also assume that no other tax reforms are implemented and the combined impact of the two

changes is to reduce the average effective tax rate in country A. If statutory tax rates in other countries do not change, multinationals should respond to the reforms in country A by shifting income to foreign countries because companies focus on statutory rate changes rather than on investment incentives when engaging in income shifting. Assume that a completely different set of reforms is enacted. For example, authorities offer a reduced tax rate to foreign companies who agree to produce manufactured goods in country A. Also assume that no other tax changes are approved either in country A or in other countries. In this case, the average effective tax rate in country A falls and multinationals should respond by shifting income into country A. Thus, in this case, a decrease in the average effective tax rate in country A is associated with companies shifting profits into that country because the average effective tax rate change is caused by a change in the statutory rate.

Two studies in this body of literature, Harris<sup>16</sup> and Klassen, Lang, and Wolfson<sup>17</sup>, examine whether U.S. multinationals responded to the Tax Reform Act of 1986<sup>18</sup> (1986 Act) by changing the amount of income they reported for tax purposes in both their domestic and foreign affiliates. The 1986 Act affected both the U.S. corporate statutory tax rate and the U.S. average effective tax rate. The reform reduced the statutory tax rate on corporate income from 45 percent to 34 percent. The reduction was implemented over the two-year period, 1987 to 1988. Another provision of the 1986 Act eliminated the investment tax credit. The combined impact of the decrease in the statutory tax rates and the elimination of the investment tax credit was to increase the U.S. average effective tax rate. Since, as discussed immediately above, income shifting strategies are likely to be influenced by statutory tax rates but not investment incentives, both Harris and Klassen *et al.* conjecture that U.S. multinationals should have responded to the 1986 Act tax reforms by reporting additional income in affiliates in the United States and less in affiliates in foreign countries after 1986. Table 3 contains brief summaries of these studies.

Harris<sup>19</sup> examines firm-level data to determine if the 1986 Act affected income shifting strategies of U.S. multinationals. He predicts that if the reform did influence strategies, the impact on reported U.S. earnings should have been especially strong for intangible-intensive multinational companies.<sup>20</sup> To test this theory, he compares the reported income of U.S.

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<sup>16</sup> David G. Harris, The Impact of U.S. Tax Law Revision on Multinational Corporations' Capital Location and Income-Shifting Decisions, 31 J. of Acct. Res. 111 (1993 Supp.).

<sup>17</sup> Kenneth Klassen, Mark Lang, and Mark Wolfson, Geographic Income Shifting by Multinational Corporations in Response to Tax Rate Changes, 31 J. of Acct. Res. 141 (1993 Supp.).

<sup>18</sup> Pub. L. No. 99-514, 100 Stat. 2553.

<sup>19</sup> Harris, supra note 16.

<sup>20</sup> This is because transfer pricing rules are especially difficult to enforce for the exchange of marketing intangibles and other intangibles that result from research and development.

intangible-intensive multinationals with that of both domestic and foreign intangible-intensive non-multinationals. He reasons that if U.S. multinationals shifted income in response to the decline in the U.S. statutory rate, then the trend in their reported income both in the United States and overseas during the 1980s should differ from that of domestic and foreign non-multinational companies. Using data for the 1984 to 1990 period, he regresses reported income of a company in a given country in a given year against its reported income in that country in the previous year, its total assets in that country in the previous year, and two dummy variables. The first dummy variable indicates whether or not the company is a multinational. The second specifies whether or not the company spends a significant amount on marketing and research and development. His results indicate U.S. multinationals with relatively high marketing and research and development expenses increased the amount of income they reported in the United States over the 1987 to 1988 period by more than domestic non-multinationals over the same period. In addition, their reported earnings in affiliates in foreign countries fell by more than the reported earnings of foreign non-multinationals over the same period. Thus, consistent with his conjecture, his results suggest that U.S. multinationals responded to the decline in the U.S. statutory rate by reporting more income in the United States and less overseas.

Klassen, Lang, and Wolfson<sup>21</sup> also study the impact of the 1986 Act on reported earnings of U.S. multinationals. Unlike Harris, however, they examine reported earnings for 1987 separate from those for 1988. Their analysis, like that employed by Harris, involves a comparison in the trend in reported earnings of U.S. multinational companies with those of both domestic and foreign non-multinationals. Their analysis uses data on equity, income tax payments, and assets of 191 U.S. multinationals, 1,446 non-multinational U.S. companies, and 2,095 non-multinational foreign companies over the 1984 to 1990 period. The regression equation relates the change in the ratio of taxable income to book equity of a particular company in a given year to several dummy variables. One dummy variable categorizes the firm as a multinational or a non-multinational. Another indicates the percentage of the firm's total assets that were located in each of four regions (Europe, Canada, the United States, and the rest of the world) over the six-year period. The results for 1987 but not for 1988 support their conjecture about income shifting. Specifically, the results suggest that, in 1987, U.S. multinationals reported a greater increase in U.S. earnings than were reported by U.S. non-multinational companies. That same year, these companies reported a larger decline in foreign earnings than were reported by foreign non-multinationals. The opposite was found to be true for both the comparison with domestic non-multinationals and foreign non-multinationals in 1988. The authors suggest that the 1988 results may be explained by the fact that corporate statutory tax rates also fell in several foreign countries that year. Thus, the response to the decline in foreign statutory tax rates may have simply outweighed the response to the decline in the U.S. statutory rate.

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<sup>21</sup> Klassen, Lang, and Wolfson, *supra* note 17.

Klassen, Lang, and Wolfson also study the impact of the Canadian and European tax reforms on reported earnings of U.S. multinationals. Because corporate statutory tax rates rose in Canada and fell both in the United Kingdom and in France between 1985 and 1986, the authors conjecture that U.S. multinationals should have responded to these reforms by reporting relatively more income in Europe and relatively less in Canada over the two-year period. The regression analysis in this case is identical to that used to study the impact of the U.S. reforms. The same data are also employed. Consistent with their conjecture, the findings indicate that U.S. multinationals with assets in both Canada and in Europe reported a larger increase in European earnings over the two-year period than were reported by European non-multinational companies. They also report a larger decline in Canadian earnings than were posted by Canadian non-multinational companies over that period.

In summary, evidence from this body of literature suggests that multinationals respond to changes in the incentive to shift income. Specifically, if the incentive increases because the statutory tax rate in a particular country falls, multinationals appear to report more income for affiliates in that jurisdiction. This is evidenced by an increase in reported earnings in that country. Similarly, if the incentive is reduced because the corporate statutory tax rate in a particular country rises, multinationals seem to report fewer earnings for affiliates in that country. Finally, the findings of these studies indicate that a change in the incentive to shift income does not necessarily correspond to a change in a particular country's average effective tax rate. Provisions in the 1986 Act simultaneously decreased the statutory rate and increased the U.S. average effective tax rate. Companies responded to the change in the statutory rate, not to the change in the average effective tax rate, by shifting more income into the United States.

### **III. Reported Profitability of U.S. Companies and U.S. Affiliates of Foreign Multinationals**

Studies in the third body of literature were motivated by the findings of a study conducted by the U.S. General Accounting Office.<sup>22</sup> In this study, the U.S. General Accounting Office indicates that the percentage of foreign controlled corporations (FCCs) (i.e., U.S. corporations more than 50% owned by foreign shareholders) that paid no U.S. taxes between 1989 and 1995 was higher than the percentage of U.S.-controlled U.S. corporations that paid no taxes over the same period.<sup>23</sup> Specifically, the percentage of FCCs that did not pay taxes ranged from 67 percent to 73 percent while the percentage of U.S.-controlled corporations that did not pay taxes only ranged from 59 percent to 62 percent. Some claim that the reason more foreign multinationals are able to avoid paying U.S. taxes than U.S. companies is that foreign multinationals shift much

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<sup>22</sup> See United States General Accounting Office, Tax Administration: Foreign- and U.S.-Controlled Corporations That Did Not Pay U.S. Income Taxes, 1989-1995 (March, 1999).

<sup>23</sup> Id. at 4.

of the income they earn in the United States to affiliates in foreign countries. A casual analysis of unadjusted taxable income data lends support to this claim. Such an analysis indicates that the average FCC tends to report significantly lower profits than the average U.S. company. Authors of studies in the third body of literature would disagree. In their studies, the authors attempt to show that FCCs shift relatively little income out of the United States by providing evidence that much of the reported difference in profitability is linked to systemic differences between U.S. companies and FCCs. For example, FCCs may face higher input costs than U.S. companies because they tend to use more imported parts in production.

Two studies from the third body of literature are discussed in this appendix. The first study, Grubert, Goodspeed, and Swenson,<sup>24</sup> employs rigorous analysis to explain that a large part of the difference in profitability between FCCs and other U.S. companies may be caused by systemic differences between the two. Specifically, they estimate that nearly half of the 1987 differential may be attributable to such systemic differences. The second study, by Grubert,<sup>25</sup> also uses rigorous analysis to examine the 1993 profit differential. He finds that such differences explain more than half, and perhaps as much as 75 percent, of the differential that year. Table 4 contains brief summaries of these studies.

Grubert, Goodspeed, and Swenson<sup>26</sup> and Grubert<sup>27</sup> explain that the taxable income differential may stem from several factors. For example, foreign multinationals may shift income, either through transfer pricing or earnings stripping, to subsidiaries in countries in which corporate statutory tax rates are lower than in the United States. Another possibility is that the unadjusted ratio of taxable income to assets for FCCs is not comparable to the ratio for U.S. companies. When managers of FCCs invest in the United States, they generally purchase existing rather than new plants and equipment. Because the appraised value of an older plant or piece of machinery tends to rise when it is marked to market, the ratio of taxable income to assets of FCCs tends to fall when they invest. (The denominator but not the numerator of the ratio rises after the acquisition.) It is also possible that FCCs face higher start up costs than U.S. companies because it takes foreign managers time to learn about U.S. markets, resources, and consumers. Finally, unexpected declines in the value of the dollar relative to other currencies could increase expenses for foreign firms who rely more heavily than domestic companies on imported parts.

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<sup>24</sup> Harry Grubert, Timothy Goodspeed, and Deborah Swenson, Explaining the Low Taxable Income of Foreign-Controlled Companies in the United States, in Studies in International Taxation (Alberto Giovannini, R. Glenn Hubbard and Joel Slemrod eds., 1993).

<sup>25</sup> Harry Grubert, Another Look at the Low Taxable Income of Foreign-Controlled Companies in the United States 1 (1997) (Office of Tax Analysis Working Paper, Number 74), available at <http://www.treas.gov/ota/otapapers.html>.

<sup>26</sup> Grubert, Goodspeed, and Swenson, supra note 24.

<sup>27</sup> Grubert, supra note 25.

Because the portion of the income differential that may be attributable to income shifting is difficult to measure directly, Grubert, Goodspeed, and Swenson examine firm-level data to determine what percentage may stem from other factors. The remainder, in their opinion, is the upper bound of the portion that may stem from income shifting. For their analysis, they examine two sets of data. The first contains 1987 information on 600 non-financial FCCs and 4,000 non-financial U.S. companies. With these data, they regress a firm's ratio of taxable income to assets against foreign and industry dummy variables. They also estimate parameters for similar equations with additional independent variables, such as a firm's debt to equity ratio and dummy variables that classify the firm by acquisition date. A comparison of the parameter estimates generated from the different equations suggests that acquisition dates explain nearly a quarter of the 1987 differential in taxable income. The second set of data contains information about 110 non-financial FCCs and 1,300 non-financial U.S. corporations over the period 1980 to 1987. Using this information, they regress a firm's ratio of taxable income to assets against several dummy variables. The dummies classify the firm by age and by industry. Other dummies also interact with a time trend and with an index of the real value of the dollar. Parameter estimates from this regression suggest two things. First, the profitability of manufacturing FCCs relative to that of U.S. manufacturing companies tends to rise over time. Second, wholesale FCCs tend to be less profitable than U.S. companies when the dollar depreciates unexpectedly because the cost of imported inputs rises. Combined, these two factors explain another one-fourth of the income differential. Thus, the authors conclude that at least one-half of the 1987 differential in taxable income between U.S. companies and FCCs is attributable to factors other than income shifting.

Grubert both updates the Grubert, Goodspeed, and Swenson analysis with more recent data and investigates the importance of interest expenses, depreciation costs, dividends, and royalties. His analysis consists of two parts. First, he updates the earlier work using 1993 rather than 1987 data for the cross-section regressions and statistics for 1987 to 1993 rather than for 1980 to 1987 for the panel regressions. He finds that many of the same factors that explain some of the 1987 differential also explain a large portion of the 1993 differential. However, the relative importance of these factors changes over the five-year period. For example, differences in acquisition dates account for only 11 percent of the 1993 differential, but 25 percent of the 1987 differential. Differences in ratios of debt to assets explain roughly 16 percent of the 1993 differential, but only one percent of the 1987 differential. Although exchange rate fluctuations do not explain a significant part of the 1993 differential, the "maturation effect" continues to explain why many FCCs, especially those involved with manufacturing, tend to be less profitable than other U.S. companies. In the second part of the paper, Grubert departs from the Grubert, Goodspeed, and Swenson analysis to consider possible explanations for the difference in the ratio of taxable income to sales of FCCs and domestic companies. To do this, he runs regressions, similar to those used to analyze the ratio of taxable income to assets, on both the ratio of taxable income to sales and the ratio of operating income to sales. (Unlike taxable income, operating income excludes dividend income and accounts for both interest and depreciation expenses.) He finds a large part of the differential, 50 percent or more, may stem from the fact that relative to U.S. companies, FCCs tend to receive fewer dividends and royalties and have higher interest and

depreciation expenses. Thus, combining the results of the two parts, he concludes that more than half, and perhaps as much as three-fourths of the taxable income differential, may stem from systemic differences between domestic companies and FCCs.

Grubert also compares the profitability of U.S. companies that are only partially foreign-owned by with those of that are 100 percent foreign-owned. In his opinion, U.S. companies with one owner should shift more income than U.S. companies with multiple owners. When more than one owner is involved, consensus on a particular strategy must be reached before profits can be shifted from one affiliate to another. Building on this logic, Grubert conjectures that if income shifting explains a large portion of the profit differential, then 100 percent foreign-owned U.S. companies should shift more profits out of the United States than similar size U.S. companies that are only 25 percent to 50 percent foreign owned. This, in turn, implies that if income shifting is widely practiced by foreign multinationals, then the reported profitability of 100 percent foreign-owned U.S. companies should be noticeably lower than that of partially foreign-owned U.S. companies. Data from U.S. tax forms filed by foreign owned U.S. companies for tax year 1993 are used in the analysis. His findings suggest that there is no noticeable difference between the reported profitability of U.S. companies that are partially foreign-owned and those that are 100 percent foreign-owned. He interprets this result to reinforce the general finding of this body of literature – a large percentage of the profit differential is not explained by income shifting.

In summary, evidence in the third body of literature suggests that foreign multinationals shift relatively little income out of the United States. Specifically, they find that less than half and possibly less than one-fourth of the reported difference in profitability of U.S. companies and FCCs may be due to income shifting. The remainder can be explained by systemic differences, such as differences in input costs, between these two types of companies. If true, this evidence seems to suggest that foreign multinational companies do not respond significantly to the incentive to shift income out of the United States.

#### **IV. Conclusion**

Will U.S. tax revenue decline significantly if policymakers approve a change in the foreign-to-foreign related party rules? The answer to this question may be yes if the change would also increase the incentive to shift income. In theory, this incentive should be influenced by differences in tax rates across countries. Such differences create an opportunity for companies to reduce their tax liability by shifting income from high-tax countries, like the United States, to low-tax countries. Evidence discussed in this appendix suggests that U.S. multinationals actually do shift income in response to such differences in tax rates. The magnitude of such shifting is unclear, however. Studies that examine data on foreign subsidiaries of U.S. companies suggest that a significant amount of income is shifted from high-tax to low-tax countries. Other studies that examine data on U.S. subsidiaries of foreign companies suggest that much less income may actually be shifted in response to differences in tax rates. These latter studies suggest that at least

some portion of the initial estimates can be explained by non-tax factors, like the use of expensive foreign inputs in production.

Changes in compliance costs in a high-tax country, in theory, should also affect the incentive to shift income. Specifically, an increase in such costs should reduce the incentive to shift by offsetting savings associated with reporting income in low-tax countries. Although no empirical studies to date have examined whether U.S. multinationals respond to changes in compliance costs by shifting more or less income out of the United States, one would expect that if the foreign-to-foreign related party rules were changed such that the compliance costs associated with shifting income from the United States declined, the incentive to shift income from the United States to foreign countries would increase. This, in turn, could increase the number of companies that shift income out of the United States and reduce U.S. tax revenue.

**Table 1: Foreign tax rates and reported profits of subsidiaries of U.S. multinationals**

Study	Data	Findings
Newlon (1997)	Information reported on U.S. corporate tax returns in 1992 about U.S. and foreign tax liabilities, taxable income, total assets, total sales, and equity of foreign affiliates of U.S. multinationals.	U.S. multinationals tend to report less income in subsidiaries in countries with a high average effective tax rate than in similar size subsidiaries in countries with a relatively low average effective tax rate.
Grubert and Mutti (1991)	Statutory tax rates, average effective tax rates, gross domestic product growth rates, and aggregate measures of book income, sales, and equity of U.S. manufacturing affiliates in 33 countries in 1982.	<p>The distribution of reported income of manufacturing subsidiaries in foreign countries is correlated negatively with both the distributions of average effective tax rates and of statutory tax rates in foreign countries even after factors that affect profitability are taken into account.</p> <p>Regressions based on statutory tax rates tend to have more explanatory power than those based on average effective tax rates.</p>
Hines and Rice (1994)	Average effective tax rates and aggregate data on labor, capital, and reported profits of U.S. non-bank affiliates in 108 countries in 1982.	U.S. multinationals in non-bank industries tend to report higher profits in subsidiaries in countries with a low average effective tax rate than in subsidiaries in countries with a high average effective tax rate even after additional factors, which influence profitability, are taken into account.
Harris et. al. (1993)	Pretax profitability, research and development spending, advertising spending, depreciation, amortization, rental expenses, investment tax credits, interest expenses, and employment information for 200 randomly selected U.S. multinationals in the manufacturing sector between 1984 and 1988. Mean statutory corporate tax rates for 1984 and 1988.	U.S. multinationals in the manufacturing sector with subsidiaries located primarily in foreign countries with a mean statutory tax rate that exceeds the comparable U.S. rate tend to report more U.S. income and pay more in U.S. taxes than U.S. multinationals in the same sector with subsidiaries located primarily in foreign countries with a mean statutory tax rate that falls beneath the comparable U.S. rate.
Rousslang (1997)	Firm-level data on assets, sales, income, dividend distributions, research and development expenditures, and tax payments of foreign affiliates and domestic operations of U.S. multinationals in the manufacturing sector in 1988.	Foreign affiliates of U.S. multinationals tend to shift income earned in countries with a high average effective tax rate to countries with a low average effective tax rate.

**Table 2: Taxes and reported income of foreign subsidiaries of U.S. multinationals, 1992**

Category of average effective tax rates	Ratio of income to assets	Ratio of income to sales	Ratio of income to equity
Less than 10 %	0.102	0.098	0.196
10 % - 20 %	0.071	0.058	0.165
More than 20 %	0.054	0.042	0.155

SOURCE: Newlon (1997).

**Table 3: Tax reforms and reported profits of affiliates of U.S. multinationals**

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Study	Data	Findings
Harris (1993)	Firm-level data on income, assets, and expenses of 375 multinationals, 1,351 U.S. non-multinationals, and 1,698 foreign non-multinationals between 1984 and 1990.	Empirical findings support the proposition that intangible-intensive multinationals responded to the Tax Reform Act of 1986 by shifting income out of foreign countries and into the United States.
Klassen, Lang, and Wolfson (1993)	Annual, firm-level data on income, tax payments, and assets of 191 U.S. multinationals, 1,446 non-multinational U.S. firms, and 2,095 non-multinational foreign firms between 1984 and 1990.	The findings in this study are also consistent with the hypothesis that U.S. multinationals shifted income from subsidiaries in other countries to the United States in 1987 when the U.S. corporate statutory tax rate fell. However, in 1988, they find that these same companies may have shifted income out of the United States to foreign countries, even though the U.S. statutory rate continued to fall that year.  In addition, the results of this study are consistent with the proposition that U.S. multinationals shifted income from Canada to Europe between 1984 and 1986 when the Canadian corporate statutory tax rate rose and French and U.K. corporate statutory rates fell.

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**Table 4: Reported profits of U.S. companies and foreign controlled corporations**

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Study	Data	Finding
Grubert, Goodspeed, and Swenson (1993)	Firm-level data on income, taxes, assets, debt, equity, and expenses for a cross section of 600 non-financial foreign controlled corporations and 4,000 non-financial U.S. companies in 1987.	Approximately 50 percent of the 1987 difference in taxable income between foreign controlled corporations and U.S. companies can be attributed to special characteristics of foreign controlled corporations rather than transfer pricing.
	Firm-level data for a panel of 110 non-financial foreign controlled corporations and 1,300 non-financial U.S. corporations for 1980 to 1987.	
Grubert (1997)	Information reported on U.S. tax returns between 1987 and 1993 on taxable income, total assets, and gross receipts by U.S. companies and by U.S. operations of foreign controlled corporations.	Each year between 1987 and 1993, U.S. companies reported higher taxable income than similar size U.S. operations of foreign controlled corporations.
	Firm-level data on income, taxes, assets, debt, equity, and expenses for a cross section of 1,208 non-financial foreign controlled corporations and 4,610 non-financial U.S. companies in 1993.	More than 50 percent, and perhaps as much as 75 percent, of the difference in taxable income between foreign controlled corporations and U.S. corporations can be explained by systematic differences between the two types of corporations.
	Firm-level data for a panel of 344 non-financial foreign controlled corporations and 1,588 non-financial U.S. corporations for 1987 to 1993.	

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