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SMU Law Review

Volume 59 | Issue 2 Article 12

2006

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Lawrence Lokken

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Recommended Citation

Lawrence Lokken, *Territorial Taxation: Why Some U.S. Multinationals May Be Less than Enthusiastic about the Idea (and Some Ideas They Really Dislike)*, 59 SMU L. Rev. 751 (2006)
https://scholar.smu.edu/smulr/vol59/iss2/12

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TERRITORIAL TAXATION: WHY SOME U.S. MULTINATIONALS MAY BE LESS THAN ENTHUSIASTIC ABOUT THE IDEA (AND SOME IDEAS THEY REALLY DISLIKE)

*Lawrence Lokken**

I. INTRODUCTION

FROM the early days of the modern U.S. income tax until the present, domestic corporations, as well as U.S. citizens and residents, have been taxed on their worldwide incomes.[1] Gross income includes income "from whatever source derived."[2] Since a U.S. person's income from sources outside the United States is often also taxed by the countries from which the income originates, the law allows U.S. persons a credit against U.S. tax for income taxes paid to other countries.[3] In order to restrict the credit to its function of alleviating double taxation, the law limits this credit to the amount of the U.S. tax, before credit, on the taxpayer's income from foreign sources.[4]

A shareholder is generally not taxed on undistributed corporate earnings, whether the shareholder is a U.S. or foreign person and whether the corporation is domestic or foreign. U.S. taxation of these earnings at the corporate level is, however, significantly affected by whether the corporation is domestic or foreign.[5] The United States taxes domestic corporations on their worldwide incomes, with credit for foreign income taxes, but it only taxes foreign corporations on income from U.S. sources and on income effectively connected with U.S. trades or businesses.[6] Thus,

* Lawrence Lokken is Hugh H. Culverhouse Eminent Scholar and Professor of Law, University of Florida College of Law. Some of the points made in this article are contained in an earlier article. Lawrence Lokken, *Does the U.S. Tax System Disadvantage U.S. Multinationals in the World Marketplace?*, 4 TAX'N OF GLOBAL TRANSACTIONS 53 (2004).

1. For the early history of the U.S. international tax system, see Michale T. Graetz & Michael M. O'Hear, *The "Original Intent" of U.S. International Taxation*, 46 DUKE L.J. 1021 (1997).

2. I.R.C. § 61(a) (1994).

3. I.R.C. § 901; *see* 3 BORIS I. BITTKER & LAWRENCE LOKKEN, FEDERAL TAXATION OF INCOME, ESTATES & GIFTS ¶ 72.1 (rev. 3d ed. 2005).

4. I.R.C. § 904; *see* BITTKER & LOKKEN, *supra* note 3, ¶ 72.6.1.

5. A corporation is domestic if organized under the laws of the United States, one of the U.S. states or the District of Columbia; and it is foreign if it is organized under the laws of any other jurisdiction. I.R.C. § 7701(a)(4), (5).

6. I.R.C. §§ 61(a), 882(b); *see* BITTKER & LOKKEN, *supra* note 3, ¶67.1.1.

foreign income of U.S.-owned foreign corporations is generally not subjected to U.S. taxation until it is distributed as dividends.

Dividends from a foreign corporation are fully taxable, even if the recipient is a corporation and owns all of the distributing corporation's stock.[7] However, a domestic corporation owning at least 10% of a foreign corporation's voting stock is, upon receiving dividends, treated as having paid a ratable share of the foreign income taxes paid by the distributing corporation.[8] An amount equal to the foreign income taxes deemed paid is included in the domestic corporation's gross income as an additional dividend.[9] Apart from the fact that U.S. taxation is delayed until dividends are distributed, a domestic corporation is taxed on earnings repatriated from a foreign subsidiary essentially as though the domestic corporation had directly earned the repatriated income.[10]

The opportunity to defer U.S. taxation of unrepatriated earnings of U.S.-owned foreign corporations is limited by the Internal Revenue Code ("I.R.C.") rules on controlled foreign corporations ("CFC"s), commonly known as subpart F.[11] A U.S. shareholder of a CFC is directly taxed on several categories of CFC income, including dividends, interest, royalties, and income from sales and service transactions not sufficiently connected to the CFC's home country.[12] Most of the income directly taxed to U.S. shareholders is called "subpart F income." Very generally, the effect of the CFC rules is to restrict the deferral opportunity to active business income.

In November 2005, an Advisory Panel on Federal Tax Reform, which the President had charged with developing plans for reforming the fed-

7. On receiving dividends from a domestic subsidiary, in contrast, a domestic corporation is allowed a deduction equal to all or some portion of the dividends. I.R.C. § 243(a).

8. I.R.C. § 902; *see* BITTKER & LOKKEN, *supra* note 3, ¶ 72.9.1.

9. I.R.C. § 78.

10. Assume USCo earns 1,000 by a business carried on in foreign country *X*, which imposes tax of 300 on this income. If *USCo* conducts the business as a branch, it must include the country *X* income in its U.S. taxable income and is allowed a foreign tax credit of 300. If its precredit U.S. tax is a flat 35% of taxable income, its net U.S. tax on the country *X* income is 50 (precredit tax of 350, less credit of 300). But, if *USCo* carries on the country *X* business through a subsidiary organized under country *X* law and the subsidiary promptly distributes its after-tax income to *USCo*, *USCo* receives dividends of 700 (1,000 of pretax earnings, less 300 of country *X* tax), is deemed to pay 300 of country *X* tax, and has deemed dividends of 300. Its precredit U.S. tax on the country *X* income is thus 350 (35% of the sum of 700 and 300), it is allowed credit of 300, and its net U.S. tax on the country *X* earnings is 50. *See* United States v. Goodyear Tire & Rubber Co., 493 U.S. 132, 140 (1989) (legislative history of indirect credit "reflects an intent to equalize treatment between domestic corporations that operate through foreign subsidiaries and those that operate through unincorporated foreign branches").

11. A foreign corporation is a CFC if more than one half of its stock, by vote or by value, is owned by "United States shareholders." I.R.C. § 957(a). A U.S. shareholder is a U.S. person (U.S. citizen or resident or domestic corporation, partnership, trust, or estate) that owns at least 10% of a foreign corporation's voting stock. I.R.C. § 951(b). For purposes of both of these rules, stock ownership includes direct, indirect, and constructive ownership, as defined in I.R.C. § 958. *See* BITTKER & LOKKEN, *supra* note 3, ¶ 69.2. The term "subpart F" derives from the fact that most of the CFC rules are found in subpart F of part III of subchapter N of chapter 1 of subtitle A of the I.R.C.

12. *See* BITTKER & LOKKEN, *supra* note 3, ¶69.1.

eral tax system, issued a report outlining two alternative plans, one of them being a plan to reform the present income tax and the other being a plan to convert the income tax into a tax on consumption.[13] The first of these plans, which the Panel called a Simplified Income Tax Plan, proposed a significant alteration of the rules for taxing foreign income of U.S. companies: a move from the present credit system to a territorial or exemption system. Under an exemption system, a U.S. person's income from active business operations in foreign countries, whether carried on directly or through subsidiary corporations, would be exempted from U.S. taxation. Earlier in 2005, the staff of the Joint Committee on Taxation suggested a similar shift.[14]

As described more fully below, in recommending an exemption system, the Panel and Joint Committee staff relied on two arguments: (1) The current system, by deferring taxation of foreign earnings of U.S.-owned foreign corporations, distorts business decisions on where and how to invest these earnings; and (2) the current system often allows U.S. multinational enterprises to achieve U.S. tax results more favorable than they could obtain under a territorial system.[15] As others have pointed out, the first objection to current law could be addressed by curtailing the deferral opportunity.[16]

This article addresses the second of the justifications offered for an exemption system. It explains some of the techniques used by U.S. multinational enterprises to achieve U.S. tax results more favorable than territorial taxation, and it examines whether these results are inevitable consequences of the current regime or flow from aspects of the present rules that could easily be changed. The article concludes that Congress and the Treasury could, without adding significant complexity to the law, reform the historical worldwide/credit system in ways that would ensure tax results largely consistent with the underlying premises of this system.

II. THE PROPOSALS

A. Their Substance

The Panel and Joint Committee Staff advocate a two-part system for taxing international income of domestic corporations. Active business income earned abroad through branches and foreign subsidiaries would be exempted from U.S. taxation. Expenses attributable to this income would not be deductible, and foreign income taxes on the income would not be creditable. Other income of a domestic corporation from foreign

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13. President's Advisory Panel on Federal Tax Reform, Simple, Fair, and Pro-Growth: Proposals to Fix America's Tax System (2005) [hereinafter President's Advisory Panel].

14. Staff of J. Comm. on Taxation, 108th Cong., Options to Improve Tax Compliance and Reform Tax Expenditures (2005) [hereinafter Staff of J. Comm.].

15. President's Advisory Panel, *supra* note 13, at 103; Staff of J. Comm., *supra* note 14, at 188.

16. *See generally* J. Clifton Fleming Jr. & Robert J. Peroni, *Exploring the Contours of a Proposed U.S. Exemption (Territorial) Tax System*, 109 Tax Notes 1557 (2005).

sources would be included in the U.S. tax base, and foreign income taxes on this income would be creditable, as under present law. The CFC rules would also continue without significant change.[17]

Although both proposals use the term "territorial," the proposed systems are not truly territorial because they would only exempt foreign source income meeting specific eligibility criteria and would retain the present worldwide/credit system for all other income. The proposals are modeled on systems prevalent in continental Europe, which are usually referred to as exemption systems.[18] They do not follow the example of countries that tax their residents on no income from sources outside the country, regardless of character, which may more accurately be termed territorial taxation.[19] The term "exemption system" is used in this paper.

Under the proposals, a domestic corporation would be exempt from U.S. tax on dividends received from a foreign corporation only if the distributing corporation is a CFC and the domestic corporation owns at least 10% of the CFC's voting stock (that is, is a "United States shareholder").[20] A foreign corporation is a CFC if more than one half of its stock, by vote or by value, is owned by U.S. shareholders.[21] The exemption would also encompass income of active businesses that a domestic corporation carries on as branches in foreign countries.[22]

Foreign income taxes allocable to exempt income would be neither creditable nor deductible. For example, a domestic corporation would be allowed no credit or deduction for a foreign withholding tax on exempt dividends, and I.R.C. § 902, which treats a domestic corporation receiving dividends from a foreign corporation in which it owns at least 10% of the voting stock as though it had paid a ratable portion of the foreign income taxes paid by the foreign corporation, would not apply to a domestic corporation receiving exempt dividends.[23]

Also, a domestic corporation with exempted income would not be allowed deductions for expenses allocated and apportioned to exempt in-

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17. PRESIDENT'S ADVISORY PANEL, *supra* note 13, at 134 (observing that CFC rules are "common in territorial systems around the world"); STAFF OF J. COMM., *supra* note 14, at 189.

18. For a description of one such system, see NETHERLANDS MINISTRY OF FIN., TAXATION IN THE NETHERLANDS 13–15 (2005), *available at* http://www.minfin.nl/ (follow "English" hyperlink; then follow "taxation" hyperlink).

19. Hong Kong is one of the few jurisdictions having such a system. *See* GOV'T OF HONG KONG SPECIAL ADMIN. REGION, INLAND REVENUE DEP'T, A SIMPLE GUIDE ON THE TERRITORIAL SOURCE PRINCIPLE OF TAXATION, *available at* http://www.ird.gov.hk/eng/paf/bus_pft_tsp.htm (last visited Mar. 16, 2006).

20. STAFF OF J. COMM., *supra* note 14, at 190. The Joint Committee Staff's explanation of its proposals is more detailed than the Advisory Panel's explanation. The description in the text is thus drawn primarily from the staff's explanation. For the term "United States shareholder," see I.R.C. § 951(b) (West 2006).

21. I.R.C. § 957(a) (1994).

22. Although the proposals are not specific on the point, the term "active business income" probably refers to income that would not be subpart F income if it were income of a CFC.

23. I.R.C. § 902.

come.[24] According to the Joint Committee Staff, "for expense allocation purposes, CFC earnings would be treated as giving rise to foreign-source income as they are earned."[25] Assume *USCo*, a Delaware corporation, is sole shareholder of *FCo*, which is organized in country *X* and operates a manufacturing business in that country. During year 1, *FCo* has income of 500, all of which is produced in the manufacturing business, and it distributes 200 to *USCo* as dividends. Under the proposals, the dividends are excluded from *USCo*'s gross income, but *USCo* may not deduct expenses attributable to *FCo*'s income of 500.

The Panel and the Joint Committee Staff both recognize that economically realistic allocations and apportionments of deductions would be crucial to an appropriate implementation of the proposals.[26] If a domestic corporation incurs expenses in earning exempt income, but fails to allocate or apportion the expenses to the exempt income, the expenses effectively shelter nonexempt income from tax and thereby broaden the exemption to income equal to the sum of the properly exempted income and the improperly deducted expenses. On the other hand, if expenses incurred in earning nonexempt income are allocated against exempt income, the taxpayer is effectively denied the exemption to the extent of the improperly allocated expenses. Appropriate expense allocations are also of vital importance under current law, but both proposals suggest that this process may be even more crucial under an exemption system.[27]

The Panel also notes that arm's length pricing of goods and services transferred among and performed for related value would be "even more important in a territorial system than under current law" and that "additional resources would need to be devoted to examining these transfer prices."[28] For example, if *USCo* sells goods to *FCo* at a price less than an arm's length price for the goods, *FCo*'s income on reselling the goods will include income actually earned by *USCo*, and this income will be exempt from U.S. tax as it is realized by *FCo* and as it is distributed to *USCo* as dividends.

Under the proposals, a U.S. person's U.S. taxable income includes all foreign-source income other than CFC dividends and active business income of branches.[29] Assume *USCo* licenses country *X* rights to valuable intangibles to *FCo*, and *FCo* pays royalties to *USCo* of 140, from which *FCo* withholds 14 of country *X* tax. Under the proposals, *USCo* must include the royalties in its U.S. gross income, but it is allowed deductions for expenses attributable to the royalties and is allowed credit for foreign

24. For the allocation and apportionment of deductions between income from foreign sources (the statutory grouping) and U.S. sources (residual gross income), see Treas. Reg. § 1.861-8 (1996), discussed in Bittker & Lokken, *supra* note 3, ¶ 73.10.1.

25. Staff of J Comm., *supra* note 14, at 190.

26. President's Advisory Panel, *supra* note 13, at 134 (suggesting the adoption of "[r]easonable rules" to ensure that "expenses incurred in the United States to generate exempt foreign income would not be deductible" for U.S. tax purposes).

27. *Id.*

28. *Id.* at 134.

29. *Id.*

income taxes on the royalties. For example, if *USCo* has 40 of expenses allocable to the royalties and its precredit U.S. tax is at a flat 35%, its precredit tax on the royalties is 35 (35%of the excess of 140 over 40), it has a foreign tax credit of 14, and its after-credit tax on the royalties is 21.

B. The Justifications Offered

The Panel and the Joint Committee Staff proposals rest on two groups of arguments: that the present worldwide/credit system distorts business and investment decisions and that credit rules are not effective in restricting the credit to its role of alleviating double taxation. Only the second of these justifications is analyzed in this paper, but both of them are described here.

The Joint Committee staff explains the first justification as follows:

> It has long been recognized that the worldwide, deferral-based system of present law distorts business decisions in a number of ways. By establishing repatriation as the system's principal taxable event, the worldwide, deferral-based system creates incentives in many cases to redeploy foreign earnings abroad instead of in the United States, thereby distorting corporate cash-management and financing decisions. At the same time, basing the system on repatriation renders the payment of U.S. tax on foreign-source business income substantially elective in many cases, because repatriation itself is elective. By maintaining deferral indefinitely, a taxpayer may achieve a result that is economically equivalent to 100-percent exemption of income, with no corresponding disallowance of expenses allocable to the exempt income, provided that the taxpayer does not repatriate the earnings or run afoul of subpart F or other anti-deferral rules.[30]

According to the Panel,

> Research on the consequences of adopting a territorial system for the United States suggests that this reform could lead to both efficiency and simplification gains. Economists have found that the financial decisions of corporate managers are extremely sensitive to the tax on repatriations—lower U.S. taxes on dividend repatriations lead to higher dividend payments and vice-versa. This correlation implies that repatriation taxes reduce aggregate dividend payouts and generate an efficiency loss that would disappear if active foreign

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30. Staff of J. Comm., *supra* note 14, at 188–89. The Panel expresses this idea as follows:

> because the active business income of foreign subsidiaries of U.S. parent corporations generally is not taxable at home until it is distributed as dividends, the U.S. tax on dividend payments can be thought of as elective, much like the tax on capital gains. Due to the "time value of money" advantage of postponing tax payments, this deferral of U.S. tax allows foreign business income to be taxed at a lower effective rate than it would be if it were earned in the United States. This creates an incentive for the foreign subsidiary to retain the earnings as long as possible and distorts other business and investment decisions.

President's Advisory Panel, *supra* note 13, at 103.

> source income were exempt from U.S. tax. Corporate managers would be able to arrange corporate affairs and financial policies to meet objectives other than tax avoidance if they were freed from worrying about how to time repatriations of foreign income to reduce U.S. taxes.[31]

The worldwide/credit system is often justified on grounds of capital export neutrality, the idea that the tax law should, to the extent possible, not influence U.S. persons' choice between investing and doing business in the United States and investing and doing business in other countries.[32] It would seem that a move to an exemption system would encourage U.S. companies to move investments and resulting employment opportunities to countries with lower tax rates and thereby sacrifice capital export neutrality. According to the Panel, however, "Researchers found no definitive evidence that location incentives would be significantly changed, which suggests that the territorial system the Panel has proposed would not drive U.S. jobs and capital abroad relative to the current system."[33] The Panel finds this result "surprising" because the present system, although in concept based on worldwide taxation, is sufficiently malleable to allow many taxpayers to achieve results even more favorable than those under a territorial system.[34]

According to the Panel, its proposals would "update our international tax regime."[35] The Panel notes that many countries of continental Europe use exemption systems similar to the system it proposes and that Canada, which had historically used a credit system like the United States, has recently adopted a similar exemption system.[36] The Joint Committee Staff describes these systems as follows:

> Many countries tax resident corporations on a predominantly territorial basis by exempting dividends received from foreign subsidiaries from residence-country tax. This exemption typically applies only where the parent company's ownership in the subsidiary exceeds a certain threshold (commonly five to 10 percent), and the exemption may be total or partial (e.g., only 95 percent, or 60 percent, of qualifying dividends might be exempted, as a proxy for disallowing expenses allocable to exempt income). A number of restrictions generally apply, in order to limit the exemption to certain categories of income (e.g., active business income) and to address concerns about shifting income to lower-tax countries in order to avoid tax.

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31. President's Advisory Panel, *supra* note 13, at 134.
32. *See, e.g.*, T.D. 8767, 1998-1 C.B. 875; Staff of J. Comm. on Taxation, 99th Cong., General Explanation of the Tax Reform Act of 1986, at 964-65 (1987); Lawrence Lokken, *Whatever Happened To Subpart F? U.S. CFC Legislation After the Check-the-Box Regulations*, Fla. Tax Rev. (forthcoming 2006).
33. President's Advisory Panel, *supra* note 13, at 135.
34. *Id.*
35. *Id.* at 132.
36. The Panel does not note that many other countries, including the United Kingdom and Japan, use a credit system generally resembling that of the United States. It does not explain why it believes that its recommendation would "update" the U.S. international tax system, rather than merely change it.

These exemption systems generally do impose tax on foreign-source royalties and portfolio type income.[37]

The Panel notes that the limitation on the maximum foreign tax credit must be applied with "[m]any complicated rules," which often "allow companies to arrange their affairs so that they can avoid taxes on income earned abroad if they are able to simultaneously repatriate certain income that has been subjected to high rates of foreign tax and other income that has been subject to low rates of foreign tax."[38] The Panel states further:

> [T]he tax planning opportunities engendered by the complicated rules surrounding deferral may allow some corporations to help themselves to results that are more favorable than territorial taxation. As a result, the active foreign income of some multinationals is taxed more heavily under the current system than it would be in a predominantly territorial system, while similar income earned by other multinationals is functionally exempt from U.S. tax through "self-help." Meanwhile, the income of a third group of multinationals may be taxed at a negative rate. The result of this complexity is that the actual rates of tax paid by U.S. companies on their worldwide income vary widely from year to year, and from company to company, based on the range of foreign operations and the sophistication of their tax planning.[39]

According to the Joint Committee staff,

> The present-law system . . . creates a sort of paradox of defects: on the one hand, the system allows tax results so favorable to taxpayers in many instances as to call into question whether it adequately serves the purposes of promoting capital export neutrality or raising revenue; on the other hand, even as it allows these results, the system arguably imposes on taxpayers a greater degree of complexity and distortion of economic decision making than that faced by taxpayers based in countries with exemption systems, arguably impairing capital import neutrality in some cases.[40]

The remainder of this paper examines whether this "paradox of defects" is a necessary feature of a worldwide/credit system or is a result of corruptions in the present implementation of system that could feasibly be removed to restore the system and to serve its intended functions fairly and effectively. The paper also discusses, preliminarily and incompletely, whether the proposed exemption system would free U.S. international tax law from the asserted "paradox of defects."[41]

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37. STAFF OF J. COMM., *supra* note 14, at 187.
38. PRESIDENT'S ADVISORY PANEL, *supra* note 13, at 104.
39. *Id.*
40. STAFF OF J. COMM., *supra* note 14, at 189.
41. For another examination of this issue, see Hugh J. Ault, *U.S. Exemption/Territorial System vs. Credit-Based System*, 32 TAX NOTES INT'L 725 (2003).

III. HOW U.S. MULTINATIONALS NOW ACHIEVE U.S. TAX RESULTS MORE FAVORABLE THAN THOSE AVAILABLE UNDER TERRITORIAL TAXATION

Tax advisors have refined international tax planning in the United States to a fine art. Their tool boxes include numerous techniques for minimizing U.S. tax on U.S. multinationals' non-U.S. income. In many applications, these techniques achieve results that are not compatible with the basic premises of the U.S. international tax system: taxation of worldwide income with credit for foreign income taxes as needed to alleviate double taxation. Cumulatively, they allow many U.S. multinationals to pay less U.S. tax than they would under an exemption system.

A complete catalogue of the techniques would fill several volumes. Three commonly employed techniques, representative of three categories of techniques, are discussed and analyzed below. As shown below, a relatively simple change in the law could eliminate the distortive effects of each of these techniques. Substantially all of the inappropriate results possible under present law could similarly be remedied within the framework of a worldwide/credit system.

A. Separation of Foreign Income Taxes from Income on Which Those Taxes Were Imposed

The credit system most dramatically fails to serve its purpose of alleviating double taxation when it allows credit for foreign income taxes on income that is not subjected to U.S. taxation.

Example 1

USCo, a Delaware corporation, owns 51% of the interests in the profits and capital of a partnership, *PRS*, which is organized under the laws of foreign country *X*. The remaining interests in the partnership are owned, directly and indirectly, by unrelated residents of country *X*. For year 1, *PRS* has net income of $196 from active business operations in country *X*, but makes no distributions to its partners. *PRS* is a pass-thru entity under the tax laws of country *X*, and *USCo* is legally liable for country *X* tax of $30 on its share of *PRS*' profits. As required by country *X* law, *PRS* withholds this tax from *USCo*'s share of the profits.[42] *PRS* elects to be taxable as a corporation for U.S. tax purposes, but because it is, for these purposes, a foreign corporation with no U.S. trade or business and no income from U.S. sources, it owes no U.S. tax.

PRS is an example of what is often called a reverse hybrid entity—an entity that is classified as a corporation for U.S. tax purposes but is fiscally transparent under the tax laws of a relevant foreign country.[43] Under the so-called check-the-box regulations, any "business entity," other than an entity on a list of per se corporations, may elect for U.S. tax

42. *Cf.* I.R.C. § 1446 (1994).
43. *See, e.g.*, Treas. Reg. § 1.894-1(d)(2)(i) (1996).

purposes to be either fiscally transparent or an association taxable as a corporation.[44] The term "business entity" includes any entity that is recognized for federal tax purposes and is neither classified as a trust nor "subject to special treatment under the Internal Revenue Code" as, for example, a regulated investment company ("RIC") or real estate investment trust ("REIT").[45] The list of per se corporations consists of entities organized under the corporation laws of the U.S. states and the one type of entity under the laws of each foreign country that most resembles an entity created under a U.S. corporation law.[46] A partnership is a business entity and is not a per se corporation or a specially treated entity. It may therefore choose to be classified for U.S. tax purposes as either a partnership or an association taxable as a corporation. In Example 1, *PRS* makes the latter choice.

Since *PRS* elects to be classified as a corporation for U.S. tax purposes, *USCo* is treated for these purposes as a shareholder, not a partner. If *PRS*'s income includes no income taxable to shareholders under the CFC rules, as is assumed in this example, *USCo* is only taxed on *PRS*' income as it is distributed as dividends. Since *PRS* distributes no dividends during year 1, *USCo* is not taxed by the United States for the year on any of *PRS*'s income.

Subject to the credit limitation, a U.S. person is allowed credit against the U.S. income tax for any foreign income tax "paid" by the person.[47] A foreign income tax is considered paid by "the person on whom foreign law imposes legal liability for such tax, even if another person (for example, a withholding agent) remits such tax."[48] In Example 1, country *X* law imposes liability on *USCo* for country *X* income tax of $30 on USCo's 50% share of *PRS*'s profits for year 1. Under the legal liability rule, *USCo* is deemed to have paid country *X* tax of $30 for year 1, even though the tax is actually paid by *PRS* on *USCo*'s behalf and even though the United States has not taxed either *PRS* or *USCo* on the income that country *X* has taxed.

The U.S. tax results in Example 1 are contrary to the basic function of the foreign tax credit to alleviate double taxation. Although the income of *PRS* is taxed by country *X*, it is not taxed by the United States until it is distributed to *USCo*. No double taxation occurs for year 1, and no credit should be allowed for the year.

Under the proposed exemption system, the problem illustrated by Example 1 would disappear in some but not all situations. The proposals would permanently exempt *USCo* from U.S. tax on *PRS*'s income and would allow *USCo* no credit against U.S. tax for foreign income taxes on

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44. Treas. Reg. § 301.7701-3(a) (1996).
45. Treas. Reg. § 301.7701-2(a). For RICs and REITs, see 4 Boris I. Bittker & Lawrence Lokken, Federal Taxation of Income, Estates & Gifts ¶¶ 99.4, 99.5 (rev. 3d ed. 2005).
46. Treas. Reg. § 301.7701-2(b).
47. I.R.C. § 901(a).
48. Treas. Reg. § 1.901-2(f)(1) (1996).

that income. Since country *X* taxes on *USCo*'s share of *PRS*'s income would not be creditable, it would not be relevant that *USCo* is considered to have paid the taxes.

However, if *USCo* owned 50% or less of the interests in *PRS*, the proposals would not change the objectionable results arising under existing law. The proposed exemption applies to dividends only if the distributing corporation is a CFC. *PRS*, although considered a corporation for U.S. tax purposes, is not a CFC if *USCo* owns no more than 50% of the interests. As such, the proposed exemption for *USCo* would not apply to dividends from *PRS*, and the current credit system would extend to *USCo* with respect to its interest in *PRS*.[49] The proposals would, therefore, not obviate the need for the suggested amendment to the check-the-box regulations.

The Treasury should cure the problem illustrated in Example 1 by changing the check-the-box regulations. It should add to these regulations a rule requiring a business entity to be classified as fiscally transparent for U.S. tax purposes with respect to any member or owner of the entity if, as a result of the entity being fiscally transparent under the tax laws of a foreign country, the member or owner is legally liable for tax imposed by that country on any portion of any significant item of income for the entity. Under such a rule, *PRS* would be classified as a partnership for U.S. tax purposes because *USCo*, as a partner, is subject to country *X* income tax on its share of *PRS*'s income. *USCo* would therefore have to include its distributive share of *PRS*'s income in its U.S. taxable income for year 1.

The Claims Court's decision in *Guardian Industries Corp. v. United States* illustrates another distortion of the credit resulting from the check-the-box regulations.[50] Guardian, a Delaware corporation, was sole owner of a Luxembourg entity, Guardian Industries Europe (GIE), which was sole owner of several other Luxembourg entities that had active business operations in Europe and elsewhere.[51] For purposes of Luxembourg tax law, the Luxembourg entities constituted a consolidated group of corporations ("fiscal unity") and GIE, as parent of the group, paid Luxembourg tax on the income of all members of the group.[52] Under the check-the-box regulations, all of the entities were eligible to choose between

49. It is not clear why the Panel and Joint Committee Staff limited the proposed dividend exemption to dividends from CFCs. This limitation is not found in at least some of the foreign systems that were apparently the model for the proposals. For example, under Dutch tax law, a Dutch corporation is allowed a "participation exemption" for dividends it receives from another corporation, domestic or foreign, if it owns at least 5% of the shares of the distributing corporation; there is no requirement that the distributing corporation be controlled by Dutch residents. TAXATION IN THE NETHERLANDS, *supra* note 18, at 13. The problem illustrated by Example 1 could be minimized by extending the exemption to dividends received by a domestic corporation from a foreign corporation if the domestic corporation owns at least 10% of the foreign corporation's voting stock, whether or not the foreign corporation is a CFC.

50. Guardian Indus. Corp. v. United States, 65 Fed. Cl. 50 (2005).

51. *Id.* at 51.

52. *Id.*

corporate status and fiscal transparency for U.S. tax purposes.[53] GIE elected to be a disregarded entity, but the other Luxembourg entities were considered corporations for U.S. tax purposes.[54] Guardian, as sole owner of GIE, claimed credit for all Luxembourg tax paid by GIE, but it only included in its GIE income in its U.S. income of calculation, not the income of the other Luxembourg entities.[55]

Under the legal liability rule, the credit claimed by Guardian was fully allowable only if, under Luxembourg law, (1) GIE had "legal liability" for the all of the credited taxes and (2) its subsidiaries were not "jointly and severally liable" for any portion of the taxes.[56] Based on expert testimony presented by the parties, the court concluded that, under Luxembourg law, GIE was exclusively liable for Luxembourg taxes on the group's income.[57] Since GIE was a disregarded entity for U.S. tax purposes, its liability was considered liability of its owner, Guardian, and Guardian was therefore deemed to have paid the taxes.[58]

The results in *Guardian Industries* are not consistent with the policy of the foreign tax credit to alleviate double taxation. Guardian was allowed credit for taxes on income of the lower-tier Luxembourg entities, but none of the income of these entities was currently subjected to U.S. taxation. Since the income of the lower-tier entities was not doubly taxed, credit for foreign income taxes on the income was inappropriate. The court may have been correct in its application of current law, but the law is wrong to allow credit in such circumstances.

To address the *Guardian Industries* distortion, the Treasury should amend the check-the-box regulations to provide that a foreign entity may not elect fiscal transparency if it is classified as a corporation under the tax laws of a foreign country and, as a result, its income is subjected to a corporate income tax imposed by that country. As applied to the *Guardian Industries* situation, under this amendment, GIE would be a corporation, and Guardian, its parent, would not be allowed credit for foreign income taxes paid by GIE until it received dividends from GIE.

Yes, this would only partially remedy the problem in *Guardian Industries*. Assume GIE, the parent Luxembourg entity, has income of 400, and it has only one subsidiary (GIES), which has income of 600; GIE pays Luxembourg tax on the group's income of 300, and GIE and GIES are both corporations for U.S. tax purposes. GIES makes no distributions to GIE, but GIE distributes dividends of 100 to Guardian. Under § 902(a), Guardian, on receiving the dividends, is deemed to have paid foreign income taxes actually paid by GIE equal to GIE's post-1986 for-

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53. *Id.* at 52.

54. *Id.*

55. *Id.*

56. Treas. Reg. §§ 1.901-2(f)(1), (3) (1996). In a case of joint and several liability, foreign income taxes must be apportioned among the liable entities in proportion to their contributions to the foreign tax base.

57. *Guardian Indus. Corp.*, 65 Fed. Cl. at 55.

58. *Id.*

eign income taxes (300), multiplied by the amount of the dividend (100) and divided by GIE's post-1986 undistributed earnings (400, less foreign income taxes of 300).[59] Guardian must recognize additional dividend income equal to the foreign income taxes deemed paid.[60] In sum, Guardian has dividend income of 400 (sum of 100 and 300) and is deemed to have paid 300 of foreign income taxes. In Guardian's U.S. return, the effective rate of foreign income tax is 75% (300/400), even though foreign income taxes were actually imposed at 30 percent. This distorted result occurs because GIE is considered payor of all foreign income taxes on the group's income, even though, for U.S. tax purposes, its undistributed earnings do not include undistributed income of other members of the group.

The Treasury could remedy this second distortion in the *Guardian Industries* situation with a further amendment to the check-the-box regulations: a foreign entity should be considered fiscally transparent for U.S. tax purposes if, as a result of a consolidation regime under foreign tax law, its income is included in the tax base of a related entity and it is not legally liable for foreign income taxes imposed on its income. Under the suggested amendments to the regulations, the classification of Guardian's Luxembourg affiliates would all be reversed: GIE would be a corporation for U.S. tax purposes, and its subsidiaries would be fiscally transparent for these purposes. All of the group's income, as well as all of its foreign income taxes, would therefore be income and taxes of GIE.

In sum, the Treasury should make the following amendments to the check-the-box regulations:

Hybrid entity rule.

> A foreign business entity should be classified as an association, taxable as a corporation, if any material portion of its income is subject to a corporate income tax for which the entity is legally liable.[61]

Consolidation rule.

> A foreign business entity should be fiscally transparent for U.S. tax purposes if any material portion of its income is subject to a corporate income tax for which the entity is not legally liable but for which a related entity is legally liable.

Reverse hybrid entity rule.

> A foreign business entity should be fiscally transparent for U.S. tax purposes with respect to any member or owner of the entity if, as a result of the entity being fiscally transparent under the tax laws of a foreign country, the member or owner is legally liable for tax imposed by that country on any portion of any significant item of in-

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59. *See* I.R.C. § 902(c)(1), (2) (1994) (defining post-1986 foreign income taxes and post-1986 foreign income taxes).

60. I.R.C. § 78.

61. The Joint Committee Staff recommended a rule requiring an entity to be treated as a corporation for federal tax purposes if it is a separate business entity organized under foreign law and has only one member. STAFF OF J. COMM., *supra* note 14, at 183.

come of the entity.[62]

B. Distortions of Credit Limitation

The facts of Example 1 are not a complete story. Under § 904(a), the credit for foreign income taxes may not exceed the portion of a taxpayer's U.S. tax, before credit, that is ratably attributable to taxable income from sources outside the United States. In Example 1, *USCo* has no income from foreign sources, therefore, its credit limitation, and hence the foreign tax credit, are zero. Examples 2 and 3 illustrate means by which *USCo* may accomplish the opposite of the result illustrated in Example 1: foreign source income with no foreign income taxes.

The idea underlying the credit limitation is that since a U.S. person is only doubly taxed on income originating outside the United States, double taxation is fully alleviated by allowing the credit to offset U.S. tax on income from foreign sources only.[63] The credit limitation poorly serves this function if (1) types of income taxed by foreign countries on different bases, are mixed together in computing the limitation or (2) items that foreign countries do not view as income from sources outside the United States are treated as foreign source income in the limitation computation. These distortions are illustrated by Examples 2 and 3.

1. *The Look-Thru Loophole in the Basket Regime*

Example 2

In addition to its interest in *PRS*, as assumed in Example 1, *USCo* owns valuable intellectual property that it and its affiliates use throughout the world. *USCo* licenses country *X* rights to this property to *FCo* and, for year 1, receives royalties from *FCo* of $50. Under country *X* tax law, *PRS* is allowed a deduction for the royalties, and because country *X* has an income tax treaty with the United States following the U.S. Model Income Tax Convention, country *X* imposes no withholding tax on *USCo*'s royalty income.[64]

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62. *See also* Lokken, *supra* note 32 (suggesting similar amendments to check-the-box regulations to frustrate schemes for avoiding subpart F).

63. *See* Bittker & Lokken, *supra* note 3, ¶ 72.1.

64. *See* U.S. Model Income Tax Convention of Sept. 20, 1996, art. 12(1), *available at* http://www.ustreas.gov/offices/tax-policy/library/model1996.pdf [hereinafter U.S. Model]. The Model Tax Convention of the Organisation for Economic Cooperation and Development (OECD) also exempts royalties from withholding tax in the country of source. OECD Model Tax Convention on Income and on Capital, art. 12(1) (2005), *available at* http://www.oecd.org/dataoecd/50/49/35363840.pdf. The United States has bilateral income tax treaties with more than sixty countries. *See generally* John Venuti et al., *Current Status of U.S. Tax Treaties and International Tax Agreements*, 35 Tax Mgmt. Int'l J. 38 (2006). Most U.S. tax treaties follow the Models in exempting royalties from withholding taxes at source. For a recent example, see Convention for the Avoidance of Double Taxation and the Prevention of Fiscal Evasion with Respect to Taxes on Income, U.S., Nov. 6, 2003—Japan art. 12(1) (2003), *available at* http://www.ustreas.gov/press/releases/reports/conventionfinal.pdf.

Under U.S. tax law, *USCo*'s royalty income is from foreign sources because it is received for the use of intellectual property outside the United States.[65] If none of *USCo*'s deductions are allocated or apportioned to this income,[66] *USCo* has taxable income from sources outside the United States for year 1 of $50. If its precredit U.S. tax is a flat 35% of taxable income,[67] its credit limitation is $17.5, and its foreign tax credit is $17.5 (lesser of foreign income taxes paid ($30) or the limitation ($17.5)).

Consistently with the role of the credit to alleviate double taxation, *USCo* should not be allowed credit for year 1. It is treated as having paid foreign income taxes on income that has not yet been subject to tax in the United States, and it has foreign source taxable income that has not been burdened by tax in any foreign country. Because *PRS* is allowed deductions for its royalty payments and *USCo*'s royalty income is exempted from withholding taxes in country *X*, the $50 of royalties consists of funds generated in the business of *PRS* that country *X* does not tax at any level. Since no income of USCo or *PRS* is doubly taxed in year 1, no credit is needed to alleviate double taxation.

The credit allowed to *USCo* is an example of cross crediting: foreign income taxes on one category of income (*PRS*' business income) is credited against U.S. tax on another category of income (*USCo*'s royalty income). *USCo* is allowed credit for year 1 only because its active business and royalty income and foreign income taxes on this income are aggregated in applying the credit rules.

Since 1986, the United States has had detailed rules limiting cross crediting.[68] Generally, foreign-source royalty income is placed in a separate basket together with other "passive income" from foreign sources, and foreign income taxes on this income are creditable only to the extent of the precredit U.S. tax on the income.[69] Income from active business operations, as well as taxes on this income, usually fall into a residual category, sometimes called the general limitation basket.[70] If this separate limitation regime applied to *USCo*, its limitation in the passive basket would be $17.5 (35% of the royalty income of $50), but because it pays no foreign income taxes on passive income, its credit in this basket would be zero. Because it would have taxes, but no income, in the general limitation basket, its credit limitation for these taxes would be zero. The separate limitations would thus allow *USCo* no foreign tax credit for year 1.

For U.S. multinationals, however, the separate limitation regime is qualified by a crucial exception: interest, rents, and royalties received

65. I.R.C. § 862(a)(4).

66. The assumption that none of *USCo*'s deductions are allocated or apportioned to the royalties is not realistic, but it is a simplification that does not affect the points made here.

67. A corporation's tax is 35% of taxable income if its taxable income exceeds $10 million. I.R.C. § 11(a).

68. *See* BITTKER & LOKKEN, *supra* note 3, ¶ 72.7.1.

69. I.R.C. § 904(d)(1)(A).

70. I.R.C. § 904(d)(1)(I).

from a CFC of which the recipient is a U.S. shareholder "shall not be treated as income in a separate category" unless it is "properly allocable to" income of the CFC in a separate category.[71] In other words, royalties received by a U.S. shareholder from a CFC are passive income only if, under the U.S. rules for allocating and apportioning deductions, the CFC's royalty expense is considered a cost of earning passive income of the CFC.[72] Royalty income that is not passive is typically not within any other specific basket and is thus general limitation income. In the examples, *USCo* is a U.S. shareholder of *PRS*, which is a CFC having only active business income. *USCo*'s royalty income is therefore general limitation income, and since all of its foreign source income and foreign income taxes are in the same basket, its credit limitation in that basket is $17.5 (35% of foreign source taxable income of $50), its foreign income taxes in the basket are $30, and it is allowed credit for year 1 of $17.5.

Congress should amend the look-thru rules to make them inapplicable to royalties and interest income. The legislative history on the rules states that they are intended "to make the foreign tax credit limitation treatment of income earned through foreign branches and income earned through foreign subsidiaries more alike by, in effect, treating income earned by a foreign subsidiary as if it were earned directly by its U.S. parent."[73] Whether foreign business is done through a branch or a CFC, "it is frequently appropriate to allow cross-crediting of taxes paid by one unit of a worldwide business against income earned by another unit of that business."[74]

However, as applied to royalties and interest income, this analysis overlooks a crucial difference between branches and subsidiaries. If a U.S. company does business in country *X* through a branch located in that country and utilizes intellectual property it owns in that business, there are no royalties because the same person both owns and uses the property. Because a company's country *X* tax base is not diminished by deductions for royalties, the portions of the its income that derives from its use of the intellectual property in country *X* is taxed by country *X* on the same basis as all other income of the country *X* business. In this case, the income attributable to the intangible is appropriately included in the same basket as the other income from the business.

In contrast, if a U.S. company does business in country *X* through a subsidiary organized and doing business only in that country, the subsidiary must compensate its parent for its use of intellectual property owned

71. I.R.C. §§ 904(d)(3)(A), (C). These rules also apply to dividends received from a CFC, but since dividends are typically not deductible by the payor under the tax laws of its home country, these dividends are not part of the story told in the text.

72. STAFF OF J. COMM. ON TAXATION, 99TH CONG., GENERAL EXPLANATION OF THE TAX REFORM ACT OF 1986, at 890 (1986) [hereinafter STAFF OF J. COMM., 99TH CONG.]. For allocations and apportionments of deductions, see Treas. Reg. § 1.861-8 (as amended in 2005), discussed in BITTKER & LOKKEN, *supra* note 3, at ¶ 73.10.

73. H.R. Rep. No. 99-841 II-573 (Conf. Rep. 1986).

74. STAFF OF J. COMM. ON TAXATION, 99TH CONG., *supra* note 72, at 867.

by the parent, in the form of royalties.[75] The subsidiary is typically allowed deductions for the royalties in determining its country *X* tax.[76] Country *X* may impose a withholding tax on the parent's royalty income unless it is barred from doing so by treaty. As noted earlier, income tax treaties often preclude withholding taxes at source on royalties.

In sum, branches and subsidiaries are not analogous in this context because countries of source tax income from the use of intellectual property owned by foreign persons differently, depending on whether the owner uses the property through a branch or through a subsidiary. Similarly, interest from a CFC is not analogous to any portion of the return on capital that a U.S. company invests in a foreign branch because the former is usually deductible by the payor and taxed at source to the recipient, if at all, only by a withholding tax, while no such deduction or withholding tax applies in the latter case.

The policy to alleviate double taxation requires distinctions based on the manner in which income is taxed by foreign countries. Passive income from foreign sources is usually taxed by foreign countries, if at all, by withholding taxes imposed on the gross amounts of the income, while income in the general limitation basket is usually taxed abroad on a net basis, with deductions for costs associated with the income. Since royalties and interest from a received CFC are usually burdened by foreign income taxes in the same way as royalties and interest from unrelated persons, they should be treated the same for purposes of the limitation on the foreign tax credit. They should, in other words, be in the passive basket, not the general limitation basket. The look-thru rule for royalties and interest, which allows these royalties and interest to migrate to the general limitation basket, should be repealed.

The proposals of the Panel and the Joint Committee Staff contain nothing analogous to the look-thru rule for royalties and interest income. In Examples 1 and 2, the proposed exemption would apply to dividends that *USCo* may receive from *PRS* and to country *X* taxes on *USCo*'s share of *PRS*' income, but the royalties from *PRS* would be included in *USCo*'s U.S. taxable income, with credit for foreign income taxes on these and similar items. In the examples, current law, amended to delete the look-thru rule for royalties and interest income, would yield the same results as the Panel and staff proposals. The Panel and the Joint Committee Staff, in other words, share my belief that this rule cannot be part of a rational U.S. international tax system.

75. Royalties are required by the transfer pricing rules, which require all transactions between related persons to be priced at arm's length amounts. *See* BITTKER & LOKKEN, *supra* note 3, ¶ 79.3.

76. If country *X* has an income tax treaty with the United States following the U.S. Model, it must allow deductions for the royalties if it would allow deductions for royalties paid between residents of country *X*. U.S. Model, *supra* note 64, art. 24(3).

2. Distortions Arising From Inappropriate Source Characterizations

The credit limitation is also corrupted by source rules that sometimes characterize income that originates, economically, within the United States as being from foreign sources. The limitation is, very generally, the portion of the U.S. tax, before credit, that is ratably allocable to taxable income from sources outside the United States, as determined by the source rules of the U.S. tax law.[77] To the extent that these rules treat income that economically originates within the United States as foreign source income, they effectively allow foreign income taxes to be credited against U.S. tax on income from U.S. sources.

Example 3

In addition to the facts assumed in Examples 1 and 2, assume *USCo* produces widgets in the United States and sells them to its U.S. and foreign affiliates, including *PRS*, which resell the goods to customers in their respective jurisdictions. Title to the goods sold to *PRS* passes from *USCo* to *PRS* when *PRS* receives the goods in country *X*. For year 1, USCo has taxable income of $100 on sales of widgets to *PRS*. Country *X* taxes *PRS*'s income on its resales of the goods, but because *USCo* has no permanent establishment outside the United States, neither country *X* nor any other foreign country taxes any portion of *USCo*'s income on its sales to *PRS*.

USCo's income on the sales to *PRS* is from sources partly within the United States, where *USCo* produces the goods, and partly from sources in country *X*, where its sales to *PRS* are deemed to occur.[78] For purposes of the U.S. source rules, a sale of goods occurs where "the rights, title, and interest of the seller in the property are transferred to the buyer."[79] Since title passes from USCo to *PRS* in country *X*, the sales are deemed to occur in country *X*. Unless a taxpayer elects otherwise, income on a sale of goods that the taxpayer produces in the United States and sells outside the United States is apportioned equally between U.S. and foreign sources.[80] Absent such an election, $50 of *USCo*'s $100 of income on sales to *PRS* is from U.S. sources, and $50 is from foreign sources.

Combining Examples 1, 2, and 3, *USCo* has taxable income from foreign sources of $100 (royalties of $50 and sales income of $50). Its credit limitation is thus $35 (35% of $100). Since its foreign income taxes are $30, *USCo* is allowed credit for year 1 for all of these taxes.

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77. I.R.C. § 904(a) (1994). These rules are found in §§ 861–865. *See* Bittker & Lokken, *supra* note 3, ¶ 73.1.

78. I.R.C. § 863(b).

79. Treas. Reg. §§ 1.861-7(c), 1.863-3(c)(2) (1996).

80. Treas. Reg. § 1.863-3(b)(1) (1996). The regulations allow two elective alternatives: an independent factory price (IFP) method, and a books and records method. The IFP method may be elected only if the taxpayer establishes an independent factory price for the goods. Treas. Reg. § 1.863-3(b)(2) (1996). The books and records method may only be used with the IRS' advance approval. Treas. Reg. § 1.863-3(b)(3) (1996). *See* Bittker & Lokken, *supra* note 3, ¶ 73.6.3.

As in Examples 1 and 2, no credit is needed to alleviate double taxation because none of *USCo*'s income is doubly taxed. Moreover, country *X*'s failure to tax any portion of *USCo*'s sales income is not a mere indulgence allowed by that country's lawmakers. By international consensus, a country may only tax business profits of a resident of another country if that person has a permanent establishment in the taxing country, and given such a permanent establishment, the country may only tax business profits to the extent they are attributable to the permanent establishment.[81] None of *USCo*'s income is attributable to a foreign permanent establishment. All of its income on sales to *PRS* derives from its activities in the United States. By characterizing one half of such income as foreign-source, U.S. law effectively allows U.S. exporters to credit foreign income taxes against U.S. tax on U.S. income, contrary to the policy of restricting the credit to alleviating double taxation.

To remedy this distortion, Congress should conform the U.S. source rules to international practices in taxing business income. Income of a U.S. person on sales of goods should be entirely from U.S. sources, except to the extent it is attributable to a permanent establishment of the person outside the United States.[82] The amount of income attributable to a permanent establishment should be determined as though the permanent establishment were a separate entity dealing at arm's length with all other aspects of the taxpayer's business and investment activities.[83]

The current source rules for sales income would operate equally mischievously under the proposals of the Panel and the Joint Committee Staff. Because *USCo*'s sales income is neither CFC dividends nor income of a foreign branch, it would not be within the proposed exemption. But, if, under the proposals, all nonexempt income is lumped together in determining the limitation on the credit for foreign income taxes on nonex-

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81. The best evidence of international consensus on tax jurisdiction is the OECD's Model Tax Convention on Income and on Capital, which the OECD adopted as a guide for the formulation of income tax treaties between OECD members but is widely used by other countries in negotiating tax treaties. OECD Model Tax Convention art. 7(1), July 15, 2005 [hereinafter OECD Model]. The U.S. Model Income Tax Convention is based on the OECD Model, as is a Model adopted by a United Nations group for use in developing income tax treaties between developed and developing countries. U.N. DEP'T OF ECON. & SOC. AFFAIRS, U.N. MODEL DOUBLE TAXATION CONVENTION BETWEEN DEVELOPED AND DEVELOPING COUNTRIES, U.N. DOC. ST/ESA/PAD/SER.E/21 (2001). *See* BITTKER & LOKKEN, *supra* note 3, ¶ 65.1.6. The description in the text is a summary of article 7(1) of the OECD Model. Articles 7(1) of the U.S. and United Nations Models are essentially identical.

82. The makings of such an amendment may be found in I.R.C. § 865(e)(1) (West 2006), which uses the term "office or other fixed places of business" instead of "permanent establishment" but with no essential change in meaning. *Compare* OECD Model, *supra* note 81, art. 5, *with* I.R.C. § 864(c).

Congress should also revise the source rules applicable to foreign persons selling goods. Section 865(e)(2), which generally parallels treaty law, should be made the exclusive rule for determining the source of sales income, rather than a supplement to the title passage rule, as it is now.

83. This is the treaty rule for determining income attributable to permanent establishments. *See* OECD Model, *supra* note 81, at art. 7(2); U.S. Model, *supra* note 64, at art. 7(2).

empt income, sales income that is assigned to foreign sources, and not taxed by any foreign country, would enhance the credit limitation for foreign taxes on other nonexempt income. Even if the new law preserved the present basket system, the source rule for sales income could continue to distort the limitation for taxpayers such as *USCo*. For example, if *USCo*'s royalties (Example 2) were subjected to substantial withholding taxes and the law continued to contain a look-thru rule for royalties, income on the sales, to the extent characterized as being from foreign sources but not taxed by any foreign country, would raise the limitation to provide greater credit for foreign income taxes on the royalties.

Further, as in Example 1, the proposals would make no change in the results in Example 3 if *USCo* owned 50% or less of the interests in *PRS*, and so proscribing *PRS* characterization as a CFC. In this case, both *USCo*'s sales income and the taxes on *PRS*'s income would be outside the exemption system and subject to the residual credit system, which would presumably operate as it does under current law.

Moreover, the source rule for sales income could inappropriately expand the proposed exemption by characterizing income originating in the United States as income of a foreign branch. Assume *USCo* has a branch in country *Y* that sells goods produced by *USCo* in the United States. Under the sales source rule, *USCo* income on producing and selling these goods would be allocated one half to U.S. sources and one half to foreign sources. If the foreign-source portion is taken to be the income of the country *Y* branch, it would, under the proposals, be exempt from U.S. tax. However, if the income derives primarily from *USCo*'s manufacture of the goods and only incidentally from the sales activities of the branch, the exempted income would include income that originates economically in the United States and could not be taxed by country *Y*. This might be the case if, for example, *USCo*'s country *Y* sales were large in dollar amount, but were made to a small number of independent distributors, and the branch's function was to service *USCo*'s relationship with the distributors. In such a case, the amount attributable to *USCo*'s permanent establishment in country *Y*, which is the maximum amount that country *Y* could tax under an income tax treaty between country *Y* and the United States, may be significantly less than one half of the income. If so, the proposed exemption would extend to income that is outside the taxing jurisdiction of all countries other than the United States.

IV. CONCLUSION

The principal claim of this paper is that deficiencies in the current worldwide base/credit system do not provide a strong reason for substituting the exemption system advocated by the Panel and Joint Committee staff. These deficiencies are not inherent in the current system and can be corrected without changing the fundamental premises of U.S. international income taxation. Moreover, if not corrected, many of these deficiencies will plague the proposed system much as they have the current

system. The Panel and the Joint Committee Staff fell into a common error in tax policy discussions: comparing current law, in its highly-corrupted state, with an idealized alternative and reaching the obvious conclusion that the latter is preferable. In fairness, the proposed system must be compared with the best feasible version of a worldwide/credit system.

The examples discussed in this paper do not completely catalogue the shortcomings of current law, neither would the suggestions offered to eliminate the distortions seen in the examples would not remedy all of the shortcomings. Some observers may argue that the process of identifying and repairing each failure of current law to effect its policies would be a never-ending, futile exercise. However, as demonstrated in the analysis of the examples, this process would not be obviated by the proposed exemption system. It may be inherent in all income taxes.

This paper does not address the other claim made by the Panel and the Joint Committee Staff in support of their proposals: that an exemption system would be less inefficient economically because it would interfere less with business and investment decisions. That argument is merely a corollary of the real issue, that the flaws in the current system foster inconsistent results that diverge from the purported policy of the system. These flaws cause the distortion of business and investment decisions. This paper argues that an exemption system is not the only cure to these present ills. It is with this realization that a proposal for an exemption system must be consolidated.