The NFTC Foreign Income Project:

International Tax Policy
for the
21st Century

Part One

A Reconsideration of Subpart F

Chapter 1

A Reconsideration of Subpart F

I. Introduction

When the economic history of the 1990s is written, the accelerating trend towards the globalization of business enterprises will figure prominently. Manufacturing, service, natural resource, and even utility companies compete in markets and locate production in jurisdictions other than that in which their public parent is chartered with far greater frequency today than even 10 years ago, let alone nearly 40 years ago when subpart F was first enacted.

One of the starkest aspects of the globalization of business is the decreasing prominence of U.S.-based companies. By way of illustration one could point to a British oil company reassembling pieces of the former U.S. Standard Oil trust and a German automotive company buying one of Detroit's "big three." Statistically, the period between the 1960s and the mid-1990s has seen U.S. companies' share of cross-border direct investment drop from over half to less than a quarter, and the number of the 20 largest corporations that are headquartered in the United States drop from 18 to just eight.

The foreign competition faced by U.S.-based companies has intensified as the globalization of business has accelerated. At the same time, U.S. multinationals increasingly voice their conviction that the Internal Revenue Code of 1986 (I.R.C.) 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 two parts, the first dealing with the United States' anti-deferral regime, subpart F, the second dealing with the foreign tax credit.

It is somewhat arbitrary, of course, when analyzing whether the I.R.C. creates competitive problems for U.S. multinationals operating abroad, to separate the analysis of subpart F from that of the foreign tax credit. The foreign tax credit figures prominently where companies must repatriate most of their earnings. Subpart F figures prominently where companies reinvest much of their foreign earnings abroad. Most companies must deal with some combination of the two. Likewise, the theoretical economic underpinning for one view of an anti-deferral regime also has implications for the foreign tax credit. For example, the concept of capital export neutrality, discussed in Chapter 6, which Notice 98-35[1] identifies as an important principle underlying subpart F, requires, in its most pure form, an *unlimited* foreign tax credit.

Nevertheless, for a variety of reasons, the NFTC has chosen to separate its work into the two parts described above. First, the controversy surrounding the release of Notice 98-11,[2] the regulations implementing that notice,[3] the Congressional response thereto, and the resulting release of Notice 98-35 have focused attention on certain aspects of subpart F's impact on the competitiveness of U.S. multinationals. Notice 98-35 noted that the purpose of withdrawing Notice 98-11 and the regulations issued in March "is to allow Congress an appropriate period to review the important policy issues raised by the regulations, including the continuing applicability of the policy rationale of subpart F, and, if appropriate, [to] address these issues by legislation." The Notice specifically requested comments on the policy objectives underlying subpart F and their continued vitality. The Notice specifically asks: (1) whether such objectives "include preventing undue incentives for U.S. businesses to invest in operations abroad;" (2) whether subpart F is intended as a backstop to I.R.C. § 482; (3) whether subpart F is intended "to prevent opportunities for U.S. businesses operating internationally to achieve lower rates of current taxation than their domestic counterparts;" and, (4) whether subpart F seeks to address "harmful tax competition between countries."

Second, because of the debate over Notice 98-11, as a practical matter it appears that the likelihood of continuing Congressional attention to the subpart F area may be somewhat greater than that of legislation reforming the foreign tax credit system.

[1] Notice 98-35, 1998-27 I.R.B. 35 (June 19, 1998).

[2] Notice 98-11, 1998-6 I.R.B. 18 (January 16, 1998).

[3] T.D. 8767 (March 23, 1998).

Third, even a non-technical discussion of either subpart F or the foreign tax credit can make for lengthy and difficult reading. To address both, together with their interactions, in a single paper would be more than daunting.

This part is the first phase of the NFTC's study. It is intended to provide a brief analysis of the current complexion of subpart F, its history, how it compares with the anti-deferral regimes of the United States' major trading partners, and how it affects the competitiveness of U.S. multinationals. The primary focus of this part is on certain types of active business income (or income derived from active business income) that are included in the subpart F regime. Because of Notice 98-11 and the subsequent pronouncements, one issue considered is the payment of dividends, interest, and royalties among related persons. More generally, the report looks at the distinction between active and passive activities and how the concept of mobile activities overlays that distinction. The concept of the base company rules as a backstop to the enforcement of transfer pricing rules is also one of the themes, as are the unique "investment in U.S. property" rules of I.R.C. § 956. The report is not intended to analyze these aspects of subpart F in minute detail but does focus its economic and legal review on these general issues.

Finally, this report is not designed to be an exhaustive, academic review. Its intended audience includes many persons who may not be steeped in the arcane rules and esoteric vocabulary of either international tax law or international tax economics.

Chapter 2

Historical Perspective on Subpart F

I. Introduction

Despite various suggestions in the tax literature to the contrary, the United States has never enacted an international tax regime that makes capital export neutrality its principal goal with respect to the taxation of business income.[1] Indeed, during the period 1918–1928, the formative era for U.S. tax policy regarding international business income, the United States ceded primary taxing jurisdiction over active business income to the country of source.[2] Rules were formulated to protect the ability of the United States to collect tax on U.S.-source income, and the foreign tax credit was introduced allowing U.S. income tax to be imposed whenever the foreign country where the income was sourced failed to tax the income. The dominant purpose of the U.S. international tax system put in place then—a system that still governs U.S. taxation of international income—was to eliminate the double taxation of business income earned abroad by U.S. taxpayers, which had been imposed under the taxing regime enacted at the inception of the income tax.[3]

When the foreign tax credit was first enacted in 1918, the United States taxed income earned abroad by foreign corporations only when that

[1] "Capital export neutrality" is a term used to describe the situation in which, because investors in the capital exporting country are subject to the same tax consequences with respect to similar investments, whether made domestically or abroad, tax considerations will play no part in influencing a decision to invest in another country. See Chapter 6 for a more complete discussion of this concept.

[2] *See* Michael J. Graetz & Michael O'Hear, *The Original Intent of U.S. International Taxation,* 46 DUKE L.J. 1021 (1997).

[3] *Id.* The original system had allowed only a deduction for foreign income taxes.

income was repatriated to the United States. In addition to implementing the basic policy decision to grant source countries the principal claim to the taxation of business income, this "deferral of income"[4] reflected concerns both about whether the United States had the legal power to tax income of foreign corporations (even if owned by U.S. persons) and about the practical ability of the United States to measure and collect tax on income earned abroad by a foreign corporation. Deferral of tax on active business income remained essentially unchanged for the next 44 years—until 1962. The only exception to this rule was the result of "foreign personal holding company" legislation enacted in 1937 to curb the use of foreign corporations to hold income-producing assets and to sell assets with unrealized (and untaxed) appreciation. The foreign personal holding company rules tax currently certain kinds of "passive" income of a narrow class of corporations in the hands of their owners.[5]

However, President Kennedy, in his State of the Union Address of January 11, 1961, urged a reversal of this longstanding U.S. tax policy. In a section of his address regarding the U.S. balance of payments, President Kennedy told Congress that he would "seek tax laws which do not favor investment in other industrialized nations or tax havens."[6] The change in policy proposed by President Kennedy and his reasons for the change were detailed in the President's tax message transmitted to Congress on April 20, 1961, in which the President called for the "elimination of tax deferral privileges in developed countries and 'tax haven' privileges in all countries."[7] Despite the breadth of this proposal, the legislation that eventually passed Congress as the Revenue Act of 1962 provided for much narrower constraints on deferral. Congress aimed to curb tax haven abuses rather than to end the deferral of U.S. income tax on active business income in developed countries. This historical chapter explains how the Administration's proposal for a broad anti-deferral regime was transformed into the narrower anti-abuse provisions of the Revenue Act of 1962.

[4] *See, supra,* note 3 in the Executive Summary.

[5] *See* I.R.C. §§ 552 and 553.

[6] The State of the Union Address of the President of the United States, January 11, 1962, *reprinted in* H.R. DOC. NO. 87-251, at 12 (1962).

[7] Message of the President's Tax Recommendations, April 20, 1961, *reprinted in* H.R. DOC. NO. 87-140, at 6 (1961).

II. The Situation before 1962

During the Depression, Congress had revised the U.S. international tax provisions to raise revenue, principally by tightening limitations on the foreign tax credit. However, during the period following the end of World War II, until the 1962 legislation, U.S. tax policy had been hospitable to foreign investment. In 1954, for example, both the foreign tax credit limitation and the ability to use foreign losses had been liberalized. In 1958, a carryover of foreign tax credits was added to the I.R.C. In 1960, the foreign tax credit limitation was again liberalized.

When Congress had examined the deferral of U.S. income tax on foreign-source income before 1961, the question had not been whether to eliminate or curb deferral, but whether to extend it. In 1959, for example, the Ways and Means Committee held detailed hearings on the Foreign Investment Incentive Act, introduced by Representative Hale Boggs (and eponymously termed the "Boggs Bill"), which would have extended to domestic corporations the deferral privileges enjoyed by foreign U.S. controlled corporations.[8] Ultimately this bill died a quiet death. Nevertheless, the arguments for and against the bill provide a good starting point for analyzing the debate over subpart F that would take place in 1961 and 1962.[9]

The Boggs Bill proposed that U.S. corporations that derived 90 percent or more of their income from active business activities and from foreign sources might elect not to have their foreign income taxed until that income was distributed as a dividend.[10] The bill therefore sought to equalize the tax treatment of U.S. corporations with substantial foreign-source income and the tax treatment of controlled foreign corporations by extending the tax privileges of the latter to the former.

Beginning on July 7, 1959, the House Ways and Means Committee, chaired by Wilbur Mills, began hearings on the Boggs Bill.[11] Not surprisingly, business favored the foreign income provisions of the bill, while organized labor, particularly the AFL-CIO, opposed them.[12]

[8] H.R. 5, 86th Cong. (1959); *see Foreign Investment Incentive Act: Hearings Before the Comm. on Ways and Means,* 86th Cong. (1959).

[9] In addition to extending deferral privileges, the Boggs Bill contained a number of other measures favorable to foreign business activities: a liberalization of tax-free transfers of property to foreign corporations; a 14 percent reduction in tax rates for foreign business corporations; a provision permitting corporations to elect either an overall foreign tax credit limitation or a per-country limitation; a credit for taxes spared by foreign countries; and a provision for the non-recognition of gain on involuntarily converted property. H.R. 5, 86th Cong. § 2 (1959).

[10] *Foreign Investment Incentive Act: Hearings Before the Comm. on Ways and Means,* 86th Cong. iii–xiii (1959).

[11] *Id.*

[12] *Id* at 512 (Statement of Stanley Ruttenberg, Director of Research, AFL-CIO).

The Eisenhower Administration failed to present a unified view. Henry Kearnes, Assistant Secretary of the Department of Commerce, echoed the arguments of U.S. businesses. He contended that encouraging private investment abroad served the interests of U.S. foreign policy; noted that the bill would assist small businesses by granting them equivalent tax treatment to large businesses that were able to set up controlled foreign corporations; and emphasized that the bill would ameliorate already existing discrimination against U.S.-based exporters by extending favorable tax treatment to domestic corporations. Mr. Kearnes discounted arguments against deferral grounded in balance of payments concerns by arguing that receipts from foreign investments had been greater than capital outflows during the prior six years.[13]

In contrast to the Commerce Department's enthusiasm, both the State Department (represented at the hearings by Douglas Dillon, then Under Secretary of State) and the Treasury Department (represented mainly by David A. Lindsay, Assistant Secretary) objected to the Boggs Bill. Treasury argued that the revenue cost of the bill was too great, the balance of payments situation too precarious, and the need for investment incentives in developed countries too slight to justify extending deferral privileges. Lindsay observed: "[s]etting aside our fiscal situation, the problem of revenue, and the question of encouraging investment abroad, there is substantial merit to [the deferral provisions] of H.R. 5."[14] Lindsay suggested that a more limited bill that extended deferral privileges only to foreign-source income from less developed countries would be acceptable. The State Department's position, as expressed by Dillon, was the same as the Treasury's. Dillon stressed that "no new incentives [were] needed to encourage private investment in the more advanced countries."[15]

Significantly, neither the Treasury nor the State Department objected to the Boggs Bill on the ground that it offended capital export neutrality—that is, equalization of the tax treatment of foreign and domestic income so as to make taxpayers indifferent to the tax consequences of a decision to invest in the United States or abroad. When pressed by Hale Boggs to clarify the basis

---

[13] *Id.,* at 10-12 (Statement of Hon. Henry Kearns, Assistant Secretary of Commerce for International Affairs).

[14] *Id.,* at 36 (Statement of Hon. David A. Lindsay, Assistant to the Secretary of the Treasury). Lindsay presented a one-page report on the balance of payments issue that noted that European nations and Japan were building up a significant balance of payments surplus with the United States. *Id.,* at 69. The issue appeared to be of particular concern to Representatives Richard M. Simpson, the ranking Republican on the Committee and Noah M. Mason, the next most senior minority member of the Committee.

[15] *Id.,* at 80 (Statement of Hon. Douglas Dillon, Under Secretary of State).

for the State Department's objections to the bill, Mr. Dillon responded that his Department's stance was "primarily a question of revenue."[16]

Mr. Dillon made clear his lack of any principled opposition to deferral by remarking: "[w]hen we have deferral, the income is eventually still subject to U.S. tax. Therefore, there cannot be any feeling that there is inequitable treatment of American investment outside as against investment inside the United States."[17]

The Treasury Department also rejected the position that it would advance two years later. Lindsay acknowledged that one way to equalize the treatment of foreign and domestic corporations would be to tax foreign corporations as if they were managed and controlled domestically. However, he stated that the Treasury was "not prepared to make any such recommendation…and we may have a constitutional question in taxing foreign corporations on that basis."[18]

Chairman Wilbur Mills, expressing considerable skepticism about the bill, asked to "be sold on the idea that there is some overwhelming, compelling reason" for enacting the bill's "preferences."[19] Other representatives, such as Howard Baker and Thomas B. Curtis (both Republicans), expressed concerns about the use of tax havens by U.S. corporations.[20] When asked to comment on the tax haven situation by Representative Curtis, Assistant Secretary Lindsay replied that the Treasury preferred to work within the existing framework, but would support facilitating the taxation of foreign earnings and profits through tinkering with distribution rules.[21]

In sum, the Treasury's opposition to the bill, shared by the State Department, was grounded in concerns about revenue loss and the deteriorating balance of payments situation. This was a pragmatic rather than a principled opposition to extending deferral. Second, the Treasury regarded current taxation as a method of controlling deferral to be both unpalatable and of questionable constitutional validity. Third, Wilbur Mills and other members of the Ways and Means Committee were reluctant to extend additional tax privileges to U.S. business, and were uneasy with the increasing practice of U.S. companies using tax havens, such as Switzerland and Panama, to avoid taxation.

---

[16] *Id.*, at 82.

[17] *Id.*, at 92.

[18] *Id.*, at 61 (Statement of Hon. David A. Lindsay, Assistant to the Secretary of the Treasury).

[19] *Id.*, at 74.

[20] *See Id.*, at 22-23 (Statement of Hon. Henry Kearns, Assistant Secretary of Commerce for International Affairs); *Id.*, at 61(Statement of Hon. David A. Lindsay, Assistant to the Secretary of the Treasury).

[21] *Id.*, at 61 (Statement of Hon. David A. Lindsay, Assistant to the Secretary of the Treasury).

III. The Kennedy Administration's Proposal to End Deferral

President Kennedy's 1961 State of the Union Address, elaborated on in his tax message of April 20, 1961, prompted Congressional consideration during 1961 and 1962 of changes in the U.S. taxation of controlled foreign corporations. As indicated earlier,[22] in addressing broad balance of payments concerns, Kennedy announced in his State of the Union Address that his administration would ask Congress to reassess the tax provisions that favored investment in foreign countries over investment in the United States. The President, in his April tax message, urged five goals for revising U.S. tax policy: (1) to alleviate the U.S. balance of payments deficit; (2) to help modernize U.S. industry; (3) to stimulate growth of the economy; (4) to eliminate to the extent possible economic injustice; and (5) to maintain the level of revenues requested by President Eisenhower in his last budget.

In addition to changes in foreign income tax provisions, President Kennedy, in both his State of the Union Address and tax message, called for the introduction of an 8 percent investment tax credit on purchases of machinery and equipment to "spur our modernization, our growth and our ability to compete abroad."[23] Kennedy urged that this credit be limited to expenditures on new machinery and equipment "located in the United States."[24]

Specifically, with regard to the taxation of foreign income, the President stated that "changing conditions" made continuation of the "deferral privilege undesirable," and proposed the elimination of tax deferral in developed countries and in tax havens everywhere. The President stated:

> "To the extent that these tax havens and other tax deferral privileges result in U.S. firms investing or locating abroad largely for tax reasons, the efficient allocation of international resources is upset, the initial drain on our already adverse balance of payments is never fully compensated, and profits are retained and reinvested abroad which would other-

[22] *See* II. above.

[23] *See* H.R. REP. NO. 87-2508, at 2 (1962) (Conference Report).

[24] *See* Message of the President's Tax Recommendations (April 20, 1961), *reprinted in* H.R. DOC. NO. 87-140, at 4 (1961).

> wise be invested in the United States. Certainly since the post-war reconstruction of Europe and Japan has been completed, there are no longer foreign policy reasons for providing tax incentives for foreign investment in the economically advanced countries."[25]

The President called for three changes to U.S. international tax laws, which would be phased in over a two-year period. First, he recommended that U.S. owners of foreign firms be taxed each year on their current share of the undistributed profits realized by controlled foreign corporations in economically advanced countries. Second, the President proposed that tax deferral be continued in developing countries to attract private investment. Third, the President argued for the "elimination of the tax haven device anywhere in the world, even in the underdeveloped countries, through the elimination of tax deferral privileges for those forms of activities, such as trading, licensing, insurance, and others, that typically seek out tax haven methods of operation."[26] Though the President noted that "the rate of expansion of some American business operations may be reduced," he observed that "such reduction would be consistent with the efficient distribution of capital resources in the world, our balance of payments needs, and fairness to competing firms located in our own country."[27]

Thus, from its inception, the Kennedy Administration's foreign income tax proposals had three aims: (1) the creation of a U.S. tax regime based on a policy of capital export neutrality (except where U.S. foreign policy favored incentives to private investment); (2) the elimination of tax haven abuses; and (3) the amelioration of the U.S. balance of payments position. President Kennedy's 1961 proposals reversed Treasury's previous reluctance to endorse current taxation of foreign income and explicitly embraced capital export neutrality, due, in substantial part, to concerns with the U.S. balance of payments situation at the time. When combined with his investment tax credit proposals, however, the Kennedy Administration's recommendations were not neutral toward the location of capital. They favored investment in machinery and equipment to be used in the United States.

---

[25] *Id.*, at 6-7.

[26] *Id.*, at 7.

[27] *Id.*

IV. Consideration of the President's Proposals by the House Committee on Ways and Means

On May 3, 1961, the House Ways and Means Committee began to consider President Kennedy's tax proposals (which had not yet been reduced to legislative language or given form in an introduced bill). The Committee's membership was substantially the same as it had been two years earlier when it had considered the Boggs Bill. Wilbur Mills was still the Chairman, and Democrats still held a comfortable majority.

A. Treasury Secretary Dillon's Statement

The Committee heard first from Douglas Dillon, who had been promoted by President Kennedy from the State Department to Secretary of the Treasury. In sharp contrast to his earlier statements about deferral in the Boggs Bill hearings, Mr. Dillon's statement revealed that he now regarded promoting capital export neutrality as a key factor militating against the continuance of deferral of foreign-source income. In the portion of his testimony devoted to foreign investment income, Secretary Dillon reiterated the three justifications for the proposal to eliminate tax deferral for foreign income: fostering the efficient allocation of U.S. investment capital; eliminating tax haven abuse; and alleviating the U.S. balance of payments deficit. Essentially, Dillon did not give primacy to any one of these reasons for changing course.

When he introduced the Treasury's specific suggestions for ending deferral, Secretary Dillon framed his suggestions largely in terms of capital export neutrality: "To avoid the artificial encouragement to investment in other advanced countries as compared with investment in the United States, we propose that American corporations be fully taxed each year on their current share in the undistributed profits realized by subsidiary corporations organized in economically advanced countries."[28] Current taxation was not to be imposed immediately, but instead phased in over two years. Current taxation also would not be imposed on corporations in less developed countries unless the corporations were engaged in specified "tax haven" operations: "For this purpose a tax haven company would be defined generally as one receiving more than 20 percent of its gross profit from sources outside the country in which it is created."[29] The

[28] Staff of the House Comm. on Ways and Means, 90th Cong., 1 Legislative History of H.R. 10650, 87th Cong., The Revenue Act of 1962, at 126 (Comm. Print 1967) (Statement by Hon. Douglas Dillon, Secretary of the Treasury, Before the Committee on Ways and Means of the House of Representatives, on the President's Message on Taxation, May 3, 1961).

[29] *Id.*

importance of capital export neutrality as a motivation for the proposal emerged most clearly in Secretary Dillon's preemptive strike against those who he predicted would argue that the end of deferral would undermine the competitive position of U.S. firms operating abroad:

> "Either we tax the foreign income of U.S. companies at U.S. tax rates and credit income taxes paid abroad, thereby eliminating the tax factor in the U.S. investor's choice between domestic and foreign investment; or we permit foreign income to be taxed at the rates applicable abroad, thereby removing the impact, if any, which tax rate differences may have on the competitive position of the American investor abroad. Both types of neutrality cannot be achieved at once. 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."[30]

Secretary Dillon's most detailed defense of these proposals was in terms of alleviating the U.S. balance of payments deficit. He admitted that it was difficult to estimate the extent to which tax deferral contributed to that deficit, but concluded that deferral was a significant contributing factor. Its elimination, he calculated, would improve the U.S. balance of payments deficit by $390 million per year.[31] Dillon argued that although deferral of income earned abroad tended to increase the growth of U.S. capital returns from foreign investments—eventually resulting in the repatriation of higher dividends—the time frame in which this occurred was too long and adversely affected the short and medium-term balance of payments situation.

Secretary Dillon's statement also attempted to respond to the main counter-arguments he expected the proposal would confront. He anticipated the argument that the measures would hurt—rather than help—the U.S. balance of payments by observing that the finance ministers of the European Common Market unanimously believed that the United States would be justified in ending deferral to relieve its balance of payments situation. Some individuals, who later testified against the proposals, ridiculed this argument, contending that these ministers would, of course, support such a U.S. position because it would severely hinder the competitive position of U.S. firms.

---

[30] *Id.*, at 170.

[31] *Id.*, at 169.

Secretary Dillon also attempted to counter the argument that it would be unfair to change the rules on which U.S. firms had relied while making prior investment decisions, asserting that since the need to stimulate investment in advanced countries no longer existed, there could be no proper claim that preferential treatment should be continued to perpetuate a private gain.[32] Moreover, the change would not hurt companies operating abroad, Dillon asserted, because changing "the timing of income tax liability will not normally turn a profit into a loss. At most, it may slow the growth of companies abroad by making the financing of growth somewhat more expensive."[33] This reasoning also prompted derision from those who presented opposing statements to the Committee, who argued that any hindrance to the competitive position of U.S. firms placed the United States at a disadvantage in the cut-throat world of foreign trade.

B. The Reaction from Industry and Business Interests

Trade and business interests reacted swiftly and negatively to the Kennedy foreign income proposals. In Ways and Means Committee hearings in June 1961, statement after statement from business organizations and by representatives of prominent corporations attacked the Administration's proposals. Many of the United States' most significant firms and organizations, including the NFTC, the United States Chamber of Commerce, the National Association of Manufacturers, Proctor and Gamble, Boroughs Corp., and Abbott Laboratories, presented oral or written statements. These witnesses strongly defended deferral as a legitimate and non-abusive practice, repeatedly stating that they did not condone the abusive avoidance of U.S. tax. To abolish deferral, they argued, would erode the competitive position of U.S. firms operating abroad.

Neil McElroy, Chairman of Proctor and Gamble, for example, pointed out that his firm's main competitor, Unilever, was owned and based abroad (in the United Kingdom and the Netherlands) and was able to enjoy the substantial advantages of the deferral that those nations granted. He stated that "[w]e could not compete if our net cost of doing business is much greater than theirs. The result of an imposition of the U.S. tax rate on our oversea [sic] corporate earnings would be that it, and other competitive companies similarly situated, would be in an excessively competitive position." He added that "such advantages to foreign competitors could not help

[32] *Id.*

[33] *Id.*, at 170.

but impair our ability to compete in the world market."[34] Mr. McElroy defended Proctor and Gamble's use of Swiss subsidiaries as motivated not only by tax considerations but also by the geographical convenience to European markets and the excellent business infrastructure and climate in that alpine federation.[35]

Opponents of the Administration's proposals also contended that growth of U.S. investments abroad would ameliorate the nation's balance of payments position through the eventual remittance of increased dividends back to the United States. Many statements attacked the Treasury's analysis of the balance of payments problem, echoing arguments made in earlier hearings on the Boggs Bill that increasing foreign investment would eventually ameliorate the balance of payments situation as income earned abroad was repatriated. These witnesses also argued that the current U.S. balance of payments situation did not justify a wholesale reversal of U.S. tax policy with regard to foreign-source income.[36]

The arguments on behalf of U.S. businesses advanced a view of the proper standard of taxpayer equity in fundamental conflict with the Kennedy Administration's conception. The opponents of the Kennedy proposals considered the proper measure of tax equity to be whether firms conducting business in the same jurisdiction were subject to the same rate of tax (capital import neutrality), not whether firms with the same nationality were taxed at the same rate (capital export neutrality). The repetition of similar arguments by firm after firm, organization after organization, made it abundantly clear to the members of the Committee that important U.S. businesses with significant financial interests abroad strenuously opposed the attempt to abolish deferral.

C. Testimony from Labor and Academics

The only support that the Kennedy proposals received during the Ways and Means Committee hearings was from organized labor. As Stanley Ruttenberg, Director of Research for the AFL-CIO made clear, his organization supported the Administration's proposals because deferral "distorted U.S. investment

[34] *Hearings on H.R. 10650 Before the Comm. on Ways and Means on the Tax Recommendations of the President Contained in His Message Transmitted to the Congress, April 20, 1961,* 87th Cong. 2921, 2926–27 (1961) (Statement of Hon. Neil McElroy).

[35] *Id.*, at 2425.

[36] *See, e.g., Hearings on H.R. 10650 Before the Comm. on Ways and Means on the Tax Recommendations of the President Contained in His Message Transmitted to the Congress, April 20, 1961,* 87th Cong. 2727, 2728–29 (1961) (Statement of Warren S. Adams II).

decisions."[37] The AFL-CIO believed that deferral encouraged the export of capital and jobs that otherwise would remain in the United States. Organized labor, however, felt most strongly about the use of tax havens, calling for their elimination in both industrialized and less developed nations. Ruttenberg reserved his most graphic language for urging the abolition of the use of tax havens, calling them a "legal monstrosity."[38]

The proposal to eliminate deferral received a lukewarm reception among the academics who presented their views to the Ways and Means Committee. Professor Albert Anthoine of Columbia Law School flatly opposed the Administration's proposals. Dan Throop Smith, of Harvard Business School, remarked to the committee that "though there seems to be need for some change, the specific proposals appear to go too far."[39] Roy Blough of Columbia University argued that although the Treasury had identified areas for concern, significantly more research was needed before the Administration's proposals should be enacted.

D. Executive Sessions of the House Committee on Ways and Means

Following its public hearings, the Committee on Ways and Means considered the Administration's proposals in executive sessions closed to the public. The fierce opposition to ending all deferral that had become clear in the public hearings had swayed the Committee, and by July 1961, the Treasury had retreated from its insistence on a general anti-deferral regime. Treasury then offered a more modest proposal that aimed to address only the use of tax havens. Treasury's new position marked its abandonment of a policy of capital export neutrality in U.S. international tax law and also was the beginning of the transformation of the Kennedy proposals into "anti-abuse" provisions.

On July 20, 1961, the Treasury presented a substantially scaled back proposal, which incorporated some suggestions of Committee members in light of the testimony they had heard. This Treasury proposal suggested taxing currently the income of controlled foreign corporations from certain kinds of income, including income from purchases and sales between related persons, commissions, licensing, holding company income, service income,

---

[37] *Hearings on H.R. 10650 before the Comm. on Ways and Means on the Tax Recommendations of the President Contained in his Message Transmitted to the Congress, April 20, 1961,* 87th Cong. 2595, 2597 (1961) (Statement of Stanley H. Ruttenberg, Director of Research, AFL-CIO).

[38] *Id.,* at 2598.

[39] *Hearings on H.R. 10650 before the Comm. On Ways and Means on the Tax Recommendations of the President Contained in his Message Transmitted to the Congress, April 20, 1961,* 87th Cong. 807, 807 (1961) (Statement of Dan Throop Smith, Graduate School of Business, Harvard University).

and the insurance of U.S. risks abroad. Current taxation would be imposed if the income arose from transactions with related parties outside the country in which the controlled corporation was organized, where five or fewer U.S. shareholders owned more than 50 percent of the stock of the foreign corporation, but only to those shareholders that owned 10 percent or more of the stock of the corporation.[40]

From the summer of 1961 through early 1962, the Treasury Department and the Ways and Means Committee worked to agree on a concrete legislative approach to restrict deferral. By March 1962, the Ways and Means Committee had prepared legislation and reported it to the House.[41] The Committee explicitly announced that the legislation did not go as far as the President's initial proposal. Instead, the Committee's March 1962 proposal had four objectives: (1) to prevent U.S. taxpayers from taking advantage of foreign tax systems to avoid taxation by the United States "on what could ordinarily be expected to be U.S. income;"[42] (2) to reach income retained abroad that was not used in the taxpayer's trade or business and not invested in an under-developed nation; (3) to prevent the repatriation of income to the United States in such ways that it would not be subject to U.S. taxation; and (4) to prevent taxpayers from using foreign tax systems to "siphon off sales profits from goods manufactured by related parties either in the United States or abroad."[43] Specifically, the legislation proposed taxation of income from the insurance abroad of U.S. risks; income from patents, copyrights, and exclusive processes developed in the United States and transferred to foreign subsidiaries; and dividends, rents, royalties, and income from sales of goods for use outside the country where the controlled subsidiary was organized. In addition to containing provisions directed at tax havens, the bill also limited deferral in developed countries by taxing currently foreign-source business income unless that income was reinvested in the same trade or business or in a less developed country.

The reasons enunciated by the Ways and Means Committee for the changes it proposed reflected continuity with—not a departure from—long-standing U.S. international tax policies. In particular, the Committee voiced concerns with protecting the U.S. tax base on U.S.-source income and limiting deferral to active foreign-source business income. The major shift,

[40] Staff of the Joint Comm. on Internal Revenue Taxation, 87th Cong., 1st Sess., General Explanation of Comm. Discussion Draft of Revenue Bill of 1961, at 5, 51-54 (Comm. Print 1961).

[41] H.R. 10650, 87th Cong. (1962).

[42] H.R. Rep. No. 87-1447, at 58 (1962) (Revenue Act of 1962, Report of the Committee on Ways and Means).

[43] *Id.*

recommended by the Kennedy Administration, to a general policy of capital export neutrality had been rejected.

The legislation adopted by the Ways and Means Committee also contained an investment tax credit along the lines proposed by President Kennedy, a substantial incentive for new investment in the United States. The Committee's legislation allowed an investment tax credit equal to 8 percent of the cost of investment in new plant and equipment used in the United States.[44]

On March 28, 1962, the House of Representatives passed the Revenue Act of 1962, including the foreign income provisions, substantially as they had been reported by the Committee on Ways and Means, and an investment tax credit, although the credit amount was reduced from 8 to 7 percent.[45] The burden of shaping the foreign income proposals then moved to the Senate.

V. "Tax Haven" Legislation in the Senate

A. Senate Finance Committee Hearings

From April 2, 1962 to July 3, 1962, the Senate Finance Committee held hearings on the 1962 Revenue Act. Many of those who had presented their views to the Committee on Ways and Means repeated them before the Senate. The debate over the policy implications of the foreign income proposals was not significantly advanced.

Opponents attacked the House bill, emphasizing that it would erode the competitive position of U.S. businesses operating abroad. They also complained about the complexity of the foreign income provisions, the inconsistency of the proposals with other legislation intended to foster foreign trade, and the discretion that the requirement that earnings be reinvested in the same trade or business would grant to the Treasury.

The Treasury, for its part, presented the Finance Committee with two contradictory options for taxing foreign income, both of which differed from the House's approach. Although, Secretary Dillon stated that the House bill was effective in addressing the use of tax havens to divert income earned in one foreign jurisdiction to another foreign country, he renewed the Kennedy Administration's call for a policy of capital

[44] *See* Staff of the Joint Comm. On Internal Revenue Taxation, 87th Cong., 1st Sess., General Explanation of Comm. Discussion Draft of Revenue Bill of 1961, at 7 (Comm. Print 1961).

[45] *See* H.R. 10650, 87th Cong. § 2 (1962).

export neutrality, urging elimination of deferral for foreign income in all developed countries and in tax haven jurisdictions, whether or not in developed countries. Secretary Dillon stated:

> "The privilege of deferring U.S. taxes until income is repatriated as dividends should simply be eliminated for our subsidiaries in advanced industrial countries… The deferral privilege should be retained, for income earned in less-developed countries, in line with our general foreign policy objectives."[46]

Some policymakers in the Treasury had held out hope when the Department initially retracted from urging the elimination of deferral in general in July 1961, that the Senate Finance Committee might prove more receptive to the idea of capital export neutrality.

Secretary Dillon's primary objection to the deferral left in place under the House bill was that it provided a tax incentive to invest abroad. He said a "drain is imposed on our already adverse balance of payments and the reduced domestic investment limits employment opportunities and retards our economic growth."[47] Dillon contended that each dollar invested abroad in developed countries provided only a comparatively small impetus to U.S. employment. On the other hand, he claimed that each dollar invested abroad had a relatively large effect on the U.S. balance of payments position. He said the effects of eliminating deferral would be twofold: it would create smaller net capital outflows and would eliminate the "tax inducement" to leave earnings abroad, thus presumably encouraging capital invested abroad for tax-related reasons to return to the United States.[48]

Treasury, however, also offered a second option, urging elimination of deferral only for tax havens and not for any manufacturing operations abroad. One member of the Treasury staff, who worked on the legislation, said the Treasury placed this narrower option before the Finance Committee because it was concerned that the Senators might accept taxpayer arguments that even the House bill was too harsh.[49]

[46] 1 *Revenue Act of 1962: Hearings Before the Senate Comm. on Finance,* 87th Cong. at 89 (1962) (Statement by Hon. Douglas Dillon, Secretary of the Treasury).

[47] *Id.,* at 99.

[48] *Id.,* at 101.

[49] *See* Stanford G. Ross, *Report on the United States Jurisdiction to Tax Foreign Income,* 49b STUD. ON INT'L FISCAL L. 184, 212 (1964).

Secretary Dillon described the problem of tax havens as follows: low tax rates in certain jurisdictions, combined with the U.S. policy of not taxing currently retained earnings from foreign subsidiaries, invited the use of foreign subsidiaries to channel profits from overseas operations to tax haven corporations, which were subject to tax rates significantly lower than U.S. rates. He singled out corporations acting as middlemen in largely "paper transactions."[50] Dillon regarded these tax haven activities as "a most serious breach in our principle of tax neutrality."[51]

Dillon claimed that the problem of tax havens "is growing in quantitative terms by leaps and bounds every year. We are dealing here with a tax differential on retained income, not of 5 or 10 percentage points, but of 40 or 50 percentage points."[52] In answering a question by Senator Frank Carlson of Kansas, Secretary Dillon emphasized his discomfort with the increased use of tax havens by U.S. corporations operating abroad. Dillon noted that "the abuse of these foreign tax havens . . . has become a scandalous thing. It is not that everyone who uses them should be stigmatized that way, but they have been very seriously abused, and that is the second major reason they should be prohibited."[53] Secretary Dillon suggested only one change to the bill as it affected tax havens: that the exemption for tax haven profits invested in less developed countries be restricted to earnings generated in less developed countries, so as to avoid presenting an "artificial stimulus to investment in advanced industrial countries."[54]

The Secretary summed up his recommendations in the area of deferral as follows: "Tax fairness, revenue requirements, and our balance of payments position all demand that the tax deferral privilege now enjoyed by controlled foreign corporations in industrialized countries should be eliminated."[55] But Dillon's response to a question by Senator Carlson about whether the "ultimate effect of these provisions would be to reduce the revenues to the United States rather than increase it" made it clear that the Treasury regarded capital export neutrality and balance of payments concerns as paramount. Dillon answered as follows:

---

[50] 1 *Revenue Act of 1962: Hearings Before the Senate Comm. on Finance,* 87th Cong. at 98 (1962) (Statement by Hon. Douglas Dillon, Secretary of the Treasury).

[51] *Id.*

[52] *Id.,* at 99.

[53] *Id.,* at 449.

[54] *Id.,* at 103.

[55] *Id.,* at 106.

> "I do not think they would reduce the revenue. I do not think we would get all the revenue back that might be expected on a gross basis, and our figures or our estimates take that into account.
>
> "That is why we have estimated a relatively low figure of income for the tax haven provisions, because one of the things that this may do is simply make tax havens less attractive in Europe. Companies may operate more normally in the country in which they are manufacturing, in which their manufacturing concern is located, and pay taxes there, so we will not get the actual tax.
>
> "But the tax inducement to go abroad and to make new investments because of these very low taxes will be removed, and we will gain in our balance of payments from this."[56]

B. Senate Finance Committee Action

The Senate Finance Committee ultimately adopted the general approach of the House bill, but further diluted the anti-deferral measures. The Senate eliminated the "same trade or business" requirements of the House legislation and also added two "safety valves" or relief provisions. First, the bill exempted U.S. shareholders from current taxation if their foreign corporations paid substantial current dividend distributions (as specified by a minimum distribution schedule) or otherwise paid high foreign taxes. Second, the bill permitted deferral in cases of specifically sanctioned export trade where the government was actively seeking to promote and expand U.S. exports.

The foreign income provisions of the legislation provoked considerable disagreement among the Senators on the Finance Committee. Senators Paul Douglas, Albert Gore, Sr., Frank Carlson, Wallace Bennett, John M. Butler, Carl Curtis, Thurston Morton, and Eugene McCarthy all attached additional or dissenting views to the Finance Committee's Report on the legislation.[57] Unsurprisingly, they did not agree about how or why the legislative approach of the Committee was defective. For Senator McCarthy, the bill was too far-reaching and its effects were too uncertain. Acknowledging the existence of tax haven abuses, he argued that "[w]e should not throw the baby out with the bath water but should reconsider the means by which we undertake to

---

[56] *Id.*, at 449.

[57] *See* S. Rep. No. 87-1881 (1962).

correct abuses."[58] Senators Carlson, Bennett, Butler, Curtis, and Morton argued that none of the objectives that the Kennedy Administration had advanced for the legislation had stood up in the hearings, that the tax provisions were of dubious constitutionality, too complex, and would have unintended adverse economic effects. Consequently, they argued that action on the legislation should be postponed.

Significantly, these Senators also expressed concern about ambiguity as to what constituted the tax haven abuse to be curbed by the legislation. In the Senate hearings, pressed by Senator Curtis, Secretary Dillon had defined a tax haven transaction as "one where a company incorporated in country A purchases from country B and resells in country C." Senator Curtis asked if "all such operations . . . [were] tax haven transactions?" Dillon responded that "[n]ot all such operations are necessarily tax haven transactions, and that is the specific reason why I requested . . . that the Secretary of the Treasury be given authority to exempt specific transactions, specific operations that are not entered into for the purpose of tax avoidance."[59]

Not all the Senators felt that the bill as referred by the Finance Committee was too far-reaching. Senators Douglas and Gore, Sr. complained that too little had been done to curb the tax subsidy for moving U.S. capital abroad and then advocated replacement of the House and Senate anti-deferral provisions by "the complete removal of the deferral privilege."[60]

VI. Final Passage of the Revenue Act of 1962

Despite the reservations of some members of the Committee, the Finance Committee's revisions were sent to the Senate floor where they passed and were forwarded to a conference committee. In conference, the House acceded to the Senate's changes, and the foreign income provisions, as modified by the Senate, were passed by Congress in the first days of October 1962. The 7 percent credit and the geographical restrictions of eligibility to U.S.

[58] S. REP. NO. 87-1881 at 351, 354 (1962) (Additional Views of Sen. Eugene J. McCarthy on H.R. 10650).

[59] S. REP. NO. 87-1881 AT 357, 373-75 (1962) (Dissenting Views of Senators Frank Carlson, Wallace F. Bennett, John Marshall Butler, Carl T. Curtis, and Thurston B. Morton on Sec. 11—Foreign Source Income, H.R. 10650 as Amended by Senate Finance Committee) (quoting 10 *Revenue Act of 1962: Hearings Before the Senate Comm. on Finance,* 87th Cong., 2d Sess., on H.R. 10650 at 4309-4310 (1962)).

[60] S. REP. NO. 87-1881 AT 389, 424 (1962) (Supplemental and Minority Views of Senators Paul Douglas and Albert Gore).

property were retained by the Senate and conference committee, and were enacted into law in the final version of the bill.[61]

VII. "Tax Havens" and the Definition of Abuse

It is clear that neither the House nor the Senate embraced the Kennedy Administration's call to shift U.S. international tax law to a policy of capital export neutrality. Instead, the 1962 legislation, as ultimately enacted, was targeted at eliminating certain "abuses" permitted under prior law. The historical record, however, is far from clear about exactly what the "abuses" were that Congress intended to curb.

The abuses that the Revenue Act of 1962 sought to rectify changed substantially as the legislation made its way through the legislative process. Under President Kennedy's original proposal contained in his tax message of April 1961, and urged throughout the Congressional process by Treasury Secretary Dillon, any deferral of U.S. taxation constituted an abuse. An exception to current taxation would have been provided for (and limited to) investments in less developed countries, but this exception was explicitly grounded in foreign policy, not tax policy, considerations.

Treasury's proposal of July 20, 1961, implicitly treated as abusive the deferral of tax on income from transactions between a foreign corporation and a related party outside the country in which the foreign corporation was organized.[62] In the legislation sent to the House by the Committee on Ways and Means and adopted by the House, the abuse appeared to be the avoidance of "taxation by the United States on what could ordinarily be expected to be U.S. source income."[63] As stated above, this concern was consistent with U.S. tax policy dating back to the formative period of 1918–1928, and can be viewed, not as a change in policy, but rather as an application of longstanding policies to new circumstances.

In the Senate Finance Committee hearings, Secretary Dillon singled out as abusive the use of foreign corporations that market their goods or services in third countries with the subjective intent of "reducing taxes."[64] It is clear, however, that Congress did not intend to reverse the policy of generally

---

[61] *See* H.R. Rep. 87-2508 (1962) (Conference Report).

[62] Staff of the Joint Comm. on Internal Revenue Taxation, 87th Cong., General Explanation of Comm. Discussion Draft of Revenue Bill of 1961, at 5 (Comm. Print 1961).

[63] H.R. Rep. No. 87-1447, at 58 (1962) (Committee on Ways and Means, Revenue Act of 1962).

[64] *Id.*

permitting deferral of active business income earned abroad. Ultimately, no clear Congressional understanding of exactly what constituted an abuse can be determined from the history of the 1962 Revenue Act. Indeed, the Act left determinations of abuse—at least to some extent—up to the Treasury on a case-by-case basis.

The lack of clarity in the historical record of the 1962 Act about what constituted an abuse of tax deferral in international transactions has resulted in ongoing debates about the proper scope of subpart F that continue to this day. As subsequent chapters show, legislation since 1962 has changed the rules for when current taxation is required, but has not resolved the basic debate that raged in 1962. Moreover, interpretations of the 1962 Act subsequent to its enactment have sometimes described as abusive any transaction where a foreign government imposes lower tax than would be imposed by the United States on the same transaction or income.[65] This cannot be right. In 1962, Congress clearly rejected making capital export neutrality the linchpin of U.S. international tax policy. Attempting to force a strained interpretation of the legislation it did enact into an endorsement of capital export neutrality by defining anything that departs from capital export neutrality as an abuse flagrantly disregards the historical record.

VIII. Conclusions

The anti-abuse approach adopted by Congress in 1962 has often been described as a political compromise, one that sought to achieve a balance between inconsistent goals. On the one hand, Congress clearly concluded that ensuring the competitiveness of U.S.-based companies required the retention of deferral for most active business operations; thus, a company's tax-influenced decision to move "bricks and mortar" activities into a low-tax jurisdiction, although a clear violation of strict capital export neutrality principles, remained well outside the scope of the statute, because Congress decided that U.S.-based companies needed to be able to compete in world markets by engaging in such activities on the same terms as their foreign competitors. On the other hand, concerns about the protection of the U.S. tax base moved Congress to end deferral for certain categories of income that were deemed to be most susceptible of being moved out of the United States for tax reasons.

Although the historical record does not support the conclusion that this anti-abuse notion was grounded in capital export neutrality, proponents

---

[65] *See* Stanford G. Ross, *Report on the United States Jurisdiction to Tax Foreign Income,* 49b STUD. ON INT'L FISCAL L. 184, 212 (1964).

of that principle have steadily argued that it was. Thus, subpart F has often been described as a "balancing" between competitiveness and capital export neutrality concerns. While the history contains no evidence of such a balancing by Congress, the concept of such a balance may nevertheless be a useful analytical tool, not least because Treasury has recently described subpart F as requiring a balance among rival goals that include competitiveness, capital export neutrality, and fairness. Accordingly, the remainder of this part of the NFTC Foreign Income Project will examine the ways in which the policy balances within subpart F have shifted over time, and compare those shifts with comparable policies in other countries and with changes in the macroeconomic context in which subpart F operates.

Chapter 3

Failure of U.S.-International Tax Policy to Reflect the Development of a Global Economy

I. Introduction

Since it was enacted in 1962, subpart F has been the subject of recurrent tinkering and numerous revisions, as well as a substantial overhaul in 1986. Reviewing this legislative activity makes it clear that U.S. international tax policy remained largely unchanged for nearly four decades. Legislative activity has generally focused on perceived abuses of deferral (and the foreign tax credit), while relatively little consideration has been given to the changing relationship between the U.S. economy and the rest of the world. The result has been a gradual but significant broadening of the scope of the U.S. rules that accelerate taxation of foreign income.

While the direction of U.S. tax policy in this area remained largely unchanged for years, the historical drivers of that policy have been a source of some confusion. Treasury has recently emphasized the history of subpart F, and in doing so has drawn particular attention to the capital export neutrality theory that was among the rationales initially presented by Treasury as the basis for legislative action. However, as Chapter 2 has shown, Congress adopted a compromise that balanced competitiveness with concerns about protecting the tax base (an "anti-abuse" approach that some subsequent commentators have identified with capital export neutrality). The history of subpart F since 1962 reflects a continuation of that pattern, with Congress often seeking to balance competitiveness concerns with concerns about taxpayers' ability to shift income abroad for tax reasons. However, during most of the intervening period, neither Treasury nor Congress has examined in detail changes in the global economy. Nor has Treasury or Congress assessed the impact of those changes on the balance that was struck in 1962, or sought to reevaluate the soundness of capital export neutrality as an economic theory.

Events of recent years suggest that such a fundamental reassessment is at last underway. Legislative activity in the last five years has tended toward a greater recognition of the impact of subpart F on the competitive position of U.S.-based companies. This shift in legislative focus, as well as Treasury's U.S. reevaluation of anti-deferral policy,[1] suggest that a long-overdue comparison between the policy goals of subpart F and changes in the global economy is finally being made. The NFTC applauds this development, and hopes this report will advance the process by showing that a modernization of subpart F is urgently needed. The specific changes that would accomplish such a modernization are separately addressed by the NFTC in Part III, Conclusion and Recommendations of the Foreign Income Project, but first it is necessary to recognize that the tightening of U.S. anti-deferral rules after 1962 steadily increased the tension between U.S. international tax policy and the competitive demands of a global economy, and that efforts to reduce that tension need to be reinforced and accelerated.

This chapter briefly summarizes five major types of measures that have been introduced since the enactment of subpart F in 1962:

- The addition of new categories of subpart F income;
- The narrowing of exceptions to subpart F income;
- The creation of additional anti-deferral regimes;
- Recent changes that have begun to redress the policy balance between competitiveness and anti-abuse considerations; and
- Transfer pricing developments that are relevant to subpart F.

In addition, to provide a more complete picture of the myriad changes, and how those changes have gradually increased the scope and complexity of subpart F, the Appendix to this part provides a chronological review that traces subpart F's many modifications since its 1962 enactment.

[1] *See* Policy Study, *supra* note 4 in the Executive Summary.

II. New Categories of Subpart F Income

The most significant expansions of subpart F since 1962 have been the addition of several new categories of income that were not covered by the original legislation. In general, these expansions of the scope of subpart F have applied to income from various types of active foreign business operations, and in particular have included the following:

- Shipping income was added to the categories of foreign base company income in 1975 (with an exception for amounts reinvested in shipping operations).
- Similarly, oil-related income was added as another category of base company income in 1982.
- Income from space and ocean activities was added to the foreign base company shipping category in 1986.
- Various financial transactions have been added over the years, including income from the factoring of receivables (1984), income equivalent to interest (1986), and income from notional principal contracts and stock lending transactions (1997).
- Gains from various property transactions were added to foreign personal holding company (FPHC) income in 1986. Relevant categories of property include commodities, foreign currency, non-income producing property (e.g., gems and artwork), and property that produces passive income (stock, debt, licenses, annuities, etc.).
- The category of insurance income was expanded in 1986 to include income attributable to the issuing or reinsuring of any insurance or annuity contract of unrelated persons outside of the insuring company's country of incorporation, rather than only income from the insurance or reinsurance of U.S. risks. The 1986 Act also subjected related person insurance income of offshore "captive" insurance companies to current U.S. tax under the subpart F rules, and reduced the ownership thresholds for application of the insurance rules.
- Notices 98-11 and 98-35: although not a legislative enactment, another potential expansion of the categories of subpart F income should be noted here. In January 1998, Treasury issued Notice 98-11 announcing its intention to adopt regulations that would address the use of certain "hybrid branch" arrangements that had the effect of reducing foreign taxes but did not give rise to subpart F inclusions. Regulations that would have created subpart F income with respect to such transactions were proposed in March 1998, but their withdrawal was subsequently

announced by Notice 98-35. The proposed hybrid branch rules were severely criticized on various procedural and substantive grounds, but Notice 98-35 expresses the intention to re-issue similar rules. The Notices focused renewed attention on the policy rationale underlying the current structure of subpart F, including the theory of capital export neutrality.

III. Narrowing of Subpart F Exceptions

Over the years, the narrowing of the exceptions to subpart F has had the effect of substantially expanding its scope. In particular:

- The *de minimis* exception for companies with small amounts of subpart F income has been ratcheted down from 30 percent of gross income (as originally enacted), first to 10 percent of gross income (1975), and then to the lesser of 5 percent of gross income or $1 million (1986). Thus, what was a significant exception in 1962 has become essentially irrelevant for a controlled foreign corporation (CFC) of any size.

- An exception that applied when a CFC distributed minimum dividends to its U.S. shareholders was repealed in 1975.
- An exception that applied to income reinvested in less developed countries was also repealed in 1975.
- The exceptions that had shielded banks, insurance companies, and other financial institutions from current taxation with respect to "passive" type income were repealed in 1986, subjecting U.S. financial institutions operating overseas to current U.S. taxation regardless of their level of substantive economic activity overseas.
- Also in 1986, the same country exception applicable to interest, rents, and royalties was narrowed, by making it inapplicable to the extent the payment reduced the payor's subpart F income.
- The exception from foreign base company shipping income for amounts reinvested in foreign base company shipping operations was repealed in 1986.
- The exception from foreign base company income for a CFC that was not formed or availed of to avoid tax was changed in 1986 with the introduction of an objective test requiring income to be subject to an effective foreign tax rate higher than 90 percent of the maximum corporate U.S. tax rate. This reversed the 1969 change that had adopted

the subjective test because the previous objective test was found to be insufficiently flexible to deal with issues such as government-mandated dispositions.

- The extent to which prior year deficits, or the deficits of affiliates in the same chain of ownership, could be taken into account to reduce the subpart F income of a CFC, was substantially restricted in 1986.
- The *de minimis* rule under which insurance income was exempted from the subpart F provisions if it amounted to 5 percent or less of the total premiums and other consideration received was repealed in 1986.

IV. Creation of Additional Anti-Deferral Regimes

A. Passive Foreign Investment Company Provisions

The 1986 Act added a new anti-deferral provision relating to passive foreign investment companies (PFICs). Congress sought to eliminate the economic benefit of deferral and so remove the tax advantages that U.S. shareholders in foreign investment funds had over U.S. persons investing in domestic funds. Under these rules, any U.S. person (regardless of percentage ownership or the aggregate percentage ownership of all U.S. persons) that invests in foreign corporations that have primarily passive investment activities will be subject to the broad economic equivalent of current U.S. taxation on its pro rata share of income. The PFIC provisions tax all income of a PFIC, not just its passive income earned.

Although initially directed at widely-held investment vehicles, the PFIC provisions as enacted also had a significant impact on CFCs that were already subject to subpart F provisions.

B. Tax on Excess Passive Assets (Section 956A)

In response to a Treasury proposal, Congress in 1993 added a new anti-deferral provision to the Code, subjecting accumulated active business profits of CFCs to current U.S. taxation (excess passive assets). A CFC had excess passive assets if the average amount of its passive assets at the end of each quarter of the taxable year exceeded 25 percent of the average amount of total assets held at the end of each quarter.

V. Recent Changes That Begin to Redress the Policy Balance

The changes described in the preceding paragraphs steadily widened the scope of income subject to current U.S. taxation during the 1970s, 1980s, and early 1990s. It must be acknowledged, however, that in recent years Congress has taken steps that have increasingly recognized the impact of U.S. international tax rules on the global competitiveness of U.S.-based companies. These changes have begun to restore the policy balance between competitiveness, on the one hand, and other U.S. tax policy goals on the other—a balance that had grown increasingly distorted as a result of changes in subpart F and the growth of a global economy. These steps toward a rebalancing of U.S. international tax policy goals represent a welcome development for U.S.-based companies, and the evidence presented in this report should both reinforce and accelerate that trend. Relevant changes have included the following:

- Repeal of the excess passive asset rules: three years after their enactment, the excess passive asset rules were repealed. Congress found that, contrary to their original intent, the provisions had created incentives for CFCs to acquire foreign assets that they otherwise would not have purchased, to reduce their percentage of passive assets and avoid the application of section 956A. In addition, section 956A imposed complex administrative and compliance difficulties, particularly in relation to the coordination of its provisions with the potentially overlapping application of the FPHC rules, section 956, and the PFIC provisions.

- Exception for active financial services income: Congress in 1997 provided for a one-year exception from subpart F for income derived in the conduct of a banking, financing, or similar business or derived from certain investments made by an insurance company. President Clinton vetoed this provision pursuant to the Line Item Veto Act, but it was reinstated by a subsequent decision of the Supreme Court. In 1998, the provision was modified and extended for an additional year.
- Amelioration of CFC/PFIC overlap: as noted above, the PFIC regime enacted in 1986 could overlap with the operation of the subpart F rules. Applying both sets of rules with respect to a single foreign company created significant complexities. Congress recognized the complexities created by the interaction of the two sets of rules, and in 1997 provided that a shareholder that is subject to the subpart F rules is generally not also subject to the PFIC provisions with regard to the same stock.

VI. Transfer Pricing Developments Relevant to Subpart F

This review of the historical landscape would be incomplete if it failed to consider the very significant changes that have taken place in the field of transfer pricing, given the close connection between transfer pricing concerns and several major provisions of the 1962 legislation. When subpart F was enacted, the use of improper transfer pricing to shift income into tax haven jurisdictions was a major concern of Treasury and Congress. Although contemporaneous efforts were being made to address transfer pricing concerns via regulations under section 482, significant aspects of subpart F were specifically intended to backstop transfer pricing enforcement by imposing current U.S. tax on various forms of tax haven income, thus reducing U.S. taxpayers' incentives to shift income into tax havens. In particular, this was one of the stated reasons for the rules relating to foreign base company sales and services. By limiting the benefit of maximizing sales or services profits in a tax haven, these rules were intended to relieve some of the pressure on the still-nascent transfer pricing regime's ability to police the pricing of cross-border transactions.[2]

Nearly four decades later, transfer pricing law and administration have undergone profound changes that call into serious question the continued relevance of subpart F to transfer pricing enforcement. Most conspicuously, based on legislative changes in the 1986 and 1993 tax acts, Treasury has promulgated detailed regulations that have drastically altered the transfer pricing enforcement landscape.[3] These regulations clarify many areas of substantive transfer pricing controversy, but perhaps more importantly they implement a structure of reporting and penalty rules that have had a considerable impact on taxpayer behavior. Further, although audit experience with the new rules is still limited, it is anticipated that the widespread availability of contemporaneous transfer pricing documentation will markedly enhance the Internal Revenue Service's ability to perform effective transfer pricing examinations.

Almost as important is the globalization of transfer pricing enforcement efforts; partly in response to U.S. initiatives in the area, and partly because of compliance concerns of their own, many of the United States' major trading partners have recently stepped up their own transfer pricing enforcement

[2] Transfer pricing was not, of course, the sole or even the principal rationale for these rules; they were also said to be justified by "anti-abuse" notions that related to protection of the U.S. tax base and, in the views of some, capital export neutrality.

[3] I.R.C. §§ 482 (last sentence) and 6662(e); Treas. Reg. §§ 1.482-1 through -8 and 1.6662-6.

efforts, enhancing reporting and penalty regimes and increasing audit activity. As a result, the role of the Organisation for Economic Cooperation and Development (OECD) as a forum for the development of international consensus on transfer pricing matters has attained new prominence, with the United States making notable efforts to ensure that its own transfer pricing initiatives win international acceptance via the OECD.

Accordingly, the ability of U.S. taxpayers to shift income into a sales base company by manipulating the pricing of transactions is far more circumscribed than it was when transfer pricing as a discipline was in its infancy. This basic change in the landscape, in combination with the general development of a global economy, suggests that transfer pricing considerations no longer provide much support for the base company sales and services rules. Indeed, treating international transactions through centralized sales or services companies as *per se* tax abusive ignores the current realities of both transfer pricing enforcement and the globally integrated business models demanded by the global marketplace.

Chapter 4

Other Countries' Approaches to Anti-Deferral Policy

I. Introduction

This chapter compares selected portions of the anti-deferral regimes of Canada, France, Germany, Japan, the Netherlands, and the United Kingdom with that of the United States. These countries were selected for comparison because they constitute, together with the United States, the countries with the most corporations that are among the world's largest 500 corporations. In the aggregate, these countries are home to 412 of the 500 largest corporations in the world,[1] and it is large multinational corporations from these countries that are the competition for U.S. corporations that conduct business abroad.

The comparison illustrates that, in several important areas, the U.S. controlled foreign corporation (CFC) provisions in subpart F are harsher than the rules in the foreign countries' comparable regimes.[2] The comparison is important, not because it implies that the United States should join a "race to the bottom," but because it demonstrates that the rest of the developed world has not joined the United States in a "race to the top."

---

[1] Based upon the Financial Times 500, THE FINANCIAL TIMES, January 22, 1998. The 412 figure includes a corporation with its home in both the United Kingdom and Australia and a corporation with its home in both the Netherlands and Belgium.

[2] For convenience, the anti-deferral regimes of all of the countries will be referred to as "CFC regimes." The actual names of the particular regimes vary.

U.S. government officials, have increasingly criticized suggestions that U.S. taxation of international business be relaxed. Their criticism either directly or implicitly accuses proponents of such relaxation of advocating an unwarranted reaction to "harmful tax competition" by joining a race to the bottom. The idea, of course, is that any deviation from the U.S. model indicates that the government concerned has yielded to powerful business interests and has enacted tax laws that are intended to provide *its* home-country based multinationals a competitive advantage. It is seldom, if ever, acknowledged that the less stringent rules adopted in other countries might reflect a conscious but different balance of the rival policy concerns of neutrality and competitiveness. U.S. officials seem to infer from the comparisons that what is being advocated is that the United States should adopt the *lowest* common denominator so as to provide U.S. businesses a competitive advantage. Officials contend this is a "slippery slope" since foreign governments will respond with further relaxations until each jurisdiction has reached the "bottom."

The inference is unwarranted. The CFC regimes enacted by these countries all were enacted in response to and after several years of scrutiny of the U.S. subpart F regime. They reflect a careful study of the impact of subpart F and, in every case, include some significant refinements of the U.S. rules. Each regime has been in place long enough for each respective government to study its operation and to conclude whether it is either too harsh or too liberal. While each jurisdiction has approached CFC issues somewhat differently, each has adopted a regime that, in at least some important respects, is less harsh than subpart F. The proper inference to draw from this comparison is that the United States has tried to lead and, while many have followed, none has followed quite as far as the United States has gone. A relaxation of subpart F to the *highest* common denominator among other countries' CFC regimes would help redress the competitive imbalance created by subpart F without contributing to a race to the bottom.

This comparison is not meant to imply that other countries' CFC regimes are uncomplicated and straightforward. These regimes tend to be complex and general rules tend to have many exceptions. A jurisdiction-based system (which uses a "black list"), for example, will typically provide exemptions that tend to make it more like a transaction-based system.[3]

Some of these regimes may also, in fact, be stricter than the U.S. subpart F regime in certain respects. This chapter has not exhaustively

[3] *I.e.,* a system which prevents deferral with respect to specific types of "tainted" income. See further at Chapter 4, II. A.

examined each of the CFC regimes to identify all the differences between them and subpart F. Where the aspects examined exhibit harsh features, these are described. Nevertheless, this chapter reveals in the several examples presented that the U.S. regime is almost always the harshest, sometimes by a wide margin. The examples were not selected intentionally to demonstrate this point, but because they present real issues faced by U.S. multinationals.

A. Introduction

Virtually every country seeks to avoid international double taxation, that is, the taxation of the same income by two countries. Some countries prevent double taxation by exempting foreign-source income. Others do it by providing a credit for foreign taxes imposed by the source country, applied against the domestic tax owed when the income is repatriated. Still others use a combination of exemption and credit.

When a country uses the credit system, it typically does not tax currently the income earned by CFCs. Instead, it "defers" domestic taxation of that income until the CFC repatriates its earnings to the domestic parent. This deferral of domestic taxation is considered appropriate for certain types of income, but inappropriate for other types. Each of the countries examined has enacted a regime aimed at preventing taxpayers from obtaining deferral with respect to certain types of income or income earned by certain types of CFCs. At the same time, however, each country has balanced its anti-deferral concerns with the need not to interfere with the ability of domestic taxpayers to compete in genuine business activities in international markets. Resolution of the conflict between these two policy objectives typically hinges on the definition of what constitutes genuine foreign business activity. Genuine business activity gains deferral; a lack of genuine business activity triggers the anti-deferral regime. As might be expected, the definition of genuine foreign business activity varies widely.

There are two primary ways in which countries prevent what they consider to be improper deferral of domestic taxation of foreign-source income earned by CFCs. A country may end deferral with respect to certain types of "tainted" income that it believes should not receive deferral. This transactional approach is the approach taken by the United States, Canada, and Germany. The alternative is to deem all income to be tainted when a CFC meets certain criteria (such as having a significant amount of tainted income or being located in certain jurisdictions). If the CFC does not meet the criteria for application of the regime, deferral is allowed for all of the income.

This jurisdiction-based approach is taken by France, Japan, and the United Kingdom. Both approaches provide exemptions that tend to minimize the differences between them.

Deferral is ended (and current inclusion achieved) by attributing either the tainted income or all income earned by the CFC to certain shareholders (usually those holding a minimum percentage ownership). Shareholders must include the attributed income in their own income currently. By requiring current inclusion of the income, the CFC regimes prevent deferral with respect to that income. CFC regimes that attribute only tainted income provide for exclusions that remove specific types of income from classes of income that normally are considered to be tainted. CFC regimes that attribute all income provide exemptions that remove all or certain income from attribution under the regime. Some of the major exclusions and exemptions of the various systems are discussed below.

B. Review of Other CFC Regimes

The U.S. subpart F regime applies to certain types of tainted income of a CFC. Only the tainted income of the CFC is attributed to affected shareholders. Income that is listed as a type of tainted income, wherever earned, is subject to attribution to the U.S. shareholders of a CFC unless an exception applies. One of the major exceptions under the U.S. CFC regime is a high tax kick-out exception for income subject to an effective income tax rate higher than 90 percent of the U.S. corporate tax rate (however, the high tax kick-out does not apply to foreign base company oil-related income). The U.S. rules will be discussed in more detail below at the beginning of each section discussing specific types of income.

Canada's transaction-based system is perhaps the least anti-competitive CFC regime. Generally, any income from an active business is not "tainted" and is not attributed to shareholders of a Canadian CFC. Passive income earned from unrelated persons, such as income from property and income from an investment business, is attributed to the shareholders of a Canadian CFC. Income from certain goods and services provided to related persons is attributed to Canadian shareholders when the income has a Canadian source or results in a deduction in Canada. Taxable capital gains realized on property that was used to earn tainted income are also attributed to Canadian shareholders. The Canadian rules provide an exception that deems amounts paid to a CFC by a related foreign corporation to be active business income if the amount is deductible in computing the income of the payer corporation.

Germany, like the United States and Canada, has a transaction-based system, but it is modified by jurisdiction-based exemptions. The regime only attributes certain tainted income to the shareholders of a CFC.[4] All income that is not on an enumerated list of exempt types of income is treated as tainted when the income of the CFC is not subject to income taxation at the rate of at least 30 percent. Germany has an unofficial list of the countries whose effective rate is less than 30 percent and a list of countries whose effective rate is more than 30 percent. However, the presumption that a rate is less than or more than 30 percent may be overcome by the tax authorities or the taxpayer. The income excluded by the enumerated list of types of exempt income is generally income from active business. Certain types of income that are on the exempt list are discussed below in the relevant sections.

The French CFC regime is jurisdiction-based, applying to CFCs in countries with a "privileged tax system." Generally, a foreign country is considered to have a privileged tax system when the foreign tax actually borne by the CFC is less than two-thirds of the domestic tax that would have been paid had the CFC been resident in France. A country is also considered to have a privileged tax system if it does not impose tax on foreign-source income of corporations established there. There is an unofficial list of the countries that are considered tax havens under the French CFC regime. When the CFC regime applies, all income of the CFC is attributed.

An exemption from the French CFC rules is provided when operations of the CFC do not have the primary effect of localizing profits in the CFC country. Such a primary effect will be deemed not to exist if the CFC is engaged principally in an active industrial or commercial business and the business operations of the CFC are carried on principally in the CFC country. A CFC is considered to be engaged principally in an active industrial or commercial business if more than 50 percent of the CFC's gross revenue is derived from industrial or commercial activities. To meet the requirement that operations be carried on principally in the CFC country, a CFC must derive more than 50 percent of its gross revenue from the sale of goods manufactured by the CFC in the CFC country or from the sale of goods in the CFC country or from services rendered in the CFC country.[5] If this require-

[4] When income is attributed to German shareholders, it is treated as a deemed dividend. Germany has a number of tax treaties that exclude dividends from German tax. While a number of these treaties require the CFC to be engaged in active business to obtain the benefits, some do not. In the past, German taxpayers could therefore largely escape the effects of the anti-deferral regime when the CFC was located in a country with which Germany had a treaty. This circumvention of the anti-deferral regime has been mostly curtailed by legislation, but there still are situations in which German multinationals can avoid tax through the treaty exemptions.

[5] It is irrelevant whether the parties with which business is conducted are related to the CFC.

ment is satisfied, the CFC is presumed to have a genuine economic reason for being in the country. In certain cases, the concept of CFC country may be extended to other local markets outside the borders of the CFC country.

Under the Japanese jurisdiction-based CFC provisions, if the regime applies, all of a CFC's income is attributed to 5 percent shareholders. The CFC regime attributes all of the CFC's income to the shareholders if the CFC's effective foreign tax rate is less than 25 percent. However, there is a major exemption under which no income is attributed to the CFC's shareholders if the CFC is engaged primarily in legitimate business activities. This exemption is available if all of the following requirements are satisfied:

- The CFC's main business must not be holding securities, licensing, or the leasing of vessels or aircraft (the "business criterion);
- The CFC must have a fixed place of business that is necessary for the conduct of its principal business in that country (the "substance criterion");
- The CFC must manage and control its business in the target territory as an independent operating unit (the "management and control criterion");
- If the main business of the CFC is wholesale, banking, trust, securities, insurance, shipping or air transport, more than 50 percent of its business must be conducted with unrelated parties (the "non-related party criterion"); and,
- If the main business of the CFC is any business other than one of those mentioned in the preceding subparagraph, that business must be conducted primarily in the CFC country (the "location criterion").

The requirement that the Japanese-owned CFC must manage its own business is essentially a formal one that is satisfied if the directors' and shareholders' meetings are held in the CFC country, and the books and records are maintained in that country.

The U.K. CFC regime is also jurisdiction-based and applies when a CFC is subject to a low rate of tax. A CFC is considered to be subject to a low rate of tax when the amount of tax paid to its country of residence is less than three-fourths of the amount the CFC would have paid had it been resident in the United Kingdom. There is a list of countries in which a CFC can, as a matter of extra-statutory concession,[6] be resident without

[6] The list will soon have statutory force.

being subject to the CFC regime provided it earns 90 percent of its income in the listed country. There is also a list of countries in which the CFC can, again as a matter of extra-statutory concession,[7] be resident without being subject to the CFC regime provided it earns 90 percent of its income in the country and is not entitled to a specified tax exemption or relief available in that country. If a CFC is subject to the regime, then all of its income, other than capital gains, will be attributed to certain U.K. resident companies that have an interest in the CFC. Two primary exemptions from attribution are for CFCs that are resident in countries included on one of the two exclusion lists and for CFCs engaged in exempt activities. A CFC will qualify for the activities exemption only if all of the following conditions are satisfied:

- The CFC has a business establishment in the CFC country;
- The operations of the CFC are effectively managed there;
- The main business must not consist of an investment business or dealing in goods for delivery to or from the United Kingdom or to or from a related party; and
- A CFC engaged primarily in a wholesale, distribution, or financial business must not derive 50 percent or more of its gross receipts from that business from related parties.

The operations are considered effectively managed in the CFC country if the business has sufficient employees to deal with its business. The United Kingdom also has a "motive" exemption that exempts a CFC from the regime if the existence of the CFC and the transactions in which it is engaged are not motivated primarily by tax avoidance.

Dutch law provides for a participation exemption that generally exempts from Dutch taxation all dividend income received from foreign subsidiaries. Because the Netherlands exempts dividends from a foreign subsidiary from income, there is no domestic income on which to defer tax. Therefore, there is no need for an elaborate anti-deferral regime. However, the Netherlands denies the benefit of the participation exemption to income derived from certain passive investments. A shareholding in intragroup finance subsidiaries resident outside the European Union will be treated as a passive investment that does not benefit from the participation exemption, unless the finance subsidiary qualifies as an "active" company based on certain "safe harbor" rules. A shareholding in a subsidiary will not be considered to be a passive investment if there is some kind of link between the

[7] The list will soon have statutory effect.

business of the parent and the activities of the subsidiary. The requisite link is minimal. One consideration in determining whether the ownership is a passive investment is the level of ownership. The greater the ownership, the less likely it is that the ownership will be considered passive. In the case of a holding company, there is a look-through to the companies that the holding company owns to determine whether ownership is passive. If the participation exemption does not apply, the annual increase in the value of the subsidiary is fully taxable at the level of the Dutch parent company, whether or not profits were distributed.

In the examples in III., below, the parent has 100 percent ownership in active companies or holding companies that own active companies. Thus, in all these examples, the Dutch tax system does not attribute the income of a CFC to the Dutch shareholders. Because Dutch multinational corporations are not taxed on current income of a foreign subsidiary under an anti-deferral regime or on the dividends from foreign subsidiaries when remitted, they enjoy a relative advantage over multinationals from each of the other countries compared.

II. Specific Comparison of CFC Regimes with Respect to Particular Classes of Income

A. Active Financial Services Income

The original intent of subpart F as enacted in 1962 was to repeal deferral for income that was passive in nature. The 1962 law was careful not to subject active business income to subpart F current taxation through a series of detailed carve-outs. In particular, dividends, interest, and certain gains derived in the active conduct of a banking, financing, or similar business, or derived by an insurance company on investments of unearned premiums or certain reserves were specifically excluded from current taxation if that income was earned from activities with unrelated parties. The CFC had to be predominantly engaged in a banking business with unrelated parties to ensure that any related party interest income also was active business income.

In 1986, Congress repealed the provisions that were put in place to ensure that a CFC's active business income would not be subject to current tax. Thus, from 1986 until 1998, most income earned by a CFC of a U.S. financial services company was subject to tax when earned, presumably because Congress believed that deferral of such income provided excessive opportunities to route income through foreign countries to maximize tax benefits.[8]

The pre-1986 treatment for active financial services income was restored in 1997,[9] with the addition of rules to address the concerns that led to the repeal in 1986. For example, to allay the concern about the mobility of such income, a CFC was required to be "predominantly engaged" in the active conduct of a banking, financing, or similar business, and 70 percent of its income had to be derived from transactions with unrelated persons. To test the effectiveness of the "predominantly engaged" and unrelated customer requirements, Congress imposed stringent restrictions on the ability to defer U.S. taxes on income with cross-border customers, and enacted the provision for one year.[10]

President Clinton exercised his line-item veto authority on the one-year provision enacted in 1997. (The Supreme Court later found the line-item veto law unconstitutional, restoring the provision for 1998.[11]) While the White House, in its statement regarding the exercise of the line-item veto, expressed concern that the provision, as drafted, was too broad and did not adequately constrain the potential mobility of active financial services income, the Administration expressed support for the policy underlying the provision.[12]

The active financing income provision was revisited in 1998, in the context of extending the provision for the 1999 tax year. Considerable changes were again made to address concerns relating to income mobility. The newly crafted provision was so narrowly drawn as to make the

---

[8] JOINT COMMITTEE ON TAXATION GENERAL EXPLANATION OF THE TAX REFORM ACT OF 1986, at 966 (Comm. Print 1986).

[9] Pub. L. No. 105-34, § 1175(a); H.R. REP. NO. 105-220, at 639-645 (1997) (Taxpayer Relief Act of 1997, Conference Report to H.R. 2014).

[10] The conference agreement contained the following statement: "The conferees recognize that insurance, banking financing and similar businesses are businesses the active conduct of which involves the generation of income, such as interest and dividends, of a type that generally is treated as passive for purposes of subpart F. For purposes of this temporary provision, the conferees intend to delineate the income derived in the active conduct of such businesses, while retaining the present-law anti-deferral rules of subpart F with respect to income not derived in the active conduct of these financial services businesses. However, the conferees recognize that the line between income derived in the active conduct of such businesses and income otherwise derived by entities so engaged can be difficult to draw. The conferees believe that the issues of the determination of income derived in the active conduct of such businesses and the potential mobility of the business activity and income recognition of insurance, banking, financing, and similar businesses require further study." *Id.*, at 644-645.

[11] *Clinton* v. *City of New York,* 118 S.Ct. 2091 (1998).

[12] In its statement dated August 11, 1997, the White House stated, "The canceled item would have allowed a small number of major U.S. banks, financing companies, insurance companies and securities firms to avoid current taxation on their income from overseas operations. *While the primary purpose of the provision was proper,* it was drafted in such a manner that would have permitted substantial abuse and created major tax loopholes for these companies." [Emphasis added.]

Congress comfortable with extending deferral treatment to cross-border income in many circumstances. Under current law, a financial services business must be truly active, if it is not to be subject to current taxation. The statute ensures this by requiring that there be a substantial number of employees carrying on substantial managerial and operational activities in the foreign country. The activities must be carried on almost exclusively with unrelated parties, and the income from the activities must be recorded on the books and records of the CFC in the country where the income was earned and the activities were performed.[13]

A comparison of current U.S. law with the laws of other foreign countries shows that U.S. law imposes significantly stricter standards for CFCs of home country-based financial services companies to qualify for deferral. None of the countries surveyed eliminates deferral for active financial services income. Such income is universally recognized as active trade or business income. Thus, if the current law provision were permitted to expire at the end of 2001, U.S. banks and other financial services companies would find themselves at a competitive disadvantage in relation to all their major foreign competitors when operating outside the United States. In addition, because the U.S. active financing income deferral provision is currently temporary, it denies U.S. companies the certainty their competitors have in their ability to rely not only on the basic concept of deferral, but also on a set of rules that must be followed to achieve deferral. The need for certainty in this area can not be overstated; U.S. companies over the last two years have been forced to implement numerous system changes to comply with two very different versions of the active financing law.

As noted above, a CFC of a U.S. financial institution must meet stringent requirements if it is to defer the taxation of its active financing income. The U.S. law has a strict unrelated customer requirement and a "predominantly engaged" requirement. In addition, an active banking, financing, securities, or insurance business is painstakingly defined by statute and accompanying legislative history. The activities that may be taken into account in determining whether a business is active also are carefully delineated in the statute and legislative history and substantially all of the CFC's activities must be comprised of such activities as defined.

Other major industrialized countries provide far more lenient requirements for a CFC to be able to defer the taxation of its active financing income. German law merely requires that the income must be earned by a

---

[13] *See* H.R. Rep. No. 105-825, at 921 (1998) (Conference Report to H.R. 4328, section 1005 of the Omnibus Consolidated And Emergency Supplemental Appropriations Act of 1999).

bank with a commercially viable office established in the CFC's jurisdiction and that the income results from transactions with customers. Germany does not require that the CFC conduct the activities generating the income or that the income come from transactions with customers solely in the CFC's country of incorporation. The United Kingdom has an even less restrictive deferral regime than Germany. The United Kingdom does not impose current taxation on CFC income as long as the CFC is engaged primarily in legitimate business activities primarily with unrelated parties. In sum, current U.S. treatment of CFC active financing income is more restrictive than the treatment afforded such CFC income by many of the United States' competitors.

B. Dividends, Interest, and Royalties from Active Earnings Received from Related Parties

The definition of foreign personal holding company income for U.S. subpart F purposes includes dividends, interest, and royalties.[14] There is an exception for royalties derived in active business, but the exception is not available for royalties from related parties.[15] Another exception for royalties is applicable when royalties are received from a related corporation for the use of property within the country of the CFC.[16] There is also an exception for dividends and interest, but the exception only applies when the dividend or interest is received from a related corporation that is incorporated in the CFC country and a substantial part of its assets are used in its trade or business located in the CFC country.[17]

Example 1(a): Active Business CFC Receives Dividend from Active Subsidiary in Another Country

The parent corporation (Parent) is a large multinational corporation located in the "home country."[18] CFC is a subsidiary of Parent and is a controlled foreign corporation located in a low tax rate country (X). Country X has a 10 percent rate of tax. CFC has an office located in Country X that manages the business of CFC.

S is a wholly owned subsidiary of CFC and is incorporated in country Y. CFC is primarily engaged in an active business conducted primarily

[14] I.R.C. § 954(c)(1)(A).

[15] I.R.C. § 954(c)(2)(A).

[16] I.R.C. § 954(c)(3)(A)(ii).

[17] I.R.C. § 954(c)(3)(A)(i).

[18] The "home country" refers to the United States, Canada, France, Germany, Japan, or the United Kingdom, as the case may be.

with unrelated parties in country X. S is engaged in an active manufacturing business in country Y. Its only income is from this active business. S pays CFC a dividend.

For U.S. tax purposes, the dividend income would be attributed to Parent under subpart F. Although S and CFC are related, the dividend would not qualify for the exception because S and CFC are not located in the same country. The dividend income would not be considered to be tainted income in Germany provided CFC's holdings in S are commercially related to its own excluded active business operations (*e.g.*, CFC is also engaged in a similar manufacturing business) or if the dividends would have been exempt if received directly by the German corporation. U.K. Parent would be exempt from attribution because CFC is principally engaged in an active business and the business operations of CFC are carried on principally with unrelated parties. French Parent would be exempt because CFC is engaged in an active business in country X. Japanese Parent would be exempt because the business of CFC is conducted primarily in country X (even if business were not conducted in country X, Japanese Parent would be exempt if the main business of CFC were wholesale, financial, shipping, or air transport because it is engaged in business primarily with unrelated parties). There would be no attribution to Canadian Parent because dividends received from other foreign related parties out of active earnings are excluded from attribution.

Thus, in the case of an active business CFC that receives a dividend from a subsidiary engaged in active business in a country other than the CFC country, the United States is the only country that always attributes the income to Parent. Germany's exception for dividends from holdings related to the CFC's own excluded active business operations allows for situations where there are business reasons for holding the stock of a corporation from another country. Japan and the United Kingdom allow for dividends from the holding of stock without attribution, whether or not the stock is related to the CFC's business, provided the CFC is engaged in an active business. France allows for dividends from the holding of stock without attribution provided the CFC is engaged in an active business in the CFC country. Canada has a blanket exemption for dividends paid to CFCs by foreign related parties out of active earnings. While the foreign countries allow for situations where legitimate active businesses earn dividend income in the normal course of business, the United States puts its multinational corporations at a disadvantage by always taxing dividend income currently unless the extremely narrow same country exception applies.

Example 1(b): Holding Company CFC Receives Dividends from Active Subsidiary in Another Country

The facts are the same as in 1(a), except that CFC is a holding company engaged in no active business. All of CFC's income is earned from controlled companies engaged in active business.

Dividend income from S would be attributable to U.S. Parent. There would be no attribution to Canadian Parent because dividends of another foreign related party out of active earnings are not attributable. French Parent of a holding company CFC, although technically subject to attribution, avoids the tax on the income through a participation exemption which excludes the attributed dividend income. As long as S qualifies for the active business in CFC country exemption or is not established in a country with a privileged tax regime, French Parent will effectively avoid attribution. Dividend income in this example would be attributable to German Parent unless the dividends would have been exempt if received directly by the German corporation. The dividend income of CFC would be attributed to Japanese Parent because a holding company does not meet the active business exemption. A U.K. CFC qualifies for exemption from attribution if it has a business establishment in the CFC country, its business is effectively managed there, and at least 90 percent of its income is derived directly or indirectly from controlled companies that are operating companies engaged in active business.

Canada, the United Kingdom, and France allow for certain holding company CFCs to receive dividends without attribution to home country shareholders. The United States, Japan, and Germany discourage holding company structures by attributing dividend income paid to the holding company, even if there are legitimate business reasons for the structures. Canadian, U.K., and French multinationals will have an advantage in situations where foreign holding companies are necessary to efficiently conduct business abroad.

Example 2(a): Active Business CFC Receives Interest from Active Subsidiary in Another Country

The facts are the same as in 1(a), except that CFC has an excess of cash earned in its active business and S has a need for cash to use in its active business. CFC lends S its excess cash. S pays CFC interest on the loan. CFC reinvests the interest income in its active business.

Under subpart F, interest income would be attributable and taxed currently in the hands of U.S. Parent. Although S and CFC are related, the interest does not qualify for any related party exception because S and CFC are not located in the same country. The interest income would not be considered to be tainted income in Germany provided CFC lent the funds on a short-term basis or borrowed the funds it lent to S exclusively on foreign capital markets from unrelated parties and lent them to S on a long-term basis. U.K. Parent would be exempt from attribution because CFC is principally engaged in an active business and the business operations of CFC are carried on principally with unrelated parties. Income would not be attributed to French Parent or Japanese Parent because CFC is principally engaged in an active business carried on in country X. The Canadian CFC rules provide an exception that deems amounts paid to a CFC by another foreign affiliate to be active business income if the amount is deductible in computing the income of the payer corporation. Therefore, the interest payment would be excluded from attribution to Canadian Parent.

Canadian, French, Japanese, and U.K. CFCs are allowed to lend money to active business subsidiaries without being penalized by the CFC rules. German CFCs are allowed to lend money to foreign active business subsidiaries as long as the loan is long-term and the money is borrowed by the CFC on foreign capital markets. U.S. multinational corporations generally are not able to provide a loan from a CFC engaged in active business with an excess of cash to a subsidiary of the CFC that is engaged in active business with a need for cash, without incurring current U.S. taxation on the interest paid from the subsidiary to the CFC. The only time U.S. multinationals are able to provide such a loan without current U.S. taxation is if both the CFC and the subsidiary are in the same country. Although income used to pay the interest is earned in an active foreign business by a party related to the U.S. multinational and the income is reinvested in an active foreign business, the U.S. rules still tax the income currently. Once again, U.S. multinationals are at a competitive disadvantage in the international marketplace.

Example 2(b): Holding Company CFC Receives Interest from Active Subsidiary in Another Country

The facts are the same as in 2(a), except CFC is not engaged in an active business. CFC earns all of its income from controlled companies engaged in active business.

As in 2(a), the interest income would also be attributable to U.S. Parent under subpart F. The interest income would not be attributed to German Parent provided CFC borrowed the funds it lent to S exclusively on foreign capital markets from unrelated parties and lent them to S on a long-term basis. Interest income paid to French and Japanese CFCs would be attributed to French Parent and Japanese Parent, respectively. A U.K. CFC qualifies for exemption from attribution if at least 90 percent of its income is derived directly or indirectly from controlled companies that are operating companies engaged in active business. The Canadian CFC rules provide an exception that deems amounts paid to a CFC by another foreign affiliate to be active business income if the amount is deductible in computing the income of the payer corporation. Therefore, the interest payment would be excluded from attribution.

Again, at least with respect to Canadian, German, and U.K. competitors, a U.S. multinational is at a disadvantage.

Example 3(a): Active CFC Receives Royalty Payments from Subsidiary in Another Country

The facts are the same as in 1(a), except that CFC actively develops intangibles. S pays CFC royalties for the use of intangibles in Country Y.

The royalty income would be attributable to U.S. Parent. Even if earned in an active business, royalties from related parties are subpart F income. Germany does not consider royalty income to be passive tainted income provided the CFC has used its own research and development activities without the participation of German Parent or an affiliated person to create the patents, trademarks, know-how, or similar rights from which the income is derived. The Canadian CFC rules provide an exception that deems amounts paid to a CFC by a related foreign corporation to be active business income if the amount is deductible in computing the income of the payer corporation. Therefore, the royalty payments would be excluded from attribution. U.K. Parent would be exempt from attribution because CFC is principally engaged in an active business and the business operations of CFC are carried on principally with unrelated parties. Income would not be attributed to French Parent or Japanese Parent because CFC is principally engaged in an active business carried on in country X.

Only members of U.S. multinational groups cannot pay royalties to a CFC that actively develops intangibles without triggering an anti-deferral regime. In each of the competitor countries' cases, such royalties are not tainted income or otherwise attributable to the CFC's shareholders.

Example 3(b): Holding Company CFC Receives Royalty Payments from a Subsidiary in Another Country

The facts are the same as in 3(a), except that CFC is not engaged in an active business. All of the income of CFC is earned from controlled companies.

The royalty income would be attributable to a U.S. shareholder of CFC. The royalty income would also be attributable to a German shareholder. Canadian CFC rules provide an exception that deems amounts paid to a CFC by another foreign affiliate to be active business income if the amount is deductible in computing the income of the payer corporation. Therefore, the royalty payments would be excluded from attribution. A U.K. shareholder of CFC qualifies for exemption from attribution if at least 90 percent of its income is derived directly or indirectly from controlled companies that are operating companies engaged in active business. The royalty income paid to French and Japanese CFCs would be attributed to their shareholders.

U.S. multinationals are at a disadvantage compared with Canadian and U.K. multinationals where it is necessary, for business reasons, to hold an intangible in a holding company CFC.

Examples 1, 2, and 3 demonstrate that U.S. multinationals are at a disadvantage in relation to multinationals from each of the competitor jurisdictions with respect to dividends, interest, or royalties received by a CFC engaged in an active business, when such items are also paid by a CFC in an active business. When the recipient is a holding company, the results are mixed, although deferral is more common than current taxation.

C. Oil-Related Income

In 1982, the United States expanded subpart F income to include "foreign base company oil-related income."[19] Congress extended subpart F to oil-related income because it thought the petroleum companies had been paying too little U.S. tax on their foreign subsidiaries' operations relative to their high revenue.[20] Specifically, Congress complained that U.S. tax could be avoided on the downstream activities of a foreign subsidiary because the income of the subsidiary was not subject to U.S. tax until that income was paid to its shareholders.[21] It claimed that, because of the fungible nature of

---

[19] Pub. L. No. 97-248, § 212(a).

[20] Joint Committee on Taxation General Explanation of the Revenue Provisions of the Tax Equity and Fiscal Responsibility Act of 1982, at 72.

[21] *Id.*

oil and because of the complex structures involved, oil income is particularly suited to tax haven type operations.[22]

Foreign base company oil-related income is foreign oil-related income other than: (1) income derived from a source within a foreign country in connection with oil or gas extracted from an oil or gas well located in that foreign country; or (2) income from oil, gas, or a primary product of oil or gas that is sold by the foreign corporation for use or consumption within the foreign country or is loaded in such country on a vessel or aircraft as fuel for such vessel or aircraft.[23] The foreign base company oil-related income rules do not apply when a related group produces less than 1,000 barrels of oil per day.

Example 4(a): Active Oil-Related Income from Unrelated Parties—Buying and Selling Outside the CFC Country

CFC operates a refinery in country X. CFC earns oil-related income in X from purchasing oil extracted from a country other than X and sells the refined product for consumption outside of X. CFC's sales are primarily conducted with unrelated parties.

Under subpart F, the income of CFC would be attributed to Parent. None of the other countries have singled out oil-related income as a type of income that should be tainted. In the other countries, oil-related income is subject to the same rules as other types of active business income.

Income from a Japanese CFC that derives its income from oil-related activities is not attributed to its shareholder if it is a legitimate business with a fixed place of business in the CFC country that manages the business. As with all U.K. CFC businesses, income from a CFC that derives its income from oil-related activities is not attributed to the CFC's shareholders if it is an active business that has a business establishment from which it manages its operations in the CFC country and it does not primarily buy the oil from or sell it to parties in the United Kingdom or to or from related parties. In Canada, CFC's oil-related income would be exempt from attribution to a Canadian shareholder unless the income arises from directly or indirectly purchasing or selling commodities or commodities futures, on a commodities futures exchange. If the income does so arise, the income could alternatively be exempt if CFC is a trader or dealer whose business is both regulated and principally carried on in the CFC country. Under the

[22] *Id.*

[23] I.R.C. § 954(g).

German processing exemption, income from the processing of oil would be excluded from tainted income even where the activity is carried on outside country X, CFC purchases all its raw materials from related parties, and CFC sells the oil to related parties. If CFC is not involved in processing, but only in buying and selling oil, the trading and commercial business exemption applies. Income from buying and selling oil is exempt unless the oil is acquired by CFC from, or sold to, a related party in Germany. Even if the oil acquired by CFC is purchased from or sold to a related party in Germany, the income may qualify as exempt if CFC is an independent sales corporation carrying on its own business without any participation by related parties. Income would be attributed to French shareholders because CFC makes sales primarily outside the CFC country.

Thus, U.S.-based and French-based multinational oil companies are in these circumstances at a competitive disadvantage in relation to oil companies from the other compared countries with respect to income earned from downstream activities. Only for U.S. and French multinational oil companies will income from an active downstream business conducted in a subsidiary in a foreign jurisdiction be attributed to the parent. In each of the other surveyed jurisdictions, such income would be entitled to deferral or exemption.

Example 4(b): Active Oil-Related Income—Buying from Unrelated Parties and Selling to Related Parties

The facts are the same as in 4(a), except CFC earns oil-related income in X from refining and sells the refined product for consumption to related parties outside the home country.

Whether oil income of CFC is from related or unrelated parties, the income would be attributed to a U.S. multinational Parent. In Canada, CFC's oil-related income would be exempt from attribution to a Canadian shareholder unless the income arises from directly or indirectly purchasing or selling commodities or commodities futures, on a commodities futures exchange. Oil income of a U.K. CFC would be attributed to the U.K. shareholder if CFC was primarily engaged in the business of delivering the oil to related parties. A French CFC's income would also be attributed because the CFC's business is not conducted primarily in the CFC country. A Japanese multinational Parent would not have the income attributed to it because CFC purchases more than 50 percent of the oil from unrelated parties. Germany would exempt the income from attribution because the oil is purchased and sold outside Germany.

Canada, Germany, and Japan do not attribute income to the CFC shareholders when oil purchased from unrelated parties is sold to related parties outside the home country. However, the United States, along with France and the United Kingdom, has chosen to put its multinational oil companies at a disadvantage by requiring attribution of the income to the home country parent.

D. Base Company Sales Income

For U.S. tax purposes, foreign base company sales income is income derived in connection with:

- The purchase of personal property from a related person and its sale to any other person where the property purchased or sold is manufactured, produced, grown, or extracted outside the country of the CFC and the property is sold or purchased for use outside the country of the CFC;
- The sale of personal property to any person on behalf of a related person where the property purchased or sold is manufactured, produced, grown, or extracted outside the country of the CFC and the property is sold or purchased for use outside the country of the CFC;
- The purchase of personal property from any person and its sale to a related person where the property purchased or sold is manufactured, produced, grown, or extracted outside the country of the CFC and the property is sold or purchased for use outside the country of the CFC; or
- The purchase of personal property from any person on behalf of a related person where the property purchased or sold is manufactured, produced, grown, or extracted outside the country of the CFC and the property is sold or purchased for use outside the country of the CFC.[24]

Example 5(a): Active Sales Income from Property Bought from Related Parties in Another Country and Sold to Unrelated Parties in Another Country

CFC is engaged in the buying and selling of personal property that it does not manufacture. The personal property is bought from related parties outside country X and the home country and sold to unrelated parties outside country X and the home country.

[24] I.R.C. § 954(d).

The income of CFC would be attributed to U.S. shareholders. In Canada, CFC's income would be exempt from attribution because the income is earned in active business. The income would be attributed to French Parent because the business is conducted primarily outside the CFC country. Germany's exemption for commercial activities does not generally apply when goods are acquired by the CFC from, or sold to, a related German party. If the goods are both purchased and sold outside Germany, the sales income is exempt, even if the goods are sold to a related party and the German shareholder of the CFC actively participates. In this Example, therefore, there would be no attribution. A CFC controlled by U.K. shareholders is subject to the CFC regime and income is attributed to its shareholders if the main business of the CFC is dealing in goods for delivery to or from the United Kingdom or to or from related parties. The main business of the CFC is dealing in goods from related parties, so the income of the CFC would be attributed to its shareholders. To qualify for exemption from attribution, a Japanese sales company must conduct its business primarily with unrelated parties. To be conducting business primarily with unrelated parties for Japanese purposes, the CFC must either purchase more than 50 percent of its goods from unrelated parties or sell more than 50 percent of its goods to unrelated parties. The income of CFC would not be attributed to Japanese shareholders because more than 50 percent of the goods are sold to unrelated parties.

Canadian, German, and Japanese multinationals have a competitive advantage over U.S. multinationals when goods bought from related parties outside the home and CFC countries are sold to unrelated parties outside the home and CFC countries.

Example 5(b): Active Sales Income from Property Bought from Unrelated Parties in Another Country and Sold to Unrelated Parties in Another Country

The facts are the same as in 5(a), except that 55 percent of the personal property is bought from unrelated parties.

Under subpart F, 45 percent of the income would be attributed to U.S. shareholders. Canada would exempt all of the income because it is active. Germany would exempt all of the income because the goods are bought and sold outside the home country. A French shareholder would be subject to attribution because the CFC's business is primarily conducted outside the CFC country. No income would be attributed to a Japanese shareholder because dealings are primarily with unrelated parties. A U.K. CFC's income would not be attributed to its shareholders because the CFC deals primarily with unrelated parties.

The United States and France are the only countries to attribute any income to the multinational shareholder of the CFC. Even though the CFC is engaged in an active sales business primarily with unrelated parties, the related party transaction income would be attributed under subpart F. The other countries recognize that in legitimate sales businesses, there still may be substantial sales to related parties. Rather than put their multinational corporations at a disadvantage by attributing the related party income, the other countries allow their transfer pricing rules to prevent any possible abuses in related party transactions.

E. Base Company Services Income

For U.S. tax purposes, foreign base company services income is income derived in connection with the performance of technical, managerial, engineering, architectural, scientific, skilled industrial, commercial, or like services that are performed for any related party outside the country of the CFC.[25]

Example 6: Active Services Income

The facts are the same as in 1(a), except that CFC receives 45 percent of its income from providing technical services for S in country Y. The other 55 percent of CFC's income comes from active business with unrelated parties resident in country X.

The income from the technical services provided to S would be attributable to U.S. Parent. Income would not be attributed to Canadian Parent because the services are not performed by an individual resident in Canada and the amount paid for the services is deductible in computing the income of a business carried on in Canada. None of the income of a French CFC would be attributed to Parent because the CFC is engaged in active business conducted primarily in the CFC country. Germany excludes income derived from services rendered by a CFC from tainted income unless a related party subject to tax in Germany participates in the rendering of the services or the services are provided by the CFC to a related party subject to tax in Germany. No income would be attributed to German Parent in this Example. A Japanese CFC that provides services must conduct its business primarily in the CFC country to avoid attribution of income to its shareholders. In this Example, no income would be attributed to Japanese

[25] I.R.C. § 954(e).

Parent. For a U.K. CFC that provides services to be exempted from the CFC regime, it must have a significant business presence in the CFC country. Further, any services provided by the CFC for nonresidents may not be performed in the United Kingdom. No income would be attributed to a U.K. shareholder in this Example.

F. Increase in Investment in the Home Country

Example 7: Increase in Investment in the Home Country

CFC has nothing invested in home country property at the beginning of the year. CFC purchases tangible property located in the home country for use in its business during the year. CFC has earnings and profits in excess of the value of the property.

Under subpart F, U.S. Parent would have to include the entire amount invested by the CFC in U.S. property for the taxable year in its income.[26]

None of the other countries that have been discussed have a provision that requires an inclusion in income by the CFC shareholders for an increase in earnings invested by the CFC in the home country. Canada and Germany have decided that, if the income earned from that property invested in the home country is of a type for which deferral should not be granted, then it is sufficient to subject the income from that investment to the anti-deferral regime (note that the CFC itself may be subject to tax in the home country because the income may be sourced in the home country). France, Japan, and the United Kingdom do not subject the income from such property to tax under the anti-deferral regime, even if the income is of a type for which deferral should not be granted, if the CFC is engaged primarily in active business.

[26] I.R.C. §§ 951(a)(1)(B), 956(a).

Table 4–1a. Summary of Examples

Country	Active financial services income from unrelated parties	Active financial services income from related parties	Engaged in active business-dividend from active business subsidiary in another country	Holding company-dividend from active subsidiary in another country
Canada	Deferred	Deferred	Deferred	Deferred
France	Deferred	Deferred	Deferred	Attributed, but gets 100% participation exemption
Germany	Deferred	Taxed currently	Deferred if holdings are commercially related to its own active business	Taxed currently unless it would have been exempt to parent
Japan	Deferred	Taxed currently	Deferred	Taxed currently
Netherlands	Deferred	Deferred	Deferred	Deferred
United Kingdom	Not taxed currently	Taxed currently	Deferred	Deferred if CFC has a business establishment effectively managed there and 90% of its income is from companies in active business
United States	Taxed currently*	Taxed currently*	Taxed currently	Taxed currently

*Ignores effects of active financial services legislation.

Table 4–1b. Summary of Examples

Country	Engaged in active business-interest from active subsidiary in another country	Holding company-interest from active subsidiary in another country	Active business-royalty payments from subsidiary in another country
Canada	Deferred	Deferred	Deferred
France	Deferred	Taxed currently	Deferred
Germany	Deferred if lent on a short-term basis or if funds are borrowed on foreign capital market and lent on a long-term basis	Deferred if funds are borrowed on foreign capital market and lent on a long-term basis	Deferred if used on R&D and no participation of related parties
Japan	Deferred	Taxed currently	Deferred if its meets non-related party or location criteria
Netherlands	Deferred	Deferred	Deferred
United Kingdom	Deferred	Deferred if CFC has a business establishment effectively managed there and 90% of its income is from companies in active business	Deferred
United States	Taxed currently	Taxed currently	Taxed currently

Table 4–1c. Summary of Examples

Country	Holding company royalty payments from subsidiary in another country	Active oil-related income from unrelated parties buying and selling outside CFC country	Active oil-related income-buying from unrelated parties in another country selling to related parties in another country
Canada	Deferred	Deferred	Deferred
France	Taxed currently	Taxed currently	Taxed currently
Germany	Taxed currently	Deferred	Deferred
Japan	Taxed currently	Deferred	Deferred
Netherlands	Deferred	Deferred	Deferred
United Kingdom	Deferred if CFC has a business establishment effectively managed there and 90% of its income is from companies in active business	Deferred	Taxed currently
United States	Taxed currently	Taxed currently	Taxed currently

Table 4–1d. Summary of Examples

Country	Active sales income—bought from related in another country sold to unrelated in another country	Active sales income—55% bought from unrelated in another country all sold to unrelated in another country	Active business—55% income from unrelated parties in CFC country, 45% service income from related party in another country	Increase in investment in home country
Canada	Deferred	Deferred	Deferred	Deferred
France	Taxed currently	Taxed currently	Deferred	Deferred
Germany	Deferred	Deferred	Deferred unless services provided to party subject to German tax	Deferred
Japan	Deferred	Deferred	Deferred	Deferred
Netherlands	Deferred	Deferred	Deferred	Deferred
United Kingdom	Taxed currently	Deferred	Deferred	Deferred
United States	Taxed currently	45% taxed currently	45% taxed currently	Taxed currently

Chapter 5

The Economy Three Decades after Subpart F

I. Overview

In 1962, the Kennedy Administration proposed to subject the earnings of U.S. controlled foreign corporations (CFCs) to current U.S. taxation. At that time, the dollar was tied to the gold standard, and the United States was the world's largest capital exporter. These capital exports drained Treasury's gold reserves, and made it more difficult for the Administration to stimulate the economy. Thus, the proposed repeal of deferral of tax on the foreign income of U.S. multinationals was intended by Treasury Secretary Douglas Dillon to serve as a form of capital control, reducing the outflow of U.S. investment abroad.

In enacting subpart F in 1962, Congress chose a middle course between Secretary Dillon's proposal to repeal deferral (*i.e.*, impose current taxation on the unremitted foreign income of U.S. CFCs) and the *status quo ante* (deferral of tax until remittance of foreign income to U.S. shareholders). Congress limited the scope of subpart F to only certain types of income because of concerns that the foreign operations of U.S. multinationals would be subject to higher tax burdens than their foreign-based competitors. In subsequent years, Congress has added additional categories of income to subpart F, often as a way to raise tax revenues.

The compromise embodied in subpart F was shaped in the global economic environment of the early 1960s—a world economy that has changed almost beyond recognition as the 21) (century begins. The gold standard was abandoned during the Nixon Administration, and the exchange rate of the dollar is no longer fixed. The United States is now the world's largest *importer* of capital, with foreign investment in U.S. assets exceeding U.S. investment in foreign assets by over $100 billion per year.

Because economic arguments advanced against the backdrop of the 1962 economy are the foundation upon which the subpart F regime was erected, the balance that was struck then may no longer be appropriate in today's economy. This chapter summarizes the salient changes in the global economy, and notes some of the ramifications of those changes for U.S. international tax policy in the 21st century.

II. Global Economic Change

National economies are becoming increasingly integrated. Globalization is being fueled both by technological change of almost unimaginable rapidity and a worldwide reduction in tax and regulatory barriers to the free international flow of goods and capital.

Reductions in the cost of computer processing, communications, and transportation costs make it possible for companies to operate efficiently across national boundaries. The cost of information processing, expressed in terms of dollars per instruction per second, has declined by a factor of over 10,000 during the last 20 years.[1] Due to advances in computer technology and fiber optics and industry deregulation, international telecommunication costs have dropped precipitously as well. For example, the cost of a three-minute telephone call between New York and London has fallen from over $50 in 1960 (in 1996 dollars) to $1 today.[2] The rapid adoption of Internet technology in commercial applications has reduced the marginal cost of international communications to very near zero.

Similarly, technological change and deregulation have led to dramatic reductions in passenger and cargo shipment costs, both by air and sea. For example, constant dollar revenues per ton-mile of air freight have fallen over 30 percent since 1965.

---

[1] *One World,* The Economist, October 18, 1997.

[2] *Id.*

III. The United States in the World Economy

This section examines five areas that have witnessed the most conspicuous changes in the global economy since 1962, and notes some of the ramifications of these changes for U.S. international tax policy in the 21st century.

A. Foreign Direct Investment

In the 1960s, the United States completely dominated the global economy, accounting for over 50 percent of worldwide cross-border direct investment and 40 percent of worldwide Gross Domestic Product (GDP). Of the world's 20 largest corporations (ranked by sales) in 1960, 18 were headquartered in the United States (see Table 5–1).

Three decades later, the United States confronts far greater competition in global markets. As of the mid-1990s, the U.S. economy accounted for about 25 percent of the world's foreign direct investment and GDP, and only 8 of the world's 20 largest corporations were headquartered in the United States. The 21,000 foreign affiliates of U.S. multinationals now compete with about 260,000 foreign affiliates of multinationals headquartered in other nations.[3] The declining dominance of U.S.-headquartered multinationals is dramatically illustrated by the recent acquisitions of Amoco by British Petroleum and the acquisition of Chrysler by Daimler-Benz. These two mergers have the effect of converting U.S. multinationals to foreign-headquartered companies.

The increased competition in foreign markets also is indicated by the declining returns earned by U.S. companies on their foreign investments. In 1985, foreign subsidiaries of U.S. multinationals generated earnings (before interest and taxes) per dollar of assets of 11.8 percent; by 1995, the return on foreign assets had declined by two percentage points, to 9.8 percent.

Ironically, despite the intensified competition in world markets, the U.S. economy is far more dependent on foreign direct investment than ever before. The fact that the world economy has grown more rapidly than the U.S. economy over the last three decades represents an opportunity for U.S. companies that are able to participate in these markets. In the 1960s, foreign operations averaged just 7.5 percent of U.S. corporate net income; by contrast, over the 1990–97 period, foreign earnings represented 17.7 percent of all U.S. corporate net income. A recent study of the Standard and Poors' (S&P) 500 corporations (the 500 largest publicly-traded U.S. corporations)

[3] UNCTAD, World Investment Report (1997).

Table 5–1. United States in the World Economy

U.S. International Trade (percent of GDP)[1]	**1960–69**	**1990–97**
Merchandise exports	3.9%	7.5%
Merchandise imports	3.2%	9.7%
Trade openness: merchandise exports plus imports	7.1%	17.2%
U.S. International Investment Position ($ billions)[2]	**1980**	**1997**
Net international investment position[3]	393	–1,224
Direct investment:		
U.S. investment abroad	396	1,024
Foreign investment in the United States	126	752
Private portfolio investment in securities:		
U.S. investment abroad	62	1,446
Foreign investment in the United States	90	2,240
U.S. Corporate Profits[4]	**1960–69**	**1990–97**
Share from foreign sources	7.5%	17.7%
Rate of return on assets (earnings before interest and taxes)[9]	**1985**	**1995**
Foreign subsidiaries minus domestic corporations	5.1%	2.2%
Gross Domestic Product (GDP)[5]	**1965**	**1996**
U.S. share of world total	39.9%	25.7%
Population	**1965**	**1997**
U.S. share of world total	5.8%	4.6%
Exports[6]	**1960**	**1996**
U.S. share of world total	16.6%	11.9%
Direct Investment Stock[7]	**1967**	**1996**
U.S. share of world outward direct investment stock	50.4%	25.0%
World's 20 Largest Corporations (ranked by sales)[8]	**1960**	**1996**
Number of U.S.-headquartered corporations	18	8

Table Notes:

[1] Survey of Current Business, U.S. Department of Commerce, July 1998.

[2] Survey of Current Business, U.S. Department of Commerce, July 1998. Direct investment at current cost.

[3] Includes all private and official government assets.

[4] Survey of Current Business, U.S. Department of Commerce, August 1998.

[5] World Economic Outlook, International Monetary Fund, 1997.

[6] International Financial Statistics, International Monetary Fund, March 1998.

[7] World Investment Report, United Nations Conference on Trade and Development, 1997 edition.

[8] Hoover's Handbook of World Business, 1998 edition.

[9] U.S. Department of Commerce data, PricewaterhouseCoopers calculations.

finds that sales by foreign subsidiaries increased from 25 percent of worldwide sales in 1985 to 34 percent in 1997.[4]

At the end of the 20th century, tax policymakers confront an economy in which U.S. multinationals face far greater competition in global markets, yet rely on these markets for a much larger share of profits and sales, than was the case when subpart F was adopted in 1962. In light of these changed circumstances, the effects of tax policy on the competitiveness of U.S. companies operating abroad is potentially of far greater consequence today than was the case in 1962.

B. The U.S. Market

In 1962, U.S. companies focused manufacturing and marketing strategies in the United States, which at the time was the largest consumer market in the world. U.S. companies generally could achieve economies of scale and rapid growth selling exclusively into the domestic market. In the early 1960s, foreign competition in U.S. markets generally was inconsequential.

The current picture is now very different. First, U.S. companies now face strong competition at home. Since 1980, the stock of foreign direct investment in the United States has increased by a factor of six (from $126 billion to $752 billion in 1997), and $20 of every $100 of global cross-border direct investment flows into the United States. Foreign companies own approximately 14 percent of all U.S. non-bank corporate assets, and over 27 percent of the U.S. chemical industry.[5] Moreover, imports have tripled as a share of GDP from an average of 3.2 percent in the 1960s to an average of over 9.6 percent over the 1990–97 period (see Table 5–1).

Second, foreign markets frequently offer greater growth opportunities than the domestic market. For example, from 1986 to 1997, foreign sales of S&P 500 companies grew 10 percent a year, compared to domestic sales growth of just 3 percent annually.[6]

From the perspective of the 1960s, there was little apparent reason for U.S. companies to direct resources to penetrating foreign markets. U.S. companies frequently could achieve growth and profit levels that were the envy of their competitors with minimal foreign operations. By contrast, in today's economy, competitive success requires U.S. companies to execute global marketing and manufacturing strategies.

[4] *U.S. Firms Global Progress is Two-Edged,* Wall Street Journal, August 17, 1998.

[5] PricewaterhouseCoopers calculations based on Department of Commerce and IRS data.

[6] *U.S. Firms Global Progress is Two-Edged,* Wall Street Journal, August 17, 1998.

C. International Trade

Over the last three decades, the U.S. share of the world's export market has declined. In 1960, one of every six dollars of world exports originated from the United States. By 1996, the United States supplied only one of every nine dollars of world export sales. Despite a 30 percent loss in world export market share, the U.S. economy depends on exports to a much greater degree. During the 1960s, only 3.2 percent of national income was attributable to exports, compared to 7.5 percent over the 1990–97 period.

Foreign subsidiaries of U.S. companies play a critical role in boosting U.S. exports—by marketing, distributing, and finishing U.S. products in foreign markets. U.S. Commerce Department data show that in 1996, U.S. multinational companies were involved in 65 percent of all U.S. merchandise export sales.[7] The importance of foreign operations also is indicated by the fact that U.S. industries with a high percentage of investment abroad are the same industries that export a large percentage of domestic production.[8]

In the 1960s, the foreign operations of U.S. companies were sometimes viewed as disconnected from the U.S. economy or, worse, as competing with domestic production and jobs. As discussed in Chapter 6, in today's highly integrated global economy, economic evidence points to a *positive* correlation between U.S. exports and U.S. investment abroad. Thus, in formulating tax rules for U.S. multinationals, policymakers must now take into account the linkages between the foreign and domestic operations of U.S. companies.

D. Foreign Portfolio Investment

In 1962, policymakers would scarcely have taken note of cross-border flows of portfolio investment. As recently as 1980, U.S. portfolio investment in foreign private sector securities amounted to only $62 billion—85 percent less than U.S. *direct* investment abroad. By 1997, U.S. portfolio investment abroad had increased over 2,200 percent to $1.4 trillion—40 percent more than U.S. *direct* investment abroad. Similarly, foreign portfolio investment in U.S. private securities increased over 2,300 percent from $90 billion in 1980 to over $2.2 trillion in 1997 (see Table 5-1).

Institutional changes have greatly facilitated foreign portfolio investment, including the growth in mutual funds that invest in foreign securities

---

[7] U.S. Bureau of Economic Analysis, Survey of Current Business (September, 1998).

[8] Robert E. Lipsey, *Outward Direct Investment and the U.S. Economy, in* The Effects of Taxation on Multinational Corporations (M. Feldstein, et al., eds., 1995).

and the listing of foreign corporations on U.S. exchanges. According to the New York Stock Exchange, the trading volume in shares of foreign firms totaled $485 billion in 1997, over 8 percent of total NYSE trading volume.[9] Market capitalization of foreign firms listed on the NYSE topped $3 trillion in 1998.[10]

The Administration's 1962 proposal to terminate deferral for U.S. controlled foreign corporations was motivated in large part by a desire to ensure that foreign direct investment not flow off-shore for tax reasons. At the time, U.S. direct investment abroad exceeded private portfolio investment by a factor of 6.5 to 1; it is, therefore, not surprising that the Administration focused much of its attention on the taxation of *direct* investment abroad in 1962.

In the current economic environment, U.S. portfolio investors (*e.g.*, individuals, mutual funds, pension funds, insurance companies, etc.) increasingly allocate capital to foreign-based multinational companies, which generally are not subject to U.S. corporate income tax. Under these circumstances, the impact of U.S. multinational corporation tax rules on the global allocation of capital is greatly diminished.[11]

E. Market Integration

The liberalization of trade and investment climates around the world has contributed to the explosive pace of economic integration. An alphabet soup of regional trade agreements has complemented the original multilateral agreement, the General Agreement on Tariffs and Trade (GATT). In addition to the formation of the European Union—the world's largest common market—free trade agreements are creating increasingly integrated multinational markets. Examples include the EEA (the European Union plus remaining members of the European Free Trade Area), NAFTA (North America), ASEAN (Southeast Asia), ANZCERTA (Australia and New Zealand), and MERCOSUR (Latin America). Almost half of the 153 regional trade agreements notified to the GATT or the World Trade Organization (WTO) have been set up since 1990.[12] Accompanying these trade agreements are hundreds of bilateral investment treaties (BITs) that reduce barriers to foreign direct investment flows. UNCTAD reports that there has been a three-fold increase in BITs in the five years to 1997.[13]

---

[9] Trading in foreign companies is primarily, but not solely, through depository receipts.

[10] NYSE, *Quick Reference Sheet,* and discussion with NYSE Research Dept., September 1998.

[11] See Section E of Chapter 6 for a discussion of this issue.

[12] THE ECONOMIST, October 3, 1998, at 19.

[13] UNCTAD, WORLD INVESTMENT REPORT (1997).

A consequence of market integration is that U.S. companies and their foreign competitors increasingly do not view their businesses as operating in separate country markets, but rather in regional markets where national boundaries often have little economic significance. In this environment, the distinctions in subpart F between economic activities conducted within and outside a foreign subsidiary's country of incorporation have in many cases become artificial. When there is a high degree of economic integration between national markets, tax rules that treat these markets separately are as arbitrary as distinctions between a company's transactions with customers in different cities in the same country.

F. Conclusions

In the decades since subpart F was enacted in 1962, the global economy has grown more rapidly than the U.S. economy. Concomitantly, U.S. companies have confronted both the rise of powerful foreign competitors and the growth of market opportunities abroad. By almost every measure—income, exports, or cross-border investment—the United States today represents a smaller share of the global market. At the same time, U.S. companies have increasingly focused on foreign markets for continued growth and prosperity. Over the last three decades, sales and income from foreign subsidiaries have increased much more rapidly than sales and income from domestic operations. To compete successfully both at home and abroad, U.S. companies have adopted global sourcing and distribution channels, as have their competitors.

These developments have a number of potential implications for tax policy. U.S. tax rules that are out of step with those of other major industrial countries are more likely to hamper the competitiveness of U.S. multinationals in today's global economy than was the case in the 1960s. The growing economic integration among nations—especially the formation of common markets and free trade areas—raises questions about the appropriateness of U.S. tax rules that treat foreign transactions that cross national borders differently from those that occur within the same country. The eclipsing of foreign direct investment by portfolio investment calls into question the ability of tax policy focused on foreign direct investment to influence the global allocation of capital. The adoption of flexible exchange rates has eliminated currency considerations as a rationale for using tax policy to discourage U.S. investment abroad. Indeed, as the world's largest debtor nation, the use of tax policy by the United States to discourage investment abroad is thoroughly antiquated.

Chapter 6

The Neutrality-Competitiveness Balance Reconsidered

I. Overview

In Notice 98-11, the Treasury Department summarized the purposes of subpart F as balancing the objectives of neutrality and competitiveness:[1]

> "U.S. international tax policy seeks to balance the objective of neutrality of taxation as between domestic and foreign business enterprises (seeking neither to encourage nor to discourage one over the other), with the need to keep U.S. business competitive. Subpart F strongly reflects and enforces that balance."

As we approach the 21st century, an important issue for policymakers is whether the balance in U.S. international tax policy struck in the Kennedy Administration remains appropriate. This Chapter considers whether U.S. international tax policy should place greater emphasis on international competitiveness in view of the changes in the global economy since the 1960s.

Section II. presents several industry case studies that illustrate the effects that the extension of subpart F to active business income has had on the ability of U.S. companies to compete internationally. These examples suggest that, absent change in subpart F, U.S. companies may not be able to maintain or increase their international market share in industries affected by these rules.

[1] Notice 98-11, 1998-6 I.R.B. 18.

Section III. reviews a substantial body of economic data and research regarding the effects of U.S. direct investment abroad on the U.S. economy, and U.S. workers in particular. Contrary to concerns raised when subpart F was enacted, the body of evidence strongly favors the view that U.S. direct investment abroad benefits U.S. workers and the U.S. economy as a whole.

Section IV. addresses the question whether U.S. policymakers should be concerned about the international competitiveness of U.S.-headquartered companies and argues that the prosperity of the U.S. economy is closely linked to the competitiveness of U.S. companies.

Section V. reviews the theoretical basis for capital export neutrality as it applies to foreign direct investment, taking into account the vastly greater importance of international portfolio investment flows and recent advances in economic theory. This review calls into question the long-accepted theory that links capital export neutrality to an internationally efficient allocation of capital.

II. How Subpart F Affects the Competitiveness of U.S. Multinationals

In its current incarnation, subpart F is imposed on many types of active business income. While most industrial countries impose current income tax on *portfolio* income earned abroad, few have anti-deferral regimes that extend to as many types of active business income as does subpart F (see Chapter 4). Indeed, in 1990, one-half of the 24 Organisation for Economic Cooperation and Development (OECD) member countries not only deferred but *exempted* active foreign business income from home country taxation, either by statute or under the terms of a tax treaty (see Table 6–1).

Table 6–1. Taxation of Foreign Business Income, OECD Countries: 1990

Territorial (exemption) tax system	
Treaty and nontreaty countries	*Treaty countries only*[2]
1. Austria	1. Australia[3]
2. Belgium[1]	2. Canada
3. France	3. Denmark[4]
4. Finland	4. Sweden
5. Luxembourg	5. Germany
6. Netherlands	
7. Switzerland[5]	

Worldwide tax system with foreign tax credit	
Treaty and nontreaty countries	*Treaty countries only*[6]
1. Greece	1. Ireland
2. Iceland	2. Norway
3. Italy	3. Portugal
4. Japan	
5. New Zealand	
6. Spain	
7. Turkey	
8. United Kingdom	
9. United States	

Table notes:

[1] Exempts 90 percent of gross dividend.

[2] For non-treaty countries, worldwide tax with credit system applies.

[3] Treaty countries with tax systems similar to Australia.

[4] Ownership requirement of 25 percent; must have tax system similar to Denmark.

[5] Switzerland credits Swiss tax on foreign dividends, effectively exempting these dividends from Swiss tax.

[6] For nontreaty countries, a deduction rather than credit is allowed for foreign taxes.

Source: OECD, TAXING PROFITS IN A GLOBAL ECONOMY: DOMESTIC AND INTERNATIONAL ISSUES, 1991.

The following three case studies illustrate how the operation of subpart F makes it difficult for U.S. multinational companies to compete successfully abroad in three industries:

- Pipeline transmission of oil and gas products;
- Foreign flag shipping; and
- Insurance.

A. Case Study 1: Pipeline Transmission of Oil and Gas Products

The Tax Equity and Fiscal Responsibility Act of 1982 expanded subpart F to include certain income from the pipeline transportation of oil, gas, and primary products—referred to as "foreign base company oil-related income." In general, subpart F applies to pipeline transportation income in any country where the product is neither produced nor sold in that country by the transporter.

This treatment seemingly is contrary to the original intent of subpart F, which primarily was aimed at passive and other easily moveable income. Pipeline transportation income is neither passive nor easily moveable. Moreover, no other major industrial country has special rules that sweep pipeline income into its anti-deferral regime. Consequently, U.S. companies find it difficult to compete with foreign-based multinationals for pipeline projects that would generate income subject to subpart F.

Table 6–2 illustrates the anti-competitive effect of the foreign base company oil-related income rules using realistic assumptions.[2] In the example, pipeline investment is $1,000, revenues are $250, and net earnings[3] are $100 after $105 of operating, maintenance and interest expenses, and $45 of depreciation expense.[4]

Under the tax law of the country in which the pipeline is located, the depreciation period is 10 years, so the annual depreciation charge for the first 10 years of pipeline operation is $100 (compared to $45 for U.S. tax purposes); consequently, foreign taxable income is $45 (compared to $100 for U.S. tax purposes). Assuming a foreign income tax rate of 33 percent, annual foreign tax liability is $15 for the first 10 years of pipeline operation.

If the pipeline company were owned by a foreign multinational, the foreign owner generally would pay no home country tax on the $85 of pipeline earnings after local income tax of $15. This generally is the case either because the parent country exempts foreign dividends under a territorial tax system, or because the country's anti-deferral rules do not reach pipeline income.

---

[2] *See* PricewaterhouseCoopers, *Revenue Estimating Issues Related to Subpart F Pipeline Income,* July 1998.

[3] Net earnings refers to "earnings and profits" under U.S. tax rules.

[4] Based upon straight-line depreciation over 22 years.

Table 6–2. Effect of Subpart F on U.S.-Owned Foreign Pipeline

Item	Foreign-owned pipeline	U.S.-owned pipeline: Same pre-tax revenues as foreign-owned pipeline	U.S.-owned pipeline: Same after-tax income as foreign-owned pipeline
Pipeline Investment	$1,000	$1,000	$1,000
Pipeline revenues	$250	$250	$359
Operating & maintenance expenses	$60	$60	$60
Interest & depreciation	$90	$90	$90
Net Earnings	$100	$100	$209
Subpart F inclusion	NA	$100	$209
Foreign taxable income	$45	$45	$154
Foreign income taxes at 33%	$15	$15	$51
Net earnings after foreign tax	$85	$85	$158
Home country tax before foreign tax credit at 35%	$0	$35	$73
Foreign tax credit*	NA	$0	$0
Net earnings after foreign & home taxes	$85	$50	$85

*Due to allocation of U.S. interest expense against foreign-source income, U.S. taxpayer has overall foreign loss and has a foreign tax credit limit of zero.

By contrast, if the pipeline company is U.S.-owned, and the pipeline generates foreign base company oil-related income under the U.S. subpart F regime, the U.S. multinational would pay both $35 of federal income tax (on the $100 of foreign earnings) and $15 of foreign income tax. A U.S. pipeline company typically will be unable to credit the $15 of foreign income taxes paid against U.S. tax liability because the allocation of U.S. interest expense against foreign-source income causes an overall foreign loss that "zeroes out" the foreign tax credit limitation.

The net result is that the U.S. pipeline company earns $50 after foreign and domestic income tax, compared to $85 for a foreign pipeline company—a *41 percent lower rate of return.* To earn the same after-tax rate of return as the foreign pipeline company, the U.S. company would need to charge 44 percent more than its foreign competitor (generating pipeline revenues of $359 as compared to $250 for the foreign competitor).[5]

The competitive disadvantage of U.S. tax rules generally is too large to overcome in pipeline projects where a significant portion of the income will be taxed under subpart F. As of the date of this writing, industry sources indicate there is no example in which a U.S. company has successfully bid on a foreign pipeline project that would have generated foreign base company oil-related income under subpart F.[6]

B. Case Study 2: Foreign-Flag Shipping

Before 1975, the foreign shipping income of U.S. controlled foreign corporations (CFCs) was taxed only when repatriated as dividends under general deferral rules. The Tax Reduction Act of 1975 extended subpart F to shipping income, but provided an exception to the extent the income was reinvested in qualified shipping assets. The Tax Reform Act of 1986 repealed this exception, thus making all foreign shipping income subject to current U.S. taxation. The extension of subpart F to foreign shipping income, along with other 1986 Act changes,[7] has made it much more expensive for U.S. companies to operate foreign flag shipping fleets as compared to foreign-headquartered competitors.

The effect of the 1986 Act can be illustrated by the following simple example. A U.S. company and a Japanese company both own and operate a shipping fleet through a Panamanian corporation, which is a common flag of convenience used by international shippers. Both companies have similar costs—for crews, fuel, and vessels—and, for the sake of example, both companies earn $1,000 from international shipping operations. This income is assumed not to be taxable under Panama's income tax system.

Under these facts, the Japanese-owned company can reinvest its $1,000 of profits in new shipping assets, and is not liable for tax in Japan until its shipping profits are repatriated. By contrast, the U.S.-owned shipping company is subject to $350 of U.S. income tax because the $1,000 of shipping income earned by its Panamanian subsidiary is deemed to be distributed to the U.S. parent under subpart F. As a result, the U.S. company has only

---

[5] If the U.S. pipeline elects to *deduct* foreign taxes, U.S. transportation rates must be 28 percent higher ($319 vs. $250) than a foreign competitor to earn the same after-tax return.

[6] U.S. international tax rules reduce the competitiveness of U.S. multinationals in many industries—not just the industries that are the subject of the three case studies included in this report.

[7] Other changes included changing the source rules to increase U.S.-source income, disallowing pre-1987 accumulated deficits, and establishing a separate foreign tax credit limitation for shipping income.

$650, after tax, to invest in new shipping assets. Consequently, the cost of capital for the U.S. shipping company is *over 50 percent higher* than for its Japanese competitor, because the U.S. company must earn over $1,000 of shipping income to finance the same amount of investment that the Japanese company can finance with $650 of income.

Data on the U.S.-owned share of the foreign-flag shipping fleet are consistent with the view that the extension of subpart F to shipping income has caused a dramatic decline in the ability of U.S. shipping companies to compete internationally. The U.S.-owned share of the world's open-registry shipping fleet has declined from 26 percent in 1975 (when subpart F was extended to shipping income), to 14 percent in 1986 (when the reinvestment exception was eliminated), to just 5 percent in 1996.[8]

The precipitous decline in U.S. market share is very likely connected to the change in the U.S. tax regime, as the other costs of operation are generally similar for U.S. and foreign operators. Moreover, there are a number of examples of U.S. companies selling 51 percent ownership in foreign shipping companies, presumably because subpart F applies only to U.S. CFCs. It is difficult to see how the U.S. economy or the U.S. Treasury has benefitted from the decline in the U.S.-controlled foreign flag fleet. In fact, the data indicate that the U.S. Treasury actually collects less tax on foreign shipping income under the current subpart F regime than was the case under the pre-1975 tax law with full deferral.[9]

C. Case Study 3: Insurance

In 1997, Congress provided a one-year exception from the subpart F rule under which U.S. parent companies are taxed currently on certain financial services income, including investment income and non-same country underwriting income of life insurance companies. In 1998, Congress extended this exception for one additional year. To assess the competitive implications of subpart F, a recent study compared the total tax burden on a hypothetical foreign life insurance subsidiary owned respectively by a U.S., Dutch, French, German, and U.K. parent company.[10]

Of the five countries studied, only the United States and the United Kingdom generally tax parent companies on dividends received from foreign subsidiaries. Dividends paid by foreign subsidiaries to parent

---

[8] Price Waterhouse, *Decline in the U.S.-Controlled Share of the Open Registry Merchant Shipping Fleet Since 1975,* June 6, 1997.

[9] *Id.*

[10] C. Dunahoo, *et al., International Competitiveness of U.S. Life Insurance Companies: Vetoed Section 1175 of the Taxpayer Relief Act of 1997,* Tax Notes at 1769-73 (September 29, 1997).

companies in France and the Netherlands generally are exempt under the territorial tax systems in those countries, and Germany exempts dividends from foreign subsidiaries in countries with which it has concluded tax treaties. The United States and the United Kingdom tax dividends received from foreign subsidiaries, but provide a credit for foreign income taxes paid, limited to the domestic tax on the foreign-source income. (Germany provides similar treatment for dividends received from non-treaty countries). Other than the United States, none of the countries have a subpart F regime that extends to the investment and non-same country underwriting income of foreign life insurance subsidiaries.

The study considered a hypothetical life insurance subsidiary incorporated in a rapidly growing foreign market that sells insurance contracts to residents of that country. The foreign country is assumed to impose a corporate income tax at a rate of 30 percent and a withholding tax at a rate of 5 percent on dividend distributions. Under foreign law, the taxable income of the life insurance subsidiary is measured using accounting principles similar to those used for U.S. regulatory purposes, while for U.S. tax purposes, the relevant income measure is earnings and profits (which typically is accelerated compared to financial accounting income). Absent the temporary exception, 25 percent of the subsidiary's earnings and profits are assumed to be treated as a deemed dividend to the U.S. parent under subpart F. Actual dividends are assumed to be 20 percent of net income.

Under these facts, absent the temporary exception from subpart F, the worldwide (domestic plus foreign) effective tax rate on a U.S.-owned foreign life insurance subsidiary's income would be 38.1 percent. If the same foreign subsidiary were owned by a parent company in any of the four other countries, the effective tax rate would be 30.7 percent—7.4 percentage points less (see Table 6–3). Consequently, absent subpart F relief, the U.S.-owned foreign life insurance subsidiary would be subject to a total tax burden *24.1 percent greater* than a subsidiary owned by a Dutch, French, German, or U.K. parent.

The tax disadvantage confronted by a U.S.-controlled foreign life insurance subsidiary can be attributed to three sources: (1) the application of subpart F, but for the temporary exception; (2) the use of earnings and profits to measure U.S. taxable income (rather than taxable income as defined under foreign law); and (3) the higher (35 percent) U.S.

Table 6–3. Effective Tax Rate on Foreign Life Insurance Subsidiary, by Home Country, 1997

[Worldwide income tax as a percentage of subsidiary's pre-tax financial income]

Home country	Effective tax rate
United States, current law[2]	38.1%
Other countries:	
United Kingdom	30.7%
France, Germany, Netherlands	30.7%

Source: C. Dunahoo, A. Lyon, and P. Merrill, "International Competitiveness of U.S. Life Insurance Companies: Vetoed Section 1175 of the Taxpayer Relief Act of 1997," TAX NOTES (September 29, 1997) pp. 1769–73.

Table 6–4. Effective Tax Rate on Foreign Life Insurance Earnings: Reconciliation

[Worldwide income tax as a percentage of subsidiary's pre-tax financial income]

Item	Effective tax rate
United States, without active finance exception	38.1%
United States, with temporary active finance exception	33.0%
As above and conform E&P to book income	31.0%
As above and reduce U.S. corporate rate to 33.5% or less	30.7%

Source: C. Dunahoo, A. Lyon, and P. Merrill, *International Competitiveness of U.S. Life Insurance Companies: Vetoed Section 1175 of the Taxpayer Relief Act of 1997,* TAX NOTES (September 29, 1997) pp. 1769–73.

corporate income tax rate as compared to the 33 percent rate in the United Kingdom (see Table 6–4).[11]

Under the facts in this example, the temporary exception to subpart F eliminated 70 percent of the extra tax burden (5.1 out of 7.4 percentage points) borne by U.S.-owned foreign life insurance subsidiaries as compared to their Dutch, French, German, and U.K. competitors (see Table 6–4).[12]

---

[11] Note that the United Kingdom has subsequently reduced its corporate tax rate to 30 percent.

[12] Similar results have been found for the property and casualty insurance industry. *See* Thomas Horst, THE TAXATION OF FOREIGN INCOME OF FINANCIAL SERVICE COMPANIES (American Council for Capital Formation, 1997).

D. Conclusion

In each of the three industries examined—oil and gas pipeline, shipping, and life insurance—the U.S. subpart F regime can cause the cost of capital for U.S. multinationals to be substantially higher than for competitors headquartered abroad. As a result, U.S. multinationals can be expected gradually to lose market share in these and other industries in which U.S. multinationals confront higher tax burdens than their foreign-based competitors. In some cases, the U.S. tax disadvantage may be overcome through higher productivity or quality, but this will not always be possible. The precipitous decline in the U.S.-owned share of the world's open-registry shipping fleet is indicative of the loss in world market share that can occur where it is difficult for U.S. multinationals to offset the higher tax burdens imposed by subpart F through cost advantages or product differentiation.

III. Is U.S. Direct Investment Abroad Harmful?

While acknowledging the anti-competitive implications of subpart F, opponents of deferral frequently argue that U.S. direct investment abroad comes at the expense of the U.S. economy. From this perspective, subpart F is viewed as protecting the U.S. economy in general—and U.S. workers specifically—from the flow of U.S. investment abroad. Opponents of deferral often oppose free trade agreements because the free flow of goods across national borders, much like the free flow of investment, is perceived as jeopardizing domestic jobs.

The data and economic studies summarized below, however, support the view that outward investment is beneficial rather than harmful to the home country economy. As noted in a recent report of the Organisation for Economic Cooperation and Development (OECD), critics of outward direct investment sometimes fail to look at the broader economic ramifications:

> "The effects of direct investment *outflows* on the source country, particularly on employment are sometimes still regarded with some disquiet. Most concerns regarding the effects of FDI [foreign direct investment] outflows may arise because investment is viewed statically and without due regard to the spillover effects it generates at home and abroad. In fact, however, domestic firms and their employees generally gain

> from the freedom of businesses to invest overseas. As with trade, FDI generally creates net benefits for host and source countries alike."[13]

A. Background: Why Do U.S. Corporations Invest Abroad?

Contrary to the idea some commentators have that U.S. corporations set up foreign affiliates as substitutes for U.S. operations, the latest U.N. report on foreign investment finds that "accessing markets will remain the principal motive for investing abroad."[14] Tariff and non-tariff barriers, transportation costs, local content requirements, location of natural resources, location of customer facilities, and other factors frequently make investing abroad the only feasible option for successfully penetrating foreign markets. Moreover, a local presence generally is required for services industries such as finance, retail, legal, and accounting.[15] In addition, multinational customers frequently prefer to deal with suppliers and service providers that have operations in all of the jurisdictions in which they operate. Foreign investment also allows U.S. parent companies to diversify risks; through diversification, a downturn in the home market may be offset by an upturn abroad.

High-income countries provide the most lucrative opportunities for U.S. multinationals. As a result, government data show that the bulk of U.S. direct investment abroad goes to high-wage, high-income countries. In 1996, U.S. multinationals located 81 percent of assets and 68 percent of employment in high-income developed countries rather than low-wage developing nations.[16] This pattern of investment is consistent with the view that the presence of rich consumer markets is a much more important explanation for U.S. investment abroad than low wages. Low wages typically indicate low productivity, so there is little if any advantage to be obtained from manufacturing in low-wage jurisdictions, particularly where the physical infrastructure (*e.g.*, transportation, communication, electricity, and water services) and legal infrastructure are not adequately developed.

Further evidence for the hypothesis that U.S. direct investment abroad is attracted by *consumer demand* rather than low-cost *labor supply* is the fact that less than 10 percent of U.S. CFC sales were exported to the United

---

[13] OECD, Open Markets Matter: The Benefits of Trade and Investment Liberalisation 49 (1998).

[14] UNCTAD, World Investment Report xix (1997).

[15] *See* OECD, Open Markets Matter: The Benefits of Trade and Investment Liberalisation 50 (1998).

[16] Developed countries are defined here as European countries, Australia, Canada, Hong Kong, Japan, New Zealand, Singapore, and South Africa. *See* U.S. Dep't of Commerce, U.S. Direct Investment Abroad (September 1998).

States (Table 6–5). If U.S. investment abroad were motivated by the desire to substitute cheap foreign labor, rather than to serve foreign markets, one would expect a significant amount of U.S. multinational production abroad to be shipped back to the United States.[17]

Table 6–5. Destination of U.S. CFC Sales, 1995

Sales destination	Sales ($ billions)	Percent of total
Local sales in foreign country	$1,214	67.7%
Exports to other foreign countries	$412	23.0%
Exports to the United States	$168	9.3%
Total sales of U.S. CFCs	$1,794	100.0%

Source: PricewaterhouseCoopers calculations based on U.S. Department of Commerce data.

If U.S. investment abroad were attracted by low wages, as critics contend, foreign employment and production of U.S. multinationals abroad would be rising in comparison to domestic employment and production. In fact, the output and employment of U.S. CFCs has declined as a share of domestic output and employment since the CFC data were first published by the Bureau of Economic Analysis in 1982 (Table 6–6).

Table 6–6. U.S. CFCs and the U.S. Economy: 1982, 1996

[Excludes banks]

Item	1982	1996
	Gross product (billions of dollars)	
U.S. CFCs	$224	$498
U.S. domestic economy	$3,242	$7,576
CFCs as a percent of U.S. domestic economy	6.9%	6.6%
	Employment (thousands)	
U.S. CFCs	5,022	6,158
U.S. domestic economy	99,526	126,708
CFCs as a percent of U.S. domestic economy	5.0%	4.9%

Source: PricewaterhouseCoopers calculations based on U.S. Dept. of Commerce data.

[17] *See* Peter Merrill & Carol Dunahoo, *Runaway Plant Legislation: Rhetoric and Reality,* TAX NOTES 221-226 (July 8, 1996) or TAX NOTES INTERNATIONAL 169-174 (July 15, 1996).

B. Indirect Benefits to Domestic Economy from Investment Abroad

The centrality of the sales expansion function of foreign affiliates suggests that the operations of U.S. parent firms and their foreign affiliates are mutually reinforcing rather than substitutes. Direct investment abroad frequently leads to additional exports of machinery and other inputs into the manufacturing process as well as additional demand at home for headquarters services such as research, engineering, and finance. The parent companies of U.S. multinationals purchase over 90 percent of their inputs from U.S.-based suppliers.[18]

1. Exports

U.S. multinational corporations play a crucial role in U.S. foreign trade. As affiliates establish production and distribution facilities abroad, export data indicate that they source a large quantity of inputs from the United States. The most recent data show that foreign affiliates of U.S. multinationals purchased $194 billion of merchandise exports from the United States in 1996. U.S. multinationals also exported an additional $213 billion of merchandise to unaffiliated foreign customers. In total, U.S. multinationals were responsible for $407 billion of merchandise exports in 1996, representing 65 percent of all U.S. merchandise exports.

Academic studies support the hypothesis that U.S. investment abroad promotes U.S. exports. For example, Prof. Robert Lipsey finds a strong positive relationship between manufacturing activity of foreign affiliates of U.S. corporations and the level of exports from the U.S. parent company.[19] A recent study based on 14 OECD countries found that "each dollar of outward FDI is associated with $2 of *additional* exports and with a bilateral trade surplus of $1.7."[20] These studies support the conclusion that if U.S. investment abroad were curtailed, exports would be lower.

2. Headquarters Services

In addition to their role in increasing demand for U.S. exports, foreign affiliates of U.S. corporations also increase the demand for U.S. headquarters services such as management, research and development, technical expertise,

---

[18] Matthew Slaughter, GLOBAL INVESTMENTS, AMERICAN RETURNS (Emergency Committee for American Trade, 1998).

[19] Robert E. Lipsey, *Outward Direct Investment and the U.S. Economy, in* THE EFFECTS OF TAXATION ON MULTINATIONAL CORPORATIONS (M. Feldstein, et al., eds., 1995).

[20] *See* OECD, OPEN MARKETS MATTER: THE BENEFITS OF TRADE AND INVESTMENT LIBERALISATION 50 (1998).

finance, and advertising. These support activities expand as U.S. affiliates compete successfully abroad.

For example, nonbank U.S. multinationals performed $113 billion of research and development in 1996 of which $99 billion, or 88 percent, was performed in the United States.[21] By contrast, 67 percent of U.S. multinational sales were in the United States.

Foreign direct investment is an important way for U.S. multinationals to increase their return on firm-specific assets, such as patents, brand names, and know-how. As noted by Prof. Lipsey, the ability to earn an enhanced return on these firm specific assets increases the reward from these activities, and increases investment in these assets domestically. Profs. Lipsey and Kravis also stress the importance of foreign sales to U.S. research and development intensity.[22]

Headquarters functions, such as research and development, finance, and management, are the types of activities that are prospering in the information-oriented economy. As such, some economists have argued that U.S. tax policy should seek to make the United States an attractive location for multinational corporations to establish their headquarters.[23] Unfortunately, because of subpart F and other aspects of U.S. international tax rules, the United States is one of the least attractive jurisdictions—from a tax perspective—for a multinational corporation's headquarters.[24]

C. U.S. Investment Abroad and U.S. Employment

Rather than draining jobs and production from the United States, the economic evidence points to the opposite conclusion—U.S. investment abroad increases activity at home. The complementary relationship between the foreign and domestic operations of U.S. multinational corporations means that U.S. workers need not be harmed by U.S. investment abroad.[25] Profs. David Riker and Lael Brainard find complementarity in U.S. multinational corporations' demand for labor at home and abroad:

---

[21] U.S. DEPARTMENT OF COMMERCE, SURVEY OF CURRENT BUSINESS, (September 1998).

[22] Irving Kravis & Robert Lipsey, *Sources of Competitiveness of the United States and of its Multinational Firms,* REVIEW OF ECONOMICS AND STATISTICS (May 1992). *See also,* Lipsey, *supra* note 19, and Slaughter, *supra* note 18.

[23] *See* Gary Hufbauer, U.S. TAXATION OF INTERNATIONAL INCOME: BLUEPRINT FOR REFORM (Institute for International Economics, 1992).

[24] *See* PRICE WATERHOUSE LLP, TAXATION OF U.S. CORPORATIONS DOING BUSINESS ABROAD: U.S. RULES AND COMPETITIVENESS ISSUES (Financial Executives Research Foundation, 1996).

[25] *See* OECD, OPEN MARKETS MATTER: THE BENEFITS OF TRADE AND INVESTMENT LIBERALISATION 73-76 (1998).

> "The fundamental empirical result is that the labor demand of U.S. multinationals is linked internationally at the firm level, presumably through trade in intermediate and final goods, and this link results in complementarity rather than competition between employers in industrialized and developing countries."[26]

The foreign operations of U.S. companies also are associated with higher wages of U.S. workers. U.S. companies that invest overseas, on average, pay higher domestic wages than do purely domestic companies in the same industries. Profs. Mark Doms and Bradford Jensen find that U.S. parent companies pay higher wages to their entire workforce, and that the wage premium in percentage terms is greater for lower paid production workers than for higher paid non-production workers.[27] Prof. Slaughter interprets this as evidence that U.S. parent companies promote a more equal distribution of income by paying higher wage premiums to traditionally lower paid workers.[28]

The relationship between the ability of U.S. companies to compete abroad and their ability to provide employment opportunities at home was noted by the Council of Economic Advisers in the 1991 *Economic Report to the President:*

> "In most cases, if U.S. multinationals did not establish affiliates abroad to produce for the local market, they would be too distant to have an effective presence in that market. In addition, companies from other countries would either establish such facilities or increase exports to that market. In effect, it is not really possible to sustain exports to such markets in the long run. On a net basis, it is highly doubtful that U.S. direct investment abroad reduces U.S. exports or displaces U.S. jobs. Indeed, U.S. direct investment abroad stimulates U.S. companies to be more competitive internationally, which can generate U.S. exports and jobs. Equally important, U.S. direct investment abroad allows U.S. firms to allocate their resources more

[26] David Riker & Lael Brainard, *U.S. Multinationals and Competition from Low Wage Countries,* NBER Working Paper No. 5959 (1997).

[27] Mark Doms & Bradford Jensen, *Comparing Wages, Skills, and Productivity Between Domestic and Foreign Owned Manufacturing Establishments in the United States,* mimeo., October 1996.

[28] Matthew J. Slaughter, *Production Transfer Within Multinational Enterprises and American Wages,* mimeo., March 1998.

efficiently, thus creating healthier domestic operations, which, in turn, tend to create jobs."[29]

D. Returns to U.S. Investors

U.S. shareholders in U.S. multinationals directly realize the benefits of the high profits and risk diversification offered by international operations. The pre-tax return on assets earned by U.S. CFCs was almost 30 percent higher than the return earned on domestic corporate investment in 1995.[30] These foreign profits totaled $150 billion, and accounted for about 18 percent of all U.S. corporate profits in 1997.[31]

The profits earned abroad by U.S. multinationals are part of U.S. national income (GNP) and are reflected in their corporate share valuations. Moreover, much of the income earned abroad by foreign subsidiaries is distributed back to the United States. According to the most recent available IRS data, in 1994, distributions from the largest U.S. CFCs totaled $50 billion, amounting to 67 percent of their net after-tax earnings and profits.

Academic research has found a large premium in the returns from foreign investment as compared to domestic investment. Prof. Martin Feldstein concludes that an additional dollar of foreign direct investment by U.S. corporations, in present value, leads to 70 percent more interest and dividend receipts and U.S. tax payments than an additional dollar of domestic investment.[32]

E. Conclusion

Fears that U.S. investment abroad comes at the expense of output, income, and employment at home are *not* supported by data or economic research. Rather, the evidence strongly confirms that market access, rather than cheap labor, motivates foreign direct investment. The overwhelming majority of foreign direct investment is in high-wage countries, and very little of the foreign output of U.S. multinationals is shipped back to the United States. Numerous studies have found that foreign investment not only produces higher returns to U.S. investors but also is complementary with economic activity in the United States—leading to increased exports and high-paid research, engineering, and other headquarters jobs in the United States. There is no evidence that U.S. investment abroad has reduced employment

---

[29] U.S. COUNCIL OF ECONOMIC ADVISERS, ECONOMIC REPORT OF THE PRESIDENT 259 (1991).

[30] Earnings (excluding capital gains and special charges) before interest and taxes as a percentage of assets, as calculated by the U.S. Dept. of Commerce.

[31] U.S. DEPT. OF COMMERCE, SURVEY OF CURRENT BUSINESS (August 1998).

[32] Martin Feldstein, *Tax Rules and the Effect of Foreign Direct Investment in U.S. National Income, in* TAXING MULTINATIONAL CORPORATIONS (Martin Feldstein, et al., eds., 1995).

or wages in the United States; indeed, the data show that companies with investment outside the United States pay better wages than purely domestic companies in the same industries.[33]

Restricting foreign investment in an attempt to protect domestic employment ultimately is a self-defeating policy. Foreign companies will seize these investment opportunities and increase market share at the expense of U.S. multinationals both at home and abroad.

Like international trade in goods and services, foreign direct investment benefits both home and host countries; thus, it is in the mutual interest of home and host countries to reduce barriers to the free flow of direct investment. In view of the recent downturn that has struck a number of emerging market economies, it is important to distinguish foreign direct investment from international portfolio investment. Portfolio investment, such as investment in short-term government and private debt obligations, can easily be withdrawn at the first hint of an economic reversal. By contrast, foreign direct investment, particularly in plant and equipment, is long-term in nature, and cannot easily be removed. Barriers to U.S. direct investment abroad not only harm the development of foreign countries, but also deprive the U.S. economy of the increased returns, exports, and wages associated with multinational investment.

IV. Is Multinational Competitiveness Important?

A 1991 report by the Congressional Joint Committee on Taxation identified three different measures of international competitiveness: (1) trade competitiveness; (2) standard of living competitiveness; and (3) multinational competitiveness.[34]

- "Trade competitiveness" refers to the ability of U.S. products to compete with foreign products in both U.S. and foreign markets. Trade competitiveness is measured by a country's trade balance.
- "Standard of living competitiveness" refers to the standard of living of U.S. residents as compared to foreign residents and typically is measured by a country's per capita income, taking into account the

[33] For anecdotal evidence from case studies of U.S. multinationals, *see* Matthew Slaughter, *supra* note 18 at Chapter V.

[34] Joint Committee on Taxation, Factors Affecting the International Competitiveness of the United States (May 30, 1991).

purchasing power of this income. Standard of living competitiveness is closely related to labor productivity.

- "Multinational competitiveness" refers to the ability of U.S.-owned companies to operate in foreign markets in competition with foreign-owned companies. Multinational competitiveness can be measured by a country's share of worldwide foreign direct investment, or by the relative rate-of-return earned on this foreign direct investment.

The Joint Committee report concludes that the goal of national policy should be to raise the standard of living of U.S. residents. The report cautions that mercantilist polices designed to improve the balance of trade may not increase the standard of living in the United States; consequently, trade competitiveness is not a reliable guide for policy. The Joint Committee report also cautions that multinational competitiveness relates only to the competitiveness of certain types of entities (*i.e.*, multinational companies) and not necessarily to the competitiveness of the U.S. economy.

In a provocative article, former Labor Secretary Robert Reich argues against multinational competitiveness as a goal for U.S. policy.[35] In Reich's view, where corporations happen to be headquartered is "fundamentally unimportant." Reich believes U.S. policymakers should focus primarily on domestic investments (whether by domestic or foreign companies) and less on the strength of U.S. companies.

In response, Prof. Laura Tyson, former Chair of the Council of Economic Advisers and former Director of the National Economic Council, points out a number of important political, strategic, and economic reasons why maintaining a high share of U.S. control over global corporate assets remains in the national interest.[36]

Tyson argues that, under current conditions, the "competitiveness of the U.S. economy remains tightly linked to the competitiveness of U.S. companies." Tyson offers a number of reasons for this linkage, including:

- U.S. multinationals locate over 70 percent of their assets and employment in the United States;
- U.S. multinationals invest more per employee and pay more per employee at home than abroad in both developed and developing countries;

---

[35] Robert Reich, *Who is Us?* HARVARD BUSINESS REVIEW, January-February 1990, at 53-64.

[36] Laura D'Andrea Tyson, *They are not Us: Why American Ownership Still Matters,* THE AMERICAN PROSPECT (Winter 1991).

- U.S. multinationals perform the overwhelming majority of their research and development at home;
- The leadership of U.S. multinationals is overwhelmingly American;
- Trade barriers frequently require U.S. companies to invest abroad in order to sell abroad; and
- U.S. affiliates of foreign firms rely much more heavily on foreign suppliers than on domestic companies.

Tyson believes that U.S. interests will be advanced through multilateral reductions in trade and investment barriers, and through policies that make the United States an attractive production location for high-productivity, high-wage, and research-intensive activities.

The "who is us?" debate has important ramifications for U.S. international tax policy. If policymakers wish to attract high-end jobs to the United States, they must consider whether the U.S. income tax system makes the United States a desirable location for establishing and maintaining a corporate headquarters. If the U.S. corporate income tax is not competitive, U.S. headquartered companies can be expected to lose world market share with a commensurate loss in the U.S. share of headquarters-type jobs. While the country of incorporation is not necessarily where headquarters functions are located, there is indisputably a very high correlation between legal residence and headquarters operations.

While this report does not claim a causal link, there can be no doubt that the U.S. share of corporate headquarters has declined since the 1960s when subpart F was enacted. Over the last three decades, the U.S. share of worldwide foreign direct investment has declined by more than its share of worldwide GDP.

A number of studies have found that, compared to other major industrial countries, the U.S. income tax system places a relatively high burden on cross-border corporate investment.[37] The tax burden is relatively high for two main reasons: (1) the U.S. international tax regime, including subpart F, is more restrictive than that of most other countries; and (2) unlike most other major industrial countries, the United States does not relieve the double taxation of corporate dividends (at the corporate and shareholder levels).

[37] For an international comparison of U.S. multinational tax competitiveness, *see* PRICE WATERHOUSE LLP, TAXATION OF U.S. CORPORATIONS DOING BUSINESS ABROAD: U.S. RULES AND COMPETITIVENESS ISSUES Chapter 10 (Financial Executives Research Foundation, 1996).

Over time, countries that place relatively high tax burdens on multinational corporations can expect to see a reduction in investment in domestic-headquartered companies. This can occur through a loss in market share and in the net of tax profits available to be reinvested in the business. Alternatively, domestic companies may merge with foreign corporations in transactions that result in a foreign-headquartered company. Recent U.S. examples include the Daimler-Chrysler, BP-Amoco, and Deutsche Bank-Bankers Trust mergers. In these examples, future investments outside the United States will most likely *not* be made by the U.S. merger partner, but instead by the foreign parent, permanently removing such investment from the U.S. corporate income tax net.

Less visibly, foreign-headquartered companies can grow at the expense of U.S.-headquartered companies if U.S. individual investors buy shares of foreign companies on U.S. or foreign exchanges. The growth in U.S. mutual funds that invest in foreign stocks is an illustration of this trend.

While some have raised concerns that a *more competitive* U.S. international tax regime would encourage U.S. companies to move plants abroad ("runaway plants"), a *noncompetitive* U.S. tax regime will increase foreign ownership of corporate assets (what might be called "runaway headquarters"). The less competitive the U.S. regime, the more likely that assets will be owned by foreign-headquartered companies.

The link between an unfavorable tax system and "runaway headquarters" has become apparent in Sweden, where the largest labor union (LO) recently called for a government commission "to investigate the sharp increase in the number of leading companies that are moving their headquarters or management functions overseas."[38] The union, representing blue-collar workers, is concerned that corporate directors located abroad would take a less favorable view towards investment in Sweden.[39] Nordbanken, Nobel Industries, ABB, Ikea, and Tetra Laval have relocated headquarters abroad "either following international mergers or for tax reasons."[40] Among other things, employers have, in part, blamed "Sweden's punitive income taxes" for the decision to locate abroad.[41]

---

[38] Financial Times, January 13, 1999, at 3.

[39] *Id.*

[40] *Id.*

[41] *Id.*

V. Reassessing Capital Export Neutrality

U.S. international tax policy has historically sought to balance two often inconsistent economic principles: competitiveness, and capital export neutrality. Federal tax policy reflects a hybrid approach, with elements of both policy principles. For example, consistent with capital export neutrality, the Internal Revenue Code taxes worldwide income and provides a foreign tax credit, yet inconsistent with capital export neutrality, U.S. taxation of most foreign subsidiary income is deferred and the foreign tax credit is subject to numerous limitations.

A. The Case for Capital Export Neutrality

Capital export neutrality stands for the principle that the decision where to locate investment—whether at home or abroad–should be unaffected by income taxes. A country can achieve capital export neutrality with respect to its resident corporations by taxing their foreign-source income as if earned at home, but with an unlimited credit for foreign income taxes. Under such a system, resident corporations presumably would locate investments where they are most productive. In this sense, capital export neutrality is viewed as a desirable goal for tax policy because it is said to lead to a globally efficient allocation of corporate investment, undistorted by taxation at home or abroad.

B. The Case Against Capital Export Neutrality

Given that capital export neutrality is one of the main justifications offered by proponents of expanding subpart F, it is worth examining carefully its intellectual foundations. In this section, it is argued that capital export neutrality is neither necessary nor sufficient for attaining a globally efficient allocation of capital.

1. Capital Export Neutrality: Theory vs. Practice

No country, including the United States, has adopted a tax system consistent with the capital export neutrality principle. No country taxes all foreign-source income on a current basis, and none allows an unlimited foreign tax credit. In particular, the United States imposes numerous limitations on its foreign tax credit, most of which are inconsistent with the capital export neutrality principle.[42] Unilateral implementation of capital export neutrality

[42] *See* R. Glenn Hubbard, *U.S. Tax Policy and Foreign Direct Investment: Incentives, Problems and Reforms,* 3 TAX POLICY AND ECONOMIC GROWTH (American Council for Capital Formation, Washington, DC, 1995); and Daniel J. Frisch, *The Economics of International Tax Policy: Some Old and New Approaches,* TAX NOTES (April 30, 1990).

principles by the United States, in a world where no country follows these principles, would not necessarily improve the global allocation of capital.

2. Corporate-Level Capital Export Neutrality Does Not Guarantee Investment Efficiency

If portfolio investment is internationally mobile, imposition of capital export neutrality at the corporate level is not sufficient to achieve an internationally efficient allocation of investment. As noted in Chapter 5, OECD data indicate that annual cross-border portfolio capital flows are now larger than direct investment flows.

Consider, for example, a U.S. microprocessor company that, through superior technology, achieves a 16 percent operating margin (pre-tax profits as a percent of revenues), whereas its foreign competitor is able to achieve only a 15 percent operating margin (see Table 6–7, below). Both the U.S. company and the foreign company are evaluating an opportunity to establish a fabrication facility in a country with a 20 percent corporate income tax rate. The foreign competitor is headquartered in a country with a territorial tax system (*i.e.*, active foreign-source income is not subject to home country tax).

On a million dollars of sales from this prospective investment, the foreign company would have pre-tax profits of $150,000 (15 percent of $1 million), $30,000 of corporate income tax liability (20 percent of $150,000), and net earnings of $120,000 available to distribute to

Table 6–7. Example: Investment Opportunity in Foreign Fabrication Facility

[Comparison of U.S. and Foreign Company Return]

Item	U.S. company	Foreign company
Revenues	$1,000,000	$1,000,000
Pre-tax profits		
16% margin	$160,000	
15% margin		$150,000
Corporate income tax		
Foreign @ 20%	$32,000	$30,000
U.S. @ 35%	$24,000	
Distributable earnings	$104,000	$120,000

shareholders ($150,000 less $30,000). By contrast, the U.S. company would have pre-tax profits of $160,000 (16 percent of $1 million), $32,000 of foreign corporate income tax (20 percent of $160,000), $24,000 of U.S. corporate income tax liability after distribution to the U.S. parent (35 percent U.S. corporate income tax rate times $160,000 of foreign profits less $32,000 foreign tax credit), and net earnings of $104,000 available to distribute to shareholders ($160,000 less $32,000 of foreign tax and less $24,000 of U.S. tax).[43] Thus, an individual investor would earn $120,000 per million of sales by investing in the foreign company, compared to only $104,000 per million of sales by investing in the U.S. company, even though the U.S. company has higher productivity.

As this example makes clear, *application of the capital export neutrality principle at the corporate level not only fails to guarantee an internationally efficient allocation of capital, but it also puts the company that is headquartered in a capital export neutrality jurisdiction at a distinct competitive disadvantage.* This occurs because shareholders in capital export neutrality countries can invest abroad without suffering home country corporate income tax, by purchasing shares in foreign-owned multinationals. As a result, over time, multinational corporations headquartered in high-tax countries that tax on the basis of capital export neutrality will be "squeezed out" of low-tax jurisdictions. This appears to have occurred in the shipping industry, where U.S. ownership of foreign flag shipping assets has dropped precipitously at the same time that the United States has imposed current taxation on foreign-source shipping income.

Application of the capital export neutrality principle at the corporate level also may fail to achieve efficiency in the allocation of capital as a result of the manner in which many countries provide relief from the double taxation of corporate income. Some countries provide a shareholder-level credit (imputation credit) for dividends distributed by domestic corporations to resident shareholders out of domestic-source income. In these countries, a resident investor may prefer to invest in a relatively unproductive domestic corporation because the home country provides an individual-level credit for dividends received from domestic, but not foreign, corporations. Similarly, a domestic corporation may prefer to invest at home rather than abroad, because only domestic-source income is taken into account for purposes of the imputation credit. Thus, a tax system with an imputation credit system *cannot* be expected to achieve an internationally efficient allocation of capital even if it follows capital export neutrality principles at the corporate level.

[43] This example assumes that foreign-source income is defined in the same way for local and U.S. tax purposes.

3. Internationally Efficient Allocation of Savings

Implementation of the capital export neutrality principle reduces the after-tax rate-of-return earned by residents of high tax countries as compared to residents of low tax countries. This occurs because, under a capital export neutrality system, the home-country tax rate is imposed on all income, whether foreign or domestic source.[44] As a result, adoption of capital export neutrality principles would depress savings in high tax countries as compared to low-tax countries. Thus, capital export neutrality principles lead to an internationally *inefficient allocation of savings*. Policymakers must, therefore, balance the potential gains in international investment efficiency from adoption of capital export neutrality principles, against the potential losses from international savings inefficiency.[45]

4. National Neutrality and Imperfect Competition

Some have argued that the objective of U.S. international tax policy should not be to maximize global welfare, but rather to maximize *domestic* welfare. If domestic welfare is the objective, it is argued that the tax system should encourage U.S. companies to invest in the locations that produce the highest return *net of foreign income taxes,* because foreign tax payments are of no benefit to the U.S. economy. This is referred to as the doctrine of "national neutrality." Profit-maximizing companies would invest in this manner if the United States had no income tax system. The national neutrality doctrine frequently is equated with a tax system in which foreign-source income is taxed in the same manner as domestic income (branch model), but with foreign income taxes *deducted* in the same manner as other current business expenses.

The U.S. Treasury Department has long identified *global* welfare maximization as the appropriate goal for U.S. tax policy. In principle, the economic position of all countries can be improved if all pursue policies that maximize global (rather than national) economic output.

Whether global or national welfare maximization is the goal, the traditional theory that links particular tax regimes with these objectives is based on a highly stylized view of multinational companies. Under this view, foreign direct investment is indistinguishable from portfolio investment. In a recent paper, Professors Michael P. Devereux and

---

[44] This discussion disregards the possibility of cross-border portfolio investment. If portfolio investment is internationally mobile, capital export neutrality fails to achieve investment efficiency (as discussed above), but does not distort the international allocation of savings.

[45] Thomas Horst, *A Note on the Optimal Taxation of International Investment Income,* 94 Q. J. OF ECON. 793-798 (1980).

R. Glenn Hubbard[46] re-examined the theory of optimal tax policy taking into account two salient economic characteristics of foreign direct investment that distinguish it from portfolio investment: (1) returns that exceed the cost of capital (*i.e.,* economic rents) due to factors such as intangibles and company-specific cost advantages; and (2) choices between mutually exclusive investment projects.

Devereux and Hubbard observe that the economics literature on multinational corporations emphasizes the presence of economic rents and that empirical studies of foreign direct investment find that investment location decisions are more closely related to *average* rather than *marginal* tax rates. These empirical observations support the view that foreign direct investment differs fundamentally from portfolio investment.

When Devereux and Hubbard take into account more realistic assumptions about the economic characteristics of foreign direct investment, they find that the tax system traditionally associated with national neutrality (current taxation of worldwide income with a deduction for foreign taxes) fails to achieve domestic welfare maximization. Absent foreign country taxation, deferral of taxation of foreign income generally results in higher national welfare than current taxation. At low rates of foreign income tax, a limited foreign tax credit with deferral of foreign income generally dominates current taxation with a deduction for foreign income taxes paid. These results stand the traditional national neutrality theory on its head.

5. Tax Compliance and Administration Costs

Several surveys of large U.S. companies support the ample anecdotal evidence that the U.S. system of taxing foreign-source income of U.S. multinationals entails significant compliance costs.

In 1989, Professors Marsha Blumenthal and Joel Slemrod[47] conducted a survey of 365 firms in the IRS's large case audit program. The survey found that 39.2 percent of total federal tax compliance costs were attributable to foreign-source income. This is much larger than the average foreign share of the companies' businesses—21.1 percent as measured by assets, 24.1 percent as measured by sales, and 17.7 percent as measured by employment (see Table 6–8).

---

[46] Michael P. Devereux and R. Glenn Hubbard, *Taxing Multinationals,* mimeo (January 11, 1999).

[47] Marsha Blumenthal and Joel Slemrod, *The Compliance Cost of Taxing Foreign-Source Income: Its Magnitude, Determinants, and Policy Implications, in* THE TAXATION OF MULTINATIONAL CORPORATIONS (Joel Slemrod, ed., 1996).

Table 6–8. Survey of 365 Firms in IRS's Large Case Audit Program, 1989

Item	Average foreign share
U.S. income tax compliance costs	39.2%
Assets	21.1%
Sales	24.1%
Employment	17.7%

Source: MARSHA BLUMENTHAL AND JOEL SLEMROD, THE COMPLIANCE COST OF TAXING FOREIGN-SOURCE INCOME: ITS MAGNITUDE, DETERMINANTS, AND POLICY IMPLICATIONS.

By contrast, a survey of 965 European companies conducted by the Ruding Committee[48] found no evidence that compliance costs were higher for foreign-source than domestic-source income. While the Ruding Committee did not comment on these results, one possible explanation is that, unlike the United States, many European countries exempt foreign-source business income, and do not have complex anti-deferral regimes and foreign tax credit systems.

The Blumenthal-Slemrod survey suggests that there is ample opportunity to reduce the compliance burden imposed by the U.S. international tax regime. Simplification should be an important consideration in any review of the current anti-deferral rules.

VI. Conclusion

U.S. international tax policy represents a balancing of two generally inconsistent economic principles—*competitiveness* and *capital export neutrality.* Subpart F, enacted in 1962, did not terminate deferral (as would be required to achieve capital export neutrality), but instead limited deferral in certain cases where opportunities for abuse were perceived to exist. In subsequent amendments to subpart F, the balance has generally shifted in favor of capital export neutrality and away from competitiveness.

As we approach the end of the 20th century, there are important reasons to re-examine the current balance point embodied in the subpart F rules:

[48] The Ruding Committee was formed in 1990 to assess the need for greater tax harmonization in the European Union. The committee released a report in 1992, containing a number of recommendations on company taxation within the European Union.

- U.S. multinationals face much greater global competition than was the case when subpart F was first enacted.
- No country, including the United States, has adopted international tax rules that are consistent with capital export neutrality. None imposes current tax on all foreign-source income and none has an unlimited foreign tax credit. Indeed, half of the OECD countries *exempt* foreign-source business income either by statute or treaty—these countries do not tax foreign-source income even when it is distributed.
- Annual foreign portfolio investment now exceeds foreign direct investment. With the growth in portfolio capital flows, imposition of capital export neutrality tax rules upon foreign direct investment does *not* necessarily improve international capital allocation, but does make it more difficult for U.S. multinationals to compete abroad.
- The theoretical link between current taxation of foreign-source income and efficient investment location depends crucially on a stylized view that treats foreign direct investment as indistinguishable from portfolio investment. Empirical evidence, however, suggests that this stylized view of foreign direct investment is incorrect. When more realistic assumption are adopted, Professors Devereux and Hubbard find that deferral, rather than current taxation, is most consistent with national welfare maximization (for investments in low-tax foreign countries).

Both changes in the international economic environment and refinements in the theory of international taxation are consistent with a re-balancing of U.S. international tax policy towards competitiveness and away from capital export neutrality. This could be accomplished by narrowing the scope of subpart F to passive income. A secondary benefit from such a shift in policy would be a major simplification of U.S. tax rules, as the subpart F rules are a source of substantial complexity and tax controversy. Such a shift also would tend to harmonize U.S. tax rules with those of other major industrial countries that target their anti-deferral rules more narrowly on passive-type income.

Appendix

Chronological Summary of Principal Modifications to Subpart F, 1962 to 1998

I. Introduction

This appendix reviews the history of subpart F decade by decade, starting with its enactment in 1962 and the changes that began to be made almost immediately in the 1960s, and continuing with the constant stream of amendments through the 1970s, 1980s, and 1990s. While Congress has sometimes tightened and sometimes relaxed the subpart F rules over the years, it is clear that the overall trend has been to expand their scope.

II. Subpart F in 1962

A. Overview

Before describing the changes that have taken place since 1962, it may be helpful briefly to review subpart F as originally enacted and to show that the original version of the rules was much more limited in scope than the current version.

The enactment of subpart F was the outcome of the Kennedy Administration's call for an end to deferral. Then-existing anti-deferral regimes, such as the accumulated earnings tax, the personal holding company tax, and the foreign personal holding company tax, generally did not reach the earnings of offshore subsidiaries controlled by U.S. companies. Congress considered the Administration's proposed response to be too broad, however, and the resulting compromise provided for accelerated taxation (ended deferral) for only four categories of income earned by controlled foreign corporations (CFCs):

- Income from the insurance abroad of U.S. risks;
- Certain passive or investment income;
- Certain related party sales and services income; and
- Otherwise active earnings invested in U.S. property.

A CFC was defined as a foreign corporation in which more than 50 percent of the voting stock was owned by "U.S. shareholders." A "U.S. shareholder" is a "U.S. person" that owns directly or indirectly 10 percent or more of the total combined voting power of a CFC. Mechanically, subpart F ended deferral by requiring U.S. shareholders to include in gross income their pro rata share of the subpart F income of the foreign corporation, of previously excluded subpart F income withdrawn from investment in less developed countries, and of the increase in earnings invested in U.S. property.[1]

Subpart F income included two categories of income: foreign base company (FBC) income and insurance income. FBC income was further divided into foreign personal holding company (FPHC) income, FBC sales income, and FBC services income.

B. Foreign Base Company Income

The largest component of the subpart F income provisions was FBC income, which, in turn, included the following three types of income discussed in 1. to 3. below.

1. Foreign Personal Holding Company Income

While Congress recognized the need for U.S. companies abroad to be on equal competitive footing with other operating businesses in the same countries, it decided not to maintain the deferral of U.S. tax on income that was passive in nature.[2] Such income was brought into FBC income, by way of cross-reference to the definitions in the existing FPHC rules. FPHC income, as defined in I.R.C. § 553, generally included income derived from:

- Dividends, interest, royalties, and annuities;
- Gains from the sale or exchange of stock and securities;
- Gains from the sale or other disposition of any interest in an estate or trust;
- Personal service contracts;

---

[1] I.R.C. § 951(a)(1).

[2] S. Rep. No. 87-1881 (1962).

- Use of corporation property by shareholders; and
- Rents, unless such rents constituted 50 percent or more of the gross income.[3]

However, for subpart F purposes, several modifications were made. First, all rents were included, without regard to the 50 percent limitation in section 553.[4] Second, exceptions were added for various types of income (including rents) that were derived from active business activities. Specifically, FPHC income did not include:

- Rents and royalties that were derived in the active conduct of a trade or business and that were received from an unrelated person.[5]
- Dividends, interest, and certain gains derived in the active conduct of a banking, financing, or similar business, or derived by an insurance company from investments of unearned premiums or certain reserves, if received from an unrelated person.[6]
- Dividends and interest received from related persons if those persons were organized and had a substantial part of their assets within the country of incorporation of the CFC.[7]
- Interest received in the conduct of a banking, financing, or similar business from a related person also engaged in the conduct of a banking, financing, or similar business if the business of both the recipient and payer were predominantly with unrelated persons.[8]
- Rent, royalties, and similar amounts received from a related person for the use of, or the privilege of using, property within the country of incorporation of the CFC.[9]

2. Foreign Base Company Sales Income

The FBC sales income provisions targeted income from the purchase and sale of property, without any appreciable value being added to the product by the selling corporation. Congress was concerned with corporations that separated their manufacturing activities from their selling activities by

[3] I.R.C. § 553(a)(1) - (6)(1962).

[4] I.R.C. § 954(c)(1)(1962).

[5] I.R.C. § 954(c)(3)(A)(1962).

[6] I.R.C. § 954 (c)(3)(B)(1962).

[7] I.R.C. § 954 (c)(4)(A)(1962).

[8] I.R.C. § 954 (c)(4)(B)(1962).

[9] I.R.C. § 954 (c)(4)(C)(1962).

establishing a selling subsidiary corporation (or branch) merely to obtain a lower rate of tax for the sales income.[10] FBC sales income was income derived from the purchase and sale of personal property if the property was either purchased from a related person or sold to a related person, if the property purchased was manufactured, produced, grown, or extracted outside the country where the CFC was organized and the property also was sold for use, consumption, or disposition outside that country.[11]

Notably, the FBC sales rules defined a category of income in which the principal focus was not on the avoidance of U.S. tax, but rather the tax that would have been imposed by the country of manufacture. There was also some discussion of the fact that the base company rules would serve to "backstop" the transfer pricing rules under I.R.C. § 482, by removing an incentive to shift profits to a tax haven sales subsidiary. However, given the broad application of the FBC sales rules to transactions with no U.S. nexus whatsoever, it seems clear that the principal focus of these rules was not the avoidance of U.S. tax, but rather non-tax policy concerns relating to capital investment by U.S.-based companies. Although this aspect of the rules received relatively limited attention in the intervening decades, it has returned to center stage in the debate engendered by Notice 98-11[12] and related pronouncements.

Another aspect of the FBC sales rules has also featured prominently in the debate on Notice 98-11. As defined in 1962, FBC sales income also included operations through a branch outside the CFC's country of incorporation, if the effect of the tax treatment of the branch had substantially the same effect as it would have if that branch were a wholly owned subsidiary corporation. For example, if the CFC's country of incorporation applied a territorial system of taxation, a foreign branch would not be subject to tax in that country, which is effectively the same treatment that a wholly owned subsidiary would receive. Notice 98-11 effectively sought to create a similar branch rule for purposes of the FPHC rules; many commentators have argued that the explicit statutory branch rule in the base company rules, and the absence of a parallel rule under the FPHC provisions, suggest that Treasury lacks the authority to do so.

---

[10] S. Rep. No. 87-1881 (1962).

[11] I.R.C. § 954(d)(1)–(2) (1962).

[12] 1998-6 I.R.B. 18.

3. Foreign Base Company Services Income

The FBC services provisions were similarly aimed at denying tax deferral when a service subsidiary was separated from the manufacturing or similar activities of a related corporation and organized in another country to benefit from a lower tax rate on the service income.[13] Under this provision, FBC services income included income from the performance of technical, managerial, engineering, architectural, scientific, skilled industrial, commercial, or similar services, performed for a related person outside the CFC's country of incorporation.

C. Exclusions and Special Rules for Foreign Base Company Income

The original subpart F provisions included several exceptions to current U.S. taxation of U.S. shareholders of CFCs. First, under a generous *de minimis* rule, FBC income was only taxed to the U.S. shareholders if it represented at least 30 percent of the gross income of the corporation. If it exceeded 70 percent, however, the entire gross income of the corporation was to be treated as FBC income and subject to the subpart F rules. Congress was only concerned with taxing FBC income when it was a major factor and concluded that, if FBC income was only a minor part of gross income, shareholders should not be taxed on any of it.[14]

Second, dividends, interest, and gains that arose from qualified investments in less developed countries were excepted from the subpart F rules to the extent they were reinvested in qualified investments in less developed countries.

Third, income derived from the use (including the hiring or leasing) of aircraft or vessels used in foreign commerce or services directly related to the use of the aircraft or vessels was also excepted from FBC income. This was provided in the interest of national defense and to encourage the U.S.-owned maritime fleet and U.S.-owned airlines operating abroad.[15]

Fourth, any income received by a CFC was excepted from the subpart F rules if it was established to the satisfaction of the Treasury that the CFC was not formed or availed of to effect a substantial reduction of income or similar taxes.

Finally, another major relief from the subpart F rules was that if minimum distributions were made to the U.S. shareholders of CFCs, then

---

[13] S.Rep. No. 87-1881 (1962).

[14] *Id.*

[15] *Id.*

subpart F income would not be taxed in the hands of the U.S. corporate shareholders. The rationale for this rule was that if the combined foreign and U.S. tax was not substantially below the U.S. corporate tax rate, the U.S. shareholders should not be subject to U.S. taxation.[16] The subpart F provisions were concerned with U.S. companies that set up foreign subsidiaries to take advantage of lower tax rates in tax haven countries, but clearly no such advantage was being sought if significant taxes were being paid currently. The minimum distribution required varied with the effective foreign tax rate. The higher the foreign effective tax rate, the lower the required minimum distribution.

D. Income from Insurance of U.S. Risks

The Life Insurance Company Income Tax Act of 1959 had for the first time imposed a tax on the underwriting gains of life insurance companies. Many U.S. companies began reinsuring their policies abroad or placing the initial policy with a U.S.-controlled foreign insurance company to avoid the tax on gains.[17] Congress sought to eliminate this tax avoidance by enacting I.R.C. § 953. A CFC that earned income from the issuing or reinsuring of any insurance or annuity contract with respect to property in, or residents of, the United States, was to be taxable in the hands of the U.S. shareholders as subpart F income. There was a *de minimis* exception for a CFC that received premiums or other consideration relating to U.S. risks that were 5 percent or less of the total premiums and other consideration.[18]

In addition, in the case of insurance, the definition of a CFC was broadened by lowering the U.S. ownership threshold to 25 percent, if U.S. risks represented 75 percent of the gross amount of all premiums and other consideration received with respect to risks held by the company.[19] This rule was intended to cover cases in which the principal business was to insure U.S. risks but control was decreased to avoid application of the subpart F provisions.[20]

E. Investment of Earnings in U.S. Property

The 1962 Revenue Act also provided that U.S. shareholders of CFCs were to be taxed on other earnings of the corporation to the extent of the corpora-

[16] *Id.*

[17] *Id.*

[18] I.R.C. § 953(a) (1962)

[19] I.R.C. § 957(b) (1962).

[20] S. Rep. No. 87-1881 (1962).

tion's investments in U.S. property. Earnings invested in the United States were taxed to the shareholders because Congress believed this to be substantially equivalent to a dividend being paid to them.[21] The concern was that U.S. CFCs with active income not subject to U.S. taxation would lend money to or purchase property from the U.S. shareholders, effectively repatriating the earnings without triggering U.S. tax.

U.S. property was defined to include:

- Tangible property located in the United States;
- Stock of a domestic corporation;
- An obligation of a U.S. person; and
- Any right to use in the United States a patent or copyright, an invention, model, or design whether or not patented, a secret formula or process, or any other similar property right, if acquired or developed by the CFC for use in the United States.

Several exceptions to the definition of U.S. property were also provided, including exceptions for U.S. government obligations and for export property.

III. Changes to Subpart F during the 1960s

A. Foreign Investors Tax Bill—1966 Amendment to I.R.C. § 952(b)

Before the 1966 amendment to I.R.C. § 952(b), subpart F income did not include income of a foreign corporation from U.S. sources which was already subject to U.S. tax because the corporation was engaged in a U.S. trade or business—subpart F was deemed to be unnecessary, given that U.S. tax already should be imposed. However, in 1966 Congress recognized that amounts connected with a U.S. trade or business might escape U.S. tax under the provisions of the Code or an applicable tax treaty. Thus, the 1966 amendment denied the subpart F exclusion for amounts enjoying such Code or treaty benefits (even if the benefit was only a reduction of the U.S. tax rate).

[21] *Id.*

B. Tax Reform Act of 1969

The Tax Reform Act of 1969 (TRA 1969) modified the I.R.C. § 954(b)(4) exception applicable to CFCs, the creation or organization of which did not have the effect of substantially reducing income or similar taxes. Certain CFCs had been required to dispose of some of their investments pursuant to local law. If the foreign country imposed little or no capital gains tax, the U.S. shareholders would be subject to the subpart F provisions because they did not meet this standard, even though the CFC had been engaged in an active business and its disposition was government mandated. TRA 1969 thus modified the exception by adopting a subjective test. If it could be established that neither:

- The creation or organization of the CFC under the laws of the foreign country; nor
- The effecting of the transaction giving rise to such income through the CFC,

had tax reduction as one of its significant purposes, then any income received by the CFC would not be considered FBC income.[22]

Although this change was a liberalization of the rule, the subjective test created difficulties of its own, and was ultimately reversed again in 1986. Further, this formulation of the rule (like the FBC sales and services rules more generally), focused subpart F determinations on the avoidance of *foreign* rather than U.S. tax. Although discouraging U.S. companies from reducing foreign taxes may seem counterintuitive from a U.S. tax policy perspective, it reflects the rules' broader policy focus on capital flows; the theory is that preventing U.S. companies from reducing the foreign taxes paid by their foreign operations may encourage them to place those operations in the United States instead.

[22] I.R.C. § 954(b)(4) (1969).

IV. Expansion and Modification of Subpart F in the 1970s

A. Tax Reduction Act of 1975

The Tax Reduction Act of 1975 (TRA 1975) saw the repeal and modification of numerous exceptions to the subpart F rules, which originally applied to amounts that were not viewed as the type of tax haven income targeted by subpart F. The exception to subpart F that applied when a CFC distributed minimum dividends to its U.S. shareholders was repealed. The exception that applied to tax haven income reinvested in less developed countries was also repealed. Shipping income was added to the categories of subpart F income, except where such income was reinvested in shipping operations. In addition, the threshold for the *de minimis* rule was reduced from 30 percent of gross income to 10 percent. Thus, TRA 1975 left in its wake a significant expansion of subpart F income, although a limited exception was also added for agricultural commodities not produced in commercially marketable quantities in the United States.

TRA 1975 reflected a compromise between the House and the Senate. In a reversal of the respective houses' roles in 1962, the Senate had called for current U.S. taxation of all income of foreign subsidiaries of U.S. corporations, but the House had recognized that this could affect U.S. corporations' ability to compete abroad.[23] The compromise that was reached was to retain deferral of foreign income generally, but to broaden the categories of "tax haven" income subject to subpart F.[24]

B. Tax Reform Act of 1976

The rules of I.R.C. § 956 relating to investments in U.S. property were modified to narrow the definition of U.S. property in 1976. As noted above, a CFC's investment in U.S. property is considered to be analogous to a dividend to the U.S. shareholders and is made subject to current U.S. taxation. Congress found that this provision could have a detrimental effect on the U.S. balance of payments by encouraging foreign corporations to invest their profits abroad.[25] A CFC with excess cash would be more likely to invest its earnings in other foreign investments which would be subject to less U.S. taxation than a U.S. investment that triggered I.R.C. § 956. Finding this to

[23] 121 Cong. Rec. H2382 (daily ed. March 26, 1975) (statement of Rep. Ullman) ("This provision [Senate amendment], if enacted would have a drastic impact on the ability of our corporations to compete in world markets").

[24] *Id.* (The conferees felt it was better to curb tax haven abuse, rather than tax "all foreign income in such a way that would reduce the competitiveness of our companies operating abroad").

[25] S. Rep. No. 94-938(I) (1976).

be detrimental to the promotion of investment in the United States, Congress provided for several exceptions to narrow the scope of "U.S. property."[26] The Tax Reform Act of 1976 thus excluded the following from the definition of U.S. property:

- Stock or debt of a domestic corporation (unless the corporation itself is a U.S. shareholder of the CFC), if the U.S. shareholders of the CFC own, or are considered to own, less than 25 percent of the total voting stock of such domestic corporation; and
- Any movable property (other than a vessel or an aircraft) that is used for exploring, developing, removing, or transporting resources from or under ocean waters when used on the U.S. continental shelf.

Although this narrowing of the definition of U.S. property was welcomed by taxpayers, the change also provides an example of the gradual accretion of modifications that make the subpart F rules confusing to read and apply. Rather than presenting a straightforward definition of U.S. property, the rules currently sweep in all domestic stock and debt, and then several paragraphs later set forth the exceptions described above (among others). Rationalizing the drafting of subpart F is thus another potential benefit of a fundamental reexamination of the rules.

V. Tightening of the Subpart F Provisions and Creation of Additional Anti-Deferral Provisions—the 1980s

A. Tax Equity and Fiscal Responsibility Act of 1982

The 1980s substantially expanded the subpart F provisions with more categories of income being classified as "tax haven income," beginning with the Tax Equity and Fiscal Responsibility Act of 1982 (TEFRA). A new category of income was added to the FBC income rules, applicable to "foreign base company oil-related income" (FORI). Under this provision, U.S. shareholders of a CFC are subject to tax currently on the foreign oil-related income of the CFC from countries other than those in which the oil and gas is extracted or consumed. FORI includes income from processing, transportation, distribution and sales, and services.[27]

---

[26] *Id.*

[27] I.R.C. § 954(a)(5) (1982).

B. Deficit Reduction Act of 1984

In the Deficit Reduction Act of 1984, Congress added a provision that defined the income from the factoring of related party receivables as interest income for purposes of subpart F. The significance of this provision has been superseded by later amendments to the definition of FPHC income (specifically, the addition of a category of "income equivalent to interest") and implementing regulations. However, the provision offers another example of the type of drafting problem that has been created by constant piecemeal tinkering over the years. The rules on related party factoring transactions are contained in I.R.C. § 864(d), where it is stated that these rules apply for purposes of subpart F. However, the subpart F provisions defining FPHC income contain no cross-reference to the I.R.C. § 864(d) rules.

C. Tax Reform Act of 1986

1. Additions to and Modifications of Foreign Personal Holding Company Income

The Tax Reform Act of 1986 (TRA 1986) significantly enlarged the categories of subpart F income, reduced or modified several exceptions to the subpart F provisions, and added an expansive new anti-deferral regime. Four new categories of income were added to FPHC income:

- Gains from sales of non-inventory property that is either non-income producing (*e.g.*, gems and artworks) or that is held for the production of passive income (*e.g.*, stock and debt);
- Gains from commodities transactions (including futures, forwards, and similar transactions), with a dealer exception;
- Net foreign currency gain attributable to any I.R.C. § 988 transaction, with an exception for transactions directly related to the business needs of the CFC; and
- Income equivalent to interest.

The same-country exception for interest, rents, and royalties was narrowed, by making it inapplicable to the extent the payment reduced the payor's subpart F income. The exceptions that had shielded banks, insurance companies, and other financial institutions from current taxation with respect to "passive" type income were repealed, subjecting U.S. financial institutions operating overseas to current U.S. taxation regardless of their level of substantive economic activity overseas.

2. Other Modifications of Subpart F Income under TRA 1986

TRA 1986 made numerous other modifications to the exceptions or exemptions from subpart F income, including the following:

- The exception from FBC shipping income for amounts reinvested in FBC shipping operations was repealed. FBC shipping income was also expanded to include any income derived from a space or ocean activity;
- The exception from FBC income for a CFC that was not formed or availed of to avoid tax was changed into an objective test which required income to be subject to an effective foreign tax rate higher than 90 percent of the maximum corporate U.S. tax rate;
- The extent to which prior year deficits, or the deficits of affiliates in the same chain of ownership could be taken into account to reduce the subpart F income of a CFC, was substantially restricted; and
- The *de minimis* exception's threshold was reduced from 10 percent of gross income to the lesser of 5 percent or $1 million.

3. Modifications of Subpart F Insurance Income

TRA 1986 also made substantial modifications to the treatment of insurance income under subpart F. The definition of insurance income was expanded to include income attributable to the issuing or reinsuring of any insurance or annuity contract of unrelated persons outside the insuring company's country of incorporation, rather than only income from the insurance or reinsurance of *U.S.* risks. In addition, TRA 1986 repealed both:

- The *de minimis* rule under which insurance income was exempted from the subpart F provisions if it amounted to 5 percent or less of the total premiums and other consideration received; and
- As noted above, the exemption from subpart F income for certain investment income attributable to unearned premiums and reserves.

TRA 1986 further subjected "related person insurance income" of off-shore "captive" insurance companies to current U.S. tax under the subpart F rules. Congress was concerned with insurance companies that avoided U.S. tax by dispersing U.S. ownership so that no more than 25 percent of their voting stock was held by 10 percent U.S. shareholders.[28]

[28] H.R. CONF. REP. NO. 99-841 (1986).

A captive insurance company is a company organized by one or more persons primarily to provide insurance protection to its owners or persons related to its owners. Congressional concern was two-fold: first, offshore captive insurance arrangements were avoiding taxation both in the United States and abroad because under certain U.S. tax treaties, such as the United States-Barbados treaty, the insurance excise tax is waived on insurance premiums paid to foreign insurers and reinsurers.[29] Second, premiums paid by U.S. taxpayers to offshore captives were found by some courts to be currently deductible, but no current tax was imposed on the premium income in the hands of the captive.[30] TRA 1986 reduced the U.S. ownership requirements for related person insurance income from 50 percent to 25 percent or more. Any U.S. person (regardless of ownership percentage) who owns or is considered to own any stock in a CFC is treated as a U.S. shareholder for purposes of the 25 percent U.S. ownership threshold and is thus subject to current tax on the corporation's related person insurance income.

4. New Anti-Deferral Regime: Passive Foreign Investment Company Provisions

TRA 1986 went beyond expanding the subpart F provisions and added a new anti-deferral provision relating to passive foreign investment companies (PFICs). Congress sought to remove the tax advantages that U.S. shareholders in foreign investment funds had over U.S. persons investing in domestic funds by eliminating the economic benefit of deferral.[31] The PFIC provisions were thus designed to discourage U.S. investors from making investments outside the United States instead of inside the United States.[32]

The PFIC provisions have a broader coverage than the subpart F provisions. Any U.S. person (regardless of percentage ownership or the aggregate percentage ownership of all U.S. persons) that invests in a foreign corporation that has primarily passive investment activities will be subject to the broad economic equivalent of current U.S. taxation on its pro rata share. The PFIC provisions tax all income of a PFIC and not just the passive income earned. A PFIC is defined as any foreign corporation at least 75 percent of the total gross income of which is passive income, or, at least 50 percent of the average value of the assets of which produce

---

[29] *Id.*

[30] *Id.*

[31] *Id.*

[32] STAFF OF THE JOINT COMMITTEE ON TAXATION, 99TH CONG. 1ST SESS., GENERAL EXPLANATION OF TAX REFORM ACT OF 1986, at 1023 (Comm. Print 1986).

passive income. The PFIC provisions created certain overlaps with the subpart F provisions but the Taxpayer Relief Act of 1997, discussed below, alleviated these overlaps.

D. Omnibus Budget Reconciliation Act of 1987

During the consideration of the Omnibus Budget Reconciliation Act of 1987, Congress considered adding to the growing list of subpart F income categories. A CFC's "imported property income" was to be subject to current U.S. taxation under the subpart F provisions. Imported property income was defined as income derived in connection with manufacturing, producing, growing, or extracting imported property; the sale, exchange, or other disposition of imported property; or the lease, rental, or licensing of imported property. This provision was proposed by the House, but was criticized for putting U.S. owners of foreign subsidiaries that produce foreign goods at a tax disadvantage compared to foreign producers of foreign goods destined for the U.S. market.[33] Although the issue of "runaway plants" has remained a subject of legislative debate, neither the imported property income provision that passed the House in 1987 nor any of its later variations has been enacted (although the provisions of I.R.C. § 956A, discussed below, had their genesis in similar policy concerns).

VI. Subpart F Provisions in the 1990s

A. Omnibus Budget Reconciliation Act of 1993 and Small Business Job Protection Act of 1996

In response to a Treasury proposal, the Omnibus Budget Reconciliation Act of 1993 (OBRA 1993) added a significant new anti-deferral provision to the Code. New I.R.C. § 956A subjected accumulated active business profits of CFCs to current U.S. taxation. The committee report to OBRA 1993 states that Congress understood that exceptions to the subpart F rules for active business operations of a CFC were justified because U.S.-owned businesses abroad had to remain competitive with their foreign counterparts.[34] However, Congress felt that the deferral of U.S. tax on accumulated active business profits was not necessary to maintain competitiveness for U.S.-owned businesses.[35] Congress thus imposed U.S. taxation on accumulated earnings and profits of a CFC that were not reinvested in active business assets (excess

---

[33] H.R. Rep. No. 100-391 (1987).

[34] H.R. Rep. No. 103-111 (1993).

[35] *Id.*

passive assets). Under I.R.C. § 956A, a U.S. shareholder of a CFC was required to take into income its pro rata share of the CFC's investment in passive assets to the extent it exceeded a certain threshold. A CFC had excess passive assets if the average amount of the passive assets, held at the end of each quarter of the taxable year, exceeded 25 percent of the average amount of total assets held at the end of each quarter of the taxable year.

The amount of earnings required to be included was the lesser of:

- The excess of the shareholder's pro rata share of the CFC's excess passive assets over the earnings and profits; or,
- The shareholder's pro rata share of the CFC's applicable earnings.

Three years after its enactment, I.R.C. § 956A was repealed by the Small Business Job Protection Act of 1996. The provision had been intended to restrict the benefits of tax deferral for CFCs that accumulated passive assets abroad. But Congress found that I.R.C. § 956A had in fact provided incentives for CFCs to make investments, enter into transactions, and engage in reorganizations to avoid application of the provision.[36] Congress found that CFCs would acquire foreign assets that they would not otherwise have purchased to reduce their percentage of passive assets to avoid application of I.R.C. § 956A.[37] The incentive was thus to make investments outside the United States, which might otherwise have been made in the United States. In addition, I.R.C. § 956A imposed complex administrative and compliance difficulties, particularly in relation to the coordination of its provisions with the potentially-overlapping application of the FPHC rules, I.R.C. § 956, and the PFIC provisions. Accordingly, I.R.C. § 956A was repealed for taxable years after 1996.

In connection with the enactment and subsequent repeal of the provisions of I.R.C. § 956A, Congress also modified the operation of the investment in U.S. property rules of I.R.C. § 956. These modifications were intended to improve the mechanical operation of the provisions, but did not alter the basic purpose or scope of the rules.

[36] H.R. Rep. No. 104-586 (1996).

[37] *Id.*

B. Taxpayer Relief Act of 1997

The Taxpayer Relief Act of 1997 (TRA 1997) added two new categories to the list of FPHC income. Net income from all types of notional principal contracts and payments in lieu of dividends derived from equity securities lending transactions under I.R.C. § 1058 are now generally considered FPHC income.[38]

TRA 1997 also provided for a one-year exception from the subpart F provisions for income derived in the conduct of a banking, financing, or similar business or derived from certain investments made by an insurance company (active banking or finance exception).[39] Congress noted that the intent of the subpart F provisions was to target income that was either passive or easily moveable.[40] As discussed above, TRA 1986 had repealed the previous active banking or finance exception but in 1997 Congress determined that the extension of the subpart F provisions to income that was neither passive nor easily moveable was inappropriate.[41] President Clinton vetoed this provision under the Line Item Veto Act, but it was reinstated by a decision of the Supreme Court.[42] In 1998, the provision was modified and extended for an additional year.[43]

As noted above, the PFIC regime enacted in 1986 could overlap with the operation of the subpart F rules; applying both sets of rules with respect to a single foreign company created significant complexities. Congress recognized the complexities created by the interaction of the two sets of rules, and under TRA 1997 provided that a U.S. shareholder that is subject to the subpart F rules is generally not also subject to the PFIC provisions with regard to the same stock.

C. Notices 98-11 and 98-35

In January 1998, Treasury announced its intention to adopt regulations that would address the use of certain "hybrid branch" arrangements that had the effect of reducing foreign taxes but did not give rise to subpart F inclusions.[44] Regulations that would have created subpart F income with respect to such transactions were proposed in March 1998, but their withdrawal was

---

[38] I.R.C. § 954(c)(1)(F)-(G) (1997).

[39] Pub. L. No. 105-34, § 1175(a).

[40] Staff of the Joint Committee on Taxation, 105th Cong., 1st Sess., General Explanation of Tax Legislation Enacted in 1997 at § XI(G)(5) (Comm. Print 1997).

[41] *Id.*

[42] *Clinton v. City of New York,* 118 S.Ct. 2091 (1998).

[43] H.R. 4328, § 1005 (1998); H.R. Doc. No. 105-825 (1998); Pub. L. No. _____, § ____.

[44] Notice 98-11, 1998-6 I.R.B. 18 (January 16, 1998).

subsequently announced in June by Notice 98-35.[45] Treasury's proposed hybrid branch rules were severely criticized on various procedural and substantive grounds, but Notice 98-35 expresses the intention to re-issue similar rules. The Notices focused renewed attention on the policy rationale underlying the current structure of subpart F, including the theory of capital export neutrality.

VII. Conclusion

Several conclusions may be drawn from the history of subpart F. First, U.S. anti-deferral rules have been the subject of constant legislative tinkering, which has created both instability and a forbiddingly arcane web of rules, exceptions, exceptions to exceptions, interactions, cross references, and effective dates, giving rise to a level of complexity that is intolerable. Second, while Congress has sometimes tightened and sometimes relaxed the subpart F rules over the years, it is clear that the overall trend has been to expand their scope. Particularly with the changes wrought in 1975 and 1986, Congress has brought more and more income within the net of current taxation, to the point where Treasury now feels justified in positing that current taxation is the general rule, with deferral permitted only as an exception.[46]

[45] Notice 98-35, 1998-27 I.R.B. 35 (June 19, 1998).

[46] Notice 98-35, 1998-27 I.R.B. 35 (June 19, 1998).