Volume I

The NFTC Foreign Income Project:

International Tax Policy

for the

21st Century

Report and Analysis

Prepared by the National Foreign Trade Council, Inc.

Fred F. Murray • Editor-in-Chief

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The NFTC Foreign Income Project:*

International Tax Policy
for the
21st Century

Part One

A Reconsideration of Subpart F

Part Two

Relief of International Double Taxation

Preface

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

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

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Executive Summary and General Observations

I. Introduction

A. Scope

This report, Parts One[1] and Two of the NFTC's Foreign Income Project, offers the NFTC's analysis of the principal tax policy considerations that have shaped the development of our recommendations for the modernization and reform of subpart F and the foreign tax credit.

B. Overview of the Issues

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

- Whether to impose any U.S. tax on income earned in other countries[2];
- If foreign income is to be taxed, whether and when to tax the income of a foreign subsidiary: when it is earned, or only when it is repatriated to the United States; and

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

[2] This analysis starts from the fundamental assumption that the United States taxes the income of its citizens and domestic corporations on a worldwide basis. The report does not attempt to address either the desirability or the implications of the adoption of a territorial system of taxation, an alternative that could itself be the subject of substantial analysis and debate. Therefore, for this analysis the question is stated not as whether but as *when* should foreign income be taxed.

- If foreign income is to be taxed, whether and how double taxation should be prevented when that income is also taxed by another country.

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

- The United States taxes the worldwide income of its citizens and residents;
- The income of foreign subsidiaries is taxed only when received by U.S. shareholders (typically in the form of a dividend), subject to certain anti-abuse rules; and
- Double taxation is avoided primarily by granting a credit against U.S. tax for the foreign taxes paid on foreign income, subject to certain limitations.

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

C. Principal Findings of the Foreign Income Project

Based on the data and analysis presented in Parts One and Two of the Foreign Income Project, the NFTC believes that the core principles and basic structure of the U.S. international tax rules remain sound. However, the balance of competing policies reflected in current law has not kept pace with the rapid development of a global economy. Consequently, the NFTC believes that it is time for a significant modernization of the U.S. rules, both

as they relate to the taxation of foreign subsidiary income (*i.e.*, the anti-deferral, or income acceleration, rules of subpart F[3]) and as they relate to the foreign tax credit. The principal findings of Parts One and Two may be briefly summarized as follows:

(i) Part One—subpart F:

- Since the enactment of subpart F nearly 40 years ago, the development of a global economy has substantially eroded the economic policy rationale of the rules.
- The breadth of subpart F exceeds the international norms for such rules, adversely affecting the competitiveness of U.S.-based companies by subjecting their cross-border operations to a heavier tax burden than that borne by their principal foreign-based competitors.
- Most important, subpart F applies too broadly to several categories of income that arise in the course of active foreign business operations, including:
  - Income from payments between active foreign affiliates;
  - Income earned by centralized sales and services companies;
  - Income earned by active businesses in the financial services and shipping sectors;
  - Incidental investment income of active businesses, such as interest on working capital; and
  - Income from the "downstream" activities of active oil businesses.

(ii) Part Two—foreign tax credit:

- The development of a global economy has confirmed the soundness and heightened the importance of the U.S. rules' core policy of avoiding international double taxation.
- In too many circumstances, however, the U.S. rules fail to achieve their purpose, leading to the double taxation of international income in many common scenarios. Flaws in the rules that lead to double taxation include:

[3] The drafters of this report are aware that it is common usage in international tax circles to refer to the normal treatment of CFC income as "deferral" of U.S. tax, and to refer to the operation of subpart F as "denying the benefit of deferral." However, given the general jurisdictional principles that underlie the operation of the U.S. rules, the drafters view that usage as somewhat inaccurate, since it could be read to imply that U.S. tax "should" have been imposed currently in some normative sense. Given that the normative rule imposes no U.S. tax on the foreign income of a foreign person, the drafters believe that subpart F can more accurately be referred to as "accelerating" a tax that would not be imposed until a later date under normal rules.

  - The 90 percent alternative minimum tax foreign tax credit limitation;
  - The structural over-allocation of interest expense against foreign-source income (exaggerating foreign effective tax rates and thus denying credits);
  - The asymmetrical treatment of foreign and domestic losses; and
  - The excessive separation of income into multiple "baskets."
- The foreign tax credit rules are unjustifiably complex, rendering them virtually inadministrable, and should be substantially simplified.

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

II. Tax Policy Considerations

A. Major Considerations Identified by Treasury

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

- Efficiency;
- Fairness;
- Competitiveness;
- Compatibility with international norms; and
- Administrability and simplicity.[4]

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

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

1. Efficiency

a. Underlying Economic Principles

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

By contrast, the principle of *competitiveness* requires that all investments made in the same country be subject to the same amount of tax, regardless of where the investor is resident. When countries impose different tax rates, cross-border investment cannot simultaneously be subject to neutral taxation (taxed at the home country rate) and competitive taxation (taxed at the host country rate).[5]

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

b. Efficiency in the Subpart F Context

The principle of capital export neutrality has tended to arise most prominently in connection with discussions of subpart F, and in particular has been cited recently by Treasury both in defense of controversial proposed rule changes[6] and more broadly in connection with its Policy Study.[7] By contrast, the implications of capital export neutrality have been less emphasized by Treasury in connection with the foreign tax credit, as Treasury has thus

[5] *See* Joint Committee on Taxation, Factors Affecting the International Competitiveness of the United States, JCS-6-91, 245 (May 30, 1991).

[6] *See, e.g.,* Notice 98-11, 1998-6 I.R.B. 13.

[7] *See* discussion in II.B.1, below.

far shown no inclination to promote the unlimited foreign tax credit that neutrality would require.

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

- The futility of attempting to achieve globally efficient capital allocation by unilateral U.S. action.
- The similar futility of attempting to advance investment neutrality by focusing solely on direct investment, particularly in light of the fact that U.S. international portfolio investment now significantly exceeds direct investment.[8]
- The fact that no country, including the United States itself, has consistently or fully adopted capital export neutrality principles in its tax law.
- Growing criticism of capital export neutrality in the economics literature.
- The anomaly presented by a tax policy that encourages the payment of higher taxes to foreign governments.

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

[8] As noted in the NFTC Subpart F Report, *supra* note 1, capital export neutrality would require imposition of a U.S. corporate level tax, on an accrual basis, on income earned by U.S. individual and institutional investors from portfolio investments in foreign corporations. This has become a far more important, though frequently overlooked, aspect of capital export neutrality because foreign portfolio investment flowing out of the United States is about twice as large as foreign direct investment.

- First, from the perspective of the tax system, insisting on higher foreign tax payments increases the amount of foreign taxes available to be credited against U.S. tax liability, and thus decreases U.S. tax collections in the long run.
- Second, from the perspective of competitiveness, it leaves U.S.-based companies in a worse position than their foreign-based competitors: U.S. companies must either pay tax at the high local rate or, if they attempt to reduce that tax they will instead trigger subpart F taxes at the U.S. rate. By contrast, foreign competitors can reduce their local taxes (for example, by way of routine transactions such as paying interest on loans from affiliates), without triggering home country taxes.[9]
- Third, there is very little empirical support for the view that U.S. investment abroad results in a corresponding reduction in investment in the United States. Indeed, there is a large body of economic research showing that the foreign employment of U.S. multinationals is complementary to their domestic employment, and that U.S. companies with the greatest foreign investment also tend to have the highest level of exports.
- Finally, the basic suggestion that tax motives are what drive U.S.-based companies into the international marketplace is seriously antiquated in the context of the global economy. Thus, subpart F's general presumption that foreign tax reduction is a cause rather than a consequence of foreign expansion is not merely out of touch with economic reality, but seriously harmful to the competitiveness of U.S.-based companies (as further discussed below).

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

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

c. Efficiency in the Foreign Tax Credit Context

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

Cross-crediting refers to the ability of a taxpayer to use credits arising from high-taxed foreign income to offset the U.S. tax that would otherwise apply to low-taxed foreign income. In connection with the enactment of the 1986 Act, Treasury believed that the dramatic lowering of the U.S. corporate tax rate would leave many U.S.-based companies with significant excess foreign tax credits (to the extent that they continued to pay foreign taxes at higher rates). Due in part to concerns that the ability to use such excess credits would encourage U.S. taxpayers to make investments in low-tax jurisdictions, Congress enacted several provisions designed to limit cross-crediting.

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

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

2. Fairness

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

a. Subpart F

In the subpart F context, there should be general agreement about two cases in which accelerated U.S. taxation is appropriate: first, where passive income is shifted into an offshore incorporated pocketbook; and second, where income is inappropriately shifted offshore through abusive transfer pricing practices. The first case is well-addressed by the extensive subpart F rules concerning foreign personal holding company (FPHC) income, while the second case is addressed by detailed transfer pricing and related penalty rules which give the IRS ample authority to curb transfer pricing abuses. Thus, little needs to be done to advance fairness in these regards.

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

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

Accordingly, we do not believe that a coherent "fairness" rationale has been advanced for the current taxation of active foreign business income. For additional analysis of these issues see the discussion in II.B.1., below.

b. The Foreign Tax Credit

Fairness is central to the very existence of a foreign tax credit. It is generally accepted that legitimate bases for a government's exercise of taxing authority include both sovereign power over the person earning the income (residence-based taxing jurisdiction), and sovereign power over the income itself (source-based taxing jurisdiction). As a result, two or more countries are often able to assert jurisdiction to tax a single item of international income. Although both such claims may be legitimate, a longstanding international consensus has sought to avoid double taxation of international income. For additional analysis of these issues, see the discussion in II.B.1., below.

The importance of preventing international double taxation is so widely accepted that it is generally taken as a given, without much analysis of why it matters. We suggest that the underlying reason for this unquestioned policy consensus is that avoiding double taxation is a matter of fundamental fairness. Certainly, efficiency and competitiveness considerations are also at work: double taxation of international commerce would likely discourage cross-border trade and investment that otherwise represented the most efficient use of capital, and a country's businesses would be ill-positioned to compete in international markets if their international income suffered endemic double taxation. Nevertheless, the NFTC Foreign Tax Credit Report shows that, as a historical matter, the 1918 enactment of the foreign tax credit was viewed as a surrender of taxing rights that was justified primarily by equitable considerations. Treasury pursued enactment of the foreign tax credit because "it touched the equitable chord of sense, and because double taxation under the heavy war rates might not only cause injustice but the actual bankruptcy of the taxpayer."[10] These equitable considerations included not only the fundamental unfairness of a confiscatory level of overall taxation, but also considerations of horizontal equity:

> …if one taxpayer is being taxed twice while the majority of men similarly situated are being taxed only once, by the same tax, something wrong or inequitable is being done which, other things being equal, the legislator should correct if he can.[11]

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

[11] *Id.,* 198.

It is also notable that the granting of the foreign tax credit was justified based on the primacy of source-based taxing jurisdiction.[12] This may be justified by the fact that the source jurisdiction provides most of the government services that enable the income to be earned, and thus constitutes a better claim to tax than the mere residence of the person earning the income, because the residence jurisdiction would ordinarily provide few, if any, services enabling its residents to earn foreign income. Thus, the United States decided that if only one tax was to be collected, it ought by rights to be the tax imposed by the source country, with the United States as the residence country limiting itself to any "residual" tax that might remain after granting a credit for the foreign tax paid.

While much in the world has changed since 1918, justice and equity have not; confiscatory levels of taxation remain fundamentally unfair, as does imposing a heavier tax burden on taxpayers with international income than on taxpayers with purely domestic income. Thus, it should be clear that preventing double taxation through the foreign tax credit continues to be consistent with, and is indeed required by, Treasury's concern for fairness in tax policy. By the same token, it is clear that the aspects of the foreign tax credit that now tend to permit double taxation in many common situations are fundamentally unfair and require reformation.[13]

c. Conclusion

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

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[12] *Id.*, 197–198.

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

3. Competitiveness

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

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

Competitiveness concerns were therefore central to the debate when subpart F was enacted in 1962, even at a time when U.S.-based companies dominated the international marketplace. In that year, 18 of the 20 largest companies in the world (ranked by sales) were headquartered in the United States, but this apparent dominance did not convince Congress that the competitive position of U.S. companies in international markets could be ignored. Thus, although the Administration originally proposed the acceleration of U.S. taxation of most foreign-affiliate income, that proposal was firmly rejected by Congress based largely on concerns about its competitive impact.[14]

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

- With the completion of the post-World War II economic recovery in Europe and Japan, and the growth of an industrial economy in many countries in Asia and elsewhere, U.S. dominance of international markets is only a memory. Of the 20 largest industrial companies, the

[14] *See* NFTC Subpart F Report, *supra* note 1, Chapter 2.

U.S.-based number has dwindled from 18 to eight. Thus, competition from foreign-based companies in international markets is far more intense today than it was in 1962.[15]

- While competition in international markets has become more intense, those markets have simultaneously become more important to the prosperity of U.S.-based companies, as foreign income has grown to be a much larger percentage of U.S. corporate earnings.
- In the nearly 40 years since subpart F was enacted, the governments of the United States' major trading partners have generally declined to follow the U.S. lead in accelerating tax on the active business income of their companies' foreign affiliates. They have certainly enacted controlled foreign corporation (CFC) tax rules that resemble subpart F, particularly as they relate to passive income, but in taxing genuine foreign business activity no other country has adopted rules with the broad sweep of subpart F, nor have other countries enacted foreign tax credit regimes as restrictive as the U.S. regime.[16] As a result, the foreign-based multinationals that are now the United States' toughest competitors have consistently enjoyed lighter home-country taxation than U.S.-based companies.
- Finally, while the competitive position of U.S.-based multinationals was steadily eroding for the above reasons, a constant expansion of subpart F and a tightening of the foreign tax credit hastened that erosion. In the decades after 1962, several major exceptions were narrowed or repealed, numerous categories of subpart F income were created or broadened, and in 1986 significant new restrictions were placed on the availability of foreign tax credits.

Although it is difficult to compare the overall impact of countries' income tax systems on the cost of cross-border investment, the data and analyses reviewed in the NFTC Subpart F and Foreign Tax Credit Reports suggest that, from a tax perspective, the United States is a relatively undesirable location for a multinational company's legal domicile. Recent trends indicate that the vast majority of cross-border mergers and acquisitions have been structured as foreign acquisitions of U.S. companies, and that the proportion of *inward* investment that is direct (rather than portfo-

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

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

lio) has increased in the 1990s, while the share of *outward* investment in direct form has decreased.[17] If these trends continue, over time we would expect to see a larger portion of U.S. and foreign economic activity carried out by companies domiciled outside the United States.

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

4. Compatibility with International Norms

As noted above, compatibility with international norms is important from a competitiveness perspective, but it bears further emphasis here that the United States' principal trading partners have consistently adopted rules that are less burdensome than the U.S. subpart F and foreign tax credit rules. We do not dispute the fact that subpart F established a model for the taxation of offshore affiliates that has been imitated to a greater or lesser degree in the CFC legislation of many countries. But looking beyond the superficial observation that other countries have also enacted CFC rules, the detailed analysis in the NFTC Subpart F Report showed that in virtually every scenario relating to the taxation of active offshore operations, the United States imposes the most burdensome regime. Looking at any given category of income, it is sometimes possible to point to one or two countries the rules of which approach the U.S. regime, but the overall trend is overwhelmingly clear: U.S.-based multinationals with active foreign business operations suffer much greater home-country tax burdens than their foreign-based competitors. A similar analysis in the NFTC Foreign Tax Credit Report showed that the regimes for the prevention of international double taxation employed by the United States' major trading partners are substantially less restrictive than the U.S. foreign tax credit rules.

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

Some commentators have suggested that the competitive imbalance created by dissimilar international tax rules should be redressed not through

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

any relaxation of the U.S. rules, but rather through a tightening of foreign tax regimes.[18] Purely as a matter of logic, the point is valid—a seesaw can be balanced either by pushing down the high end or pulling up the low end. However, the suggestion is completely impractical. Conformity and competitive balance are far more likely to be achieved through a modernization of the U.S. rules. Since the U.S. rules are out of step with the majority, from the standpoint of legislative logistics alone it would be far easier to achieve conforming legislation in the United States alone. More fundamentally, there is no particular reason to believe that numerous foreign sovereigns, having previously declined to adopt subpart F's broad taxation of active foreign businesses, or U.S.-style foreign tax credit limitation rules, will now suddenly have a change of heart and decide to follow the U.S. models.

Recent OECD initiatives relating to "harmful tax competition" do not increase the likelihood of foreign conformity with subpart F's treatment of active foreign businesses. The OECD project seeks to limit the availability and use of "tax haven" countries and regimes, but it does so in the relatively limited context of financial and other service activities that are viewed as being particularly mobile.[19] To combat the use of tax havens, the OECD has recommended that countries without CFC regimes "consider" enacting them. However, given the limited scope of the project, the OECD has not sought to address the issues that concern us here, relating to the impact of CFC rules on active foreign business operations.[20] Thus, the current work of the OECD offers little reason to expect any reduction in the discrepancy between the U.S. subpart F rules and the rules of the United States' major trading partners with respect to real foreign businesses.

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

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

[19] OECD, HARMFUL TAX COMPETITION: AN EMERGING GLOBAL ISSUE (1998).

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

5. Administrability and Simplicity

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

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

The complexity of the rules long ago reached the point that the ability of taxpayers to comply with them, and the ability of the IRS to verify compliance, were both placed in serious jeopardy. The NFTC believes that administrability concerns alone would be a sufficient reason to undertake the modernization of subpart F and the foreign tax credit, even in the absence of competitiveness and other concerns. In particular, the drafters of the Code and regulations would do well to focus not only on the legal operation of the rules, but also their practical implementation in terms of record keeping requirements, computational complexity and number and complexity of tax forms. In addition, we urge that fuller consideration be given to the interaction of multiple complex regimes. For example, it may be possible to read section 904(d) and its implementing regulations and conclude that the provision is understandable, and it may likewise be possible to read section 954 and its implementing regulations and conclude that that provision is also understandable, but when the two sets of rules must be read and implemented together, we submit that the limits of normal human understanding are rapidly exceeded.

B. Other Tax Policy Considerations

1. The Policy Study

In December 2000, the Treasury Department released a policy study, *The Deferral of Income Earned Through U.S. Controlled Foreign Corporations* (the "Policy Study").[21] The Policy Study addresses many of the same factors considered in the NFTC Subpart F Report, with a particular emphasis on

[21] *See* Policy Study, *supra* note 4.

capital export neutrality, but arrives at some markedly different conclusions. Based on the analysis that follows, however, the NFTC believes that the Policy Study fails to address, or addresses only superficially, some of the principal considerations supporting the conclusions in the NFTC Subpart F Report. As a result, the NFTC does not believe that the Policy Study makes a persuasive case for a number of its conclusions.

a. The Issue as Defined by the Policy Study

The Policy Study begins with the view that "deferral"[22] is problematic based on the interaction of the following core U.S. tax principles:

- As a basic jurisdictional matter, the United States does not tax the foreign income of foreign persons (including foreign corporations);
- The U.S. tax system recognizes a corporation as a separate taxpayer;[23] and
- It is the policy of the United States to tax U.S. persons on their worldwide income.

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

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

[22] As discussed in the NFTC Subpart F Report (see *supra* note 3), the term "deferral" itself inaccurately suggests that the current system somehow departs from normative rules that would otherwise apply; as explained above, the absence of current U.S. tax on the foreign income of a foreign corporation in fact reflects the normative limits of U.S. taxing jurisdiction, and it is the acceleration of U.S. tax through such mechanisms as subpart F that represents the departure. We nevertheless defer to Treasury's use of the term for purposes of this discussion.

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

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

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

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

The Policy Study argues more broadly that taxing the U.S. owners of foreign corporations only on the repatriation of profits produces an unequal tax

burden vis-à-vis owners of domestic companies; the time value of the deferral is said to result in a lower effective tax rate than that on domestic investments. As a threshold matter, the available evidence suggests that U.S. companies operating abroad bear tax at a rate at least as high as, if not higher than, purely domestic companies.[24] We respectfully suggest that the Policy Study's premise that foreign-source income is lightly taxed compared to domestic income is factually incorrect, and cannot be used to justify tightening the subpart F rules.

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

i. Fairness

The fairness argument proposes that, as a matter of equity, taxpayers should bear the same tax burden regardless of where their income-producing activities are located; based on its implicit definition of fairness as horizontal equity, the Policy Study suggests that companies "sophisticated enough" to operate abroad should not have a tax advantage over companies that operate purely domestically.

There are a number of difficulties with attempting to draw any conclusions concerning the proper scope of subpart F based on fairness, and particularly based on the truncated analysis presented in the Policy Study. As a threshold matter it is not clear that tax fairness can coherently be assessed at the level of corporations, given that the economic burdens of a tax system are ultimately borne by people, not companies. Many believe that a far more fundamental unfairness than that identified by the Policy Study is presented by the imposition of two levels of income tax on corporate earnings (once when they are earned by the corporation and again when they are distributed to shareholders).[25] While a detailed consideration of the issues relating to corporate tax integration is also beyond the scope of this report, we nevertheless suggest that it is difficult to justify major policy decisions on fairness grounds when this factor is not considered at all.

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[24] While the Policy Study, *supra* note 4, stated that U.S.-owned overseas operations are more lightly taxed than similar domestic investment, the NFTC Foreign Tax Credit Report, *supra* note 1, Chapter 6 shows that this claim is not clearly supported by the Policy Study's own statistics and is flatly contradicted by independent academic research.

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

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

Finally, we suggest that in weighing the two views of horizontal equity sketched above, it would be appropriate as a policy matter to take into account the competitiveness impact of the choice between them. Moreover, horizontal equity (however defined) is not an absolute and is frequently weighed against other important policies reflected in the Code. Thus, even if we were to accept the Policy Study's view of fairness (which for the reasons stated above we do not believe to be justified), it would still be necessary to weigh that factor against such countervailing considerations as the competitive position of U.S.-based companies.[26]

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

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

ii. Efficiency

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

While the Policy Study acknowledges that the economic literature does not "prove" that capital export neutrality best achieves global efficiency, it nevertheless concludes that "[w]hen the goal is to maximize global economic welfare, capital export neutrality is probably the best policy."[27] The Study then turns to an interesting analysis of whether certain aspects of subpart F are themselves consistent with capital export neutrality principles, given that:

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

The Policy Study thus takes an ambivalent view of the current "foreign-to-foreign related party rules" (*i.e.*, the foreign base company sales and services rules and the treatment of dividends and interest received from related persons as FPHC income under subpart F), concluding that these rules "have an uncertain effect on economic welfare," that they "have ambiguous effects on the allocation of capital" and that they "may not in every case be the most effective way to increase global and U.S. economic welfare." The application of these rules has ambiguous effects regarding the efficiency of capital allocation, according to the Policy Study, because the foreign-to-foreign related party rules of subpart F tend to raise overall tax burdens by more for investments in high-tax countries than for investments in lower-tax foreign countries.[28]

[27] Policy Study, *supra* note 4, 36.

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

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

In the absence of a clear economic policy justification for the foreign-to-foreign related party rules, the Policy Study does express a more purely revenue-based concern: if U.S. taxpayers had an unrestricted ability to reduce local taxes through foreign-to-foreign transactions (such that operations in any country could potentially be low-taxed), they would have an incentive to move capital abroad, potentially eroding the U.S. tax base. But there are several problems with this analysis. First, it would appear to be inconsistent with Treasury's own conclusion that for the U.S. economy as a whole, tax policy has little effect on net capital flows in or out of the country.[29] Second, this objection is inconsistent with the fact that subpart F does not currently apply to most active business operations in low-taxed countries. There would appear to be no logical basis for treating low-taxed operating income differently depending on whether it arose from local tax reduction with respect to operations in a high-tax country, or instead arose from operations in a country that had a low tax rate to begin with. In other words, penalizing only those taxpayers that operate in high-tax areas (presumably for business-efficiency reasons) makes no sense. Third, eliminating the foreign-to-foreign related party rules would encourage U.S. taxpayers to reduce their foreign tax liability, ultimately reducing the amount of foreign tax credits claimed against U.S. tax liability.

c. Competitiveness and International Norms

The Policy Study devotes a chapter to the issue of competitiveness. However, the chapter consists of less than seven pages (out of the Policy Study's 213 pages) and makes no serious effort to analyze the issue. The Study offers conclusory observations to the effect that competitiveness is affected by

[29] Policy Study, *supra* note 4, 187.

many factors, not just taxation, so that analyzing the effect of tax laws on competitiveness is extremely difficult; that, in the years since 1962, roughly half of the OECD countries have enacted some form of anti-deferral rule (including some that were recently tightened); and that the United States is still in a strong competitive position generally.[30]

The NFTC does not deny that competitiveness is affected by many factors, and that assessing the issue is difficult. However, the NFTC also believes that the Policy Study's failure to address this issue on anything other than the most superficial level is its single greatest failure, and seriously undermines its credibility. Perhaps most surprising is the Policy Study's refusal to engage in any serious analysis of the similarities and differences between the U.S. and foreign anti-deferral regimes. As pointed out in the NFTC Subpart F Report, it simply is not enough to assert generally that various countries have enacted some form of anti-deferral regime. The NFTC has not suggested that subpart F should be repealed; instead, the NFTC has demonstrated that in virtually any scenario one might choose to analyze, the U.S. rules operate more harshly than the rules that apply to the United States' foreign competitors. The Policy Study ignores this entire debate by truncating its analysis at the point where it simply notes the existence of anti-deferral rules in other countries. This obviously provides no response at all to the NFTC's finding that the U.S. rules are out of step with those of the United States' trading partners, and should be reformed not by repealing them but simply by bringing them into line with the majority view, particularly as applied to active business income.

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

[30] In support of the latter point the Policy Study, *supra* note 4, cites a study that has virtually nothing to do with taxes, is designed to measure countries that are attractive for inbound investment and says nothing about the attractiveness of the United States as a headquarters for companies with outward investment. While relying on the generalizations in this inapposite study, the Policy Study dismisses the significance of real data such as the fact that the proportion of U.S. outward investment that is direct investment vs. portfolio investment has declined from 86 percent in the 1960s to 35 percent in the 1990s, at the same time as the proportion of inward investment that is direct investment has increased, and does not comment on the high proportion of cross-border mergers and acquisitions in recent years (measured by deal value) where foreigners are the acquirers and U.S. companies are the targets.

of those facts justifies the Policy Study's failure to take the issue seriously enough to address it in detail.

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

2. Relationship between Subpart F and Foreign Tax Credit Issues

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

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

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

The two-wrongs-make-a-right nature of the argument misconceives the role of deferral in the U.S. international tax system. The argument essentially views deferral as a benefit that can appropriately be set off against some unrelated detriment; this ignores the essentially normative nature of the U.S. decision to tax foreign affiliate income only on repatriation. The deferral of U.S. tax on active foreign affiliate earnings has been a fundamental jurisdictional limitation in the U.S. tax system since the inception of the income tax,

and cannot properly be viewed as a "benefit" that should be paid for by accepting foreign tax credit provisions that lead to chronic double taxation.

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

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

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

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

C. Mobility

It has been suggested that subpart F reflects a Congressional concern about the "mobility" of income that should be taken into account in assessing any potential revision of the statute. However, the mere moveability of income is not the relevant issue; after all, any income is in some sense mobile, since any income may be moved by moving the functions that earn the income. Rather, subpart F has generally targeted income mobility only as a proxy for some other underlying tax policy concern. Accordingly, we address the issue of income mobility in three relevant contexts; as it relates to passive income, as it relates to the foreign-to-foreign related party rules, and as it relates to active income that is perceived to be geographically mobile.

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

passive income from a U.S. taxpayer to a foreign affiliate, and have thus recommended no changes relating to the basic operation of the foreign personal holding company income rules of subpart F.[31]

Active Income—Foreign-to-Foreign Rules

Turning from the category of passive income, we find that income mobility also arises as an issue in the context of some categories of active income. In particular, the foreign-to-foreign related party rules also implicate income mobility, but their underlying policy concerns are completely different from the case of passive income. Here, although the rules focus on the "deflection" of income between foreign affiliates, the fact that the United States has taxing jurisdiction over neither relevant affiliate makes it clear that mere income shifting is not the concern. Rather, the principal rationale for the foreign-to-foreign related party rules is capital export neutrality. We have set forth above the basis for our conclusion that capital export neutrality is not a persuasive justification for rules that penalize the use of centralized sales and services companies or inter-affiliate debt financing.[32]

Further, we emphasize the differences in the underlying policy concerns regarding passive and active income; in the case of passive income, subpart F prevents the improper shifting of income to a foreign affiliate that did not earn it, while the foreign-to-foreign related party rules apply regardless of whether or not the relevant affiliate in fact earned the income that it reports (by carrying out the relevant functions).

Another proffered rationale for the foreign-to-foreign rules has been that they serve to "backstop" the U.S. transfer pricing regime, which generally seeks to prevent the improper shifting of income from a U.S. taxpayer to a foreign affiliate that did not earn it. However, the transfer pricing rationale is in fact meaningless in the context of the foreign-to-foreign rules, given that (i) the United States generally has no direct tax interest[33] in which of two foreign affiliates reports a particular item of income, and (ii) the foreign base company rules only apply to sales and services between a U.S. parent and a foreign affiliate if some of the income was deflected to another CFC. In other words, the base company rules never sought to police the transfer pricing of sales or services between a U.S. parent and a CFC that

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

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

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

was actually carrying out sales or services activities in its country of incorporation.[34]

Active Income—Activities Perceived to Be Mobile

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

We emphasize that the issue is not whether U.S. companies may properly shift the *business activities* themselves (*i.e.*, functions and risks) to a foreign affiliate. To suggest that the United States would have a tax policy objection to U.S. companies carrying out active business activities through their foreign affiliates would represent a radical departure from the current structure of the rules, and one for which no cogent rationale has been articulated.[35] Rather, the question is whether the mere ability to locate such business activities in a foreign affiliate promotes the shifting of income to the foreign affiliate, particularly in connection with income that is perceived to be more mobile than traditional manufacturing income, and whether subpart F should thus be amended to impose current tax on such income that is perceived to be mobile.

We think that no such change to subpart F would be justified, for several reasons. First, it would be a solution in search of a problem; as discussed above in connection with the base company rules, transfer pricing as a discipline has matured, both in the United States and around the world, to the point that abusive transfer pricing practices are a risk that companies cannot afford to take.[36]

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

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

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

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

Indeed, an overreaction to the perceived fiscal dangers posed by electronic commerce would aptly illustrate the third and most practical problem that would face any attempt to accelerate U.S. taxation based on the perceived mobility of certain types of income earned by CFCs: that is the problem of setting and applying the standards by which income will be deemed to be "too mobile" and therefore subject to current U.S. tax. It is far from clear in the first place what standards would be applied in determining that some types of income are too mobile while other types of income are not. Second, even if such standards could be articulated, who will do the fact finding to make sure the standards are fairly applied across industry lines? It would seem an odd task for Congress to assign itself, or even to delegate to Treasury, since this type of line-drawing would seem to call for a detailed understanding of the ever-changing operations of many different industries. Yet accelerating U.S. taxation of certain categories of CFC income based on anything less would amount to taxing on the basis of reputation or opinion rather than fact.

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

conceptual or policy issues relating to income mobility not present in other industries.[37]

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

D. Conclusion as to Policy Considerations

The NFTC believes that the tax policy criteria of competitiveness, administrability, fairness and international conformity all support a significant modernization of subpart F and the foreign tax credit at this time. Further, even if Congress and the Administration are persuaded to give continued weight to the policy of capital export neutrality as a general matter (which we do not believe to be justified), it must be recognized that important aspects of current law, such as the foreign-to-foreign related party rules of subpart F, cannot be justified on the basis of that policy. Moreover, even if continued weight is given to capital export neutrality, the countervailing considerations identified in the NFTC's Foreign Income Project are sufficiently powerful to justify the reforms advocated below, which would do little more than restore the type of policy balance that Congress sought to achieve in 1962, and that has gone seriously awry in the intervening decades.

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