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NOTES

The Simplification of Subpart F

by Daniel P. Shepherdson*

I. INTRODUCTION

The function of taxation is to generate revenues sufficient for financing governmental activities and to operate as a mechanism of redistributive economic and social policy.¹ Each congressional decision to impose the burden of a tax balances the need to generate revenue against the public policy goal of encouraging or discouraging the particular targeted activity upon which the tax incidence falls. Although constitutional limits restrict the congressional exercise of the taxing power over domestic activity,² arguably few legal limits restrict the full exercise of U.S. tax jurisdiction over U.S. citizens,³ foreign corporations and nonresident alien individuals on their foreign source income.⁴ The exercise of ex-

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¹ See generally WEALTH REDISTRIBUTION AND THE INCOME TAX (A. Leibowitz ed. 1978); THE POLITICAL ECONOMY OF TAXATION (A. Peacock & F. Forte eds. 1981) [hereinafter cited as Peacock & Forte]; Houtte, *Principles of Interpretation in Internal and International Tax Law*, in DEVELOPMENTS IN TAXATION SINCE WORLD WAR I (International Bureau of Fiscal Documentation 1968) (provides a scholarly methodology for the interpretation of national tax laws and international tax conventions); van Hoorn, *Problems, Possibilities, and Limitations with Respect to Measures Against International Tax Avoidance and Evasion*, 8 GA. J. INT'L COMP. L. 763, 763-66 (1978).

² The Supreme Court has implicitly acknowledged, albeit in dicta, that:

[A]lthough a particular exertion of power by Congress was not restrained by any express limitation of the Constitution, if by the perverted exercise of such power so great an abuse was manifested as to destroy fundamental rights which no free government could consistently violate, that it would be the duty of the judiciary to hold such acts to be void upon the assumption that the Constitution by necessary implication forbade them.

McCray v. United States, 195 U.S. 27, 63 (1904). See, e.g., U.S. CONST. amend. V (due process clause); U.S. CONST. amend. XVI.

³ The Supreme Court has upheld the exercise of Congressional taxing power over U.S. citizens on their worldwide income. Cook v. Tait, 265 U.S. 47 (1924).

⁴ See Norr, *Jurisdiction to Tax and International Income*, 17 TAX L. REV. 431 (1962). But see Albrecht, *The Taxation of Aliens Under International Law*, 29 BRIT. Y.B. INT'L L. 145 (1952). See generally Choate, Hurok & Klein, *Federal Tax Policy for Foreign Income and Foreign Taxpayers*—

tended, nonterritorial tax jurisdiction often results in the imposition of double taxation on transnational business transactions.⁵ This burden on foreign source income has, however, been mitigated by the foreign tax credit,⁶ tax treaty provisions⁷ and the deferral mechanism.⁸

The Subpart F provisions⁹ were enacted as a partial exception to the deferral mechanism in order to promote greater tax neutrality¹⁰ between

History, Analysis and Prospects, 44 TEMP. L.Q. 441, 444-47 (1971); L. KRAUSE & K. DAM, FEDERAL TAX TREATMENT OF FOREIGN INCOME 107-11 app. (1964).

⁵ See van Hoorst *supra* note 1, at 767-69; J. ADAMS & J. WHALLEY, THE INTERNATIONAL TAXATION OF MULTINATIONAL ENTERPRISES IN DEVELOPED COUNTRIES 41-46 (1977); see generally Sherfy, *Background of General Policy*, in TAXATION OF FOREIGN INCOME 227-40 (Tax Institute of America 1966).

⁶ I.R.C. §§ 33, 901-04 (1983). See generally B. BITTKER & J. EUSTICE, FEDERAL INCOME TAXATION OF CORPORATIONS AND SHAREHOLDERS § 17.11 (4th ed. 1979); 1-4 R. RHOADES & M. LANGER, INCOME TAXATION OF FOREIGN RELATED TRANSACTIONS §§ 5.01-5.09 (1984); B. BITTKER & L. EBB, UNITED STATES TAXATION OF FOREIGN INCOME AND FOREIGN PERSONS 210-74 (1968); J. BISCHSEL & R. FEINSCHREIBER, FUNDAMENTALS OF INTERNATIONAL TAXATION 47-62 (1977); P. MCDANIEL & H. AULT, INTRODUCTION TO UNITED STATES INTERNATIONAL TAXATION 68-84 (1977); 1-3 E. OWENS, INTERNATIONAL ASPECTS OF UNITED STATES INCOME TAXATION: CASES AND MATERIALS 33-128 (1980) [hereinafter cited as INTERNATIONAL ASPECTS]; E. OWENS, THE FOREIGN TAX CREDIT (1961).

⁷ See generally INCOME TAX TREATIES (J. Bischsel ed. 1978); 1-2 TAX TREATIES (CCH); JOINT COMM. ON INT. REV. TAX, 87 CONG. 1ST SESS., 1-4 LEGISLATIVE HISTORY OF UNITED STATES TAX CONVENTIONS (1962); Surrey, *International Tax Conventions: How They Operate and What They Accomplish*, 23 J. TAX'N 364 (1965); Hadari, *Tax Treaties and Their Role in the Financial Planning of the Multinational Enterprises*, 20 AMER. J. COMP. L. 111 (1972); Trelles, *Double Taxation/Fiscal Evasion and International Tax Treaties*, 12 IND. L. REV. 341 (1979); Houtte, *supra* note 1, at II:9 and II:36-43; 3-4 R. RHOADES & M. LANGER, *supra* note 6; Owens, *United States Income Tax Treaties: Their Role in Relieving Double Taxation*, 17 RUTGERS L. REV. 428 (1963).

⁸ "There is no explicit statutory rule providing for deferral of the United States tax on foreign source income. Rather, deferral arises out of the basic jurisdictional distinctions between domestic and foreign corporations." 3 INTERNATIONAL ASPECTS, *supra* note 6, at 6. For the relative statutory provisions that implicitly provide for the deferral mechanism see I.R.C. §§ 861-64, 871-76, 881-82 (1983).

⁹ I.R.C. §§ 951-64 (1983). See generally SUBPART F- FOREIGN SUBSIDIARIES AND THEIR TAX CONSEQUENCES (R. Feinschreiber ed. 1979) (providing a thorough explication of Subpart F) [hereinafter cited as Feinschreiber]; The Report of the President's Task Force on Business Taxation—1970, reprinted in 24 TAX LAW. 395 (1971) [hereinafter cited as Task Force]; STAFF OF SENATE COMM. ON FINANCE, 93 CONG., 2D SESS., A SUMMARY OF ADMINISTRATION RECOMMENDATIONS ON U.S. TAXATION OF FOREIGN INCOME AND FOREIGN PERSONS (Comm. Print 1974); HOUSE COMM. ON WAYS AND MEANS, 95TH CONG., 2D SESS., THE PRESIDENT'S 1978 TAX PROGRAM 326-41 (Comm. Print 1978).

¹⁰ The goal of tax neutrality is to place an equal tax burden on both foreign and domestic investment. Ideally, tax considerations should not be dispositive factors in the decision to invest in either foreign or domestic business operations. However, all other considerations being equal, the benefit of deferral strongly favors foreign investment over domestic investment, although without deferral foreign operations of U.S. multinational enterprises (MNE's) would be at a competitive disadvantage relative to our foreign competitors that generally retain the benefit of deferral. On the other hand, the termination of deferral (which would harm our competitive position in international trade) would eliminate the tax inequity existing between foreign and domestic investment. See *gen-*

foreign and domestic investment by U.S. multinational enterprises (MNE's).¹¹ The provisions, however, are excessively complex.¹² This note will examine the policy and the mechanics of the Subpart F provisions and propose some alternatives to the existing regime.

II. INTERNATIONAL TAX MINIMIZATION

The application of U.S. income tax laws to international business transactions is complicated by a lack of uniformity among national taxing systems and a host of definitional inconsistencies regarding, for example: (1) forms of business organization; (2) types and levels of tax; (3) accounting practices; (4) source of income; (5) source/location of tangible and intangible property rights; (6) financial privacy; and, (7) information gathering.¹³ The general effect of these inconsistent definitional complexities on the international tax liability of U.S. multinational enterprises (MNE's) engaged in transnational business transactions may be either the double taxation of income¹⁴ or, in the alternative, the complete escape from income tax liability altogether.¹⁵ The potential burden of double taxation may discourage U.S. MNE's from engaging in international trade.¹⁶ On the other hand, the deferral mechanism provides an inequitable benefit to U.S. MNE's with foreign operations as compared to U.S. corporations with similar domestic operations.¹⁷ The problem of double taxation and deferral, and the complexity of their national or international resolution, may encourage active international tax minimization.¹⁸

erally L. KRAUSE & K. DAM, *supra* note 4, at 44-84; Hufbauer & Foster, *U.S. Taxation of the Undistributed Income of Controlled Foreign Corporations*, in *ESSAYS IN INTERNATIONAL TAXATION*: 1976, at 13-19 (1976).

Moreover, there are some countervailing considerations. Many of the tax expenditures (i.e. subsidies) available to domestic corporations are not available to foreign corporations. *See, e.g.*, I.R.C. §§ 48(a)(2), 168, 904, 921-27, 991-97 (1983). *See also infra* note 32 (domestic deductions permitted to a foreign taxpayer are limited).

¹¹ *See generally* R. BARNETT & R. MULLER, *GLOBAL REACH: THE POWER OF THE MULTINATIONAL CORPORATION* (1974); Vagts, *The Multinational Enterprise: A New Challenge for Transnational Law*, 83 HARV. L. REV. 739 (1970).

¹² "[O]ne of the most controversial aspects of the U.S. international tax structure over the past three decades has been the income tax treatment of foreign corporations, controlled by U.S. shareholders." P. McDANIEL & H. AULT, *supra* note 6, at 16. *See* B. BITTKER & J. EUSTICE, *supra* note 6, at § 17.11 (17:62); Feinschreiber, *supra* note 9; 1 R. Rhoades & M. Langer, *supra* note 6, at § 3.01[1].

¹³ *See* Forry & Lerner, *Taxing Multinational Enterprises: Basic Issues of International Income Tax Harmonization*, 10 INT'L LAW. 623 (1976).

¹⁴ *See supra* note 5 and accompanying text.

¹⁵ Forry & Lerner, *supra* note 13, at 623-24.

¹⁶ J. BISCHER & R. FEINSCHREIBER, *supra* note 6, at 8.

¹⁷ *See* L. KRAUSE & K. DAM, *supra* note 4, at 11-13.

¹⁸ International tax minimization is somewhat of a misnomer. In fact, no international tax is

A. *The United States Tax System*

The two general methods of national taxation are: (1) territoriality jurisdictions—which impose the incidence of taxation on the basis that the source of the income lies within the national boundaries;¹⁹ and, (2) domiciliary jurisdictions—which impose the incidence of taxation on the worldwide income of the taxpayer based upon the status within the jurisdiction.²⁰ The second method is a much broader expression of national tax jurisdiction and will result in overlapping tax liabilities for foreign source income initially taxed by foreign countries under source principles.

“The United States Internal Revenue Code subjects the global income of all the earth’s inhabitants and corporations to the United States income tax. The limitations on jurisdictional reach are found in subse-

actually minimized or avoided. Rather, the term encompasses the ability to minimize the burden of various national tax liabilities for transnational business transactions. As an illustration, assume a U.S. MNE, the X corporation, has a wholly-owned subsidiary, Z corporation, organized in a low-tax jurisdiction. Further, assume that the tax rate for the X corporation in the United States and the Y corporation in Brazil is 46%, whereas the tax rate for Z corporation is .05%. In order to minimize the overall tax liabilities, the X corporation could structure the transaction as follows: (1) The Y corporation could sell the raw materials to the Z corporation at cost and, therefore, there would be no profit in Brazil and Brazil would receive no tax; (2) the X corporation could then buy the raw materials from the Z corporation at the price at which X will sell the raw materials after they have been manufactured into a finished good and, therefore, there would be no profit in the United States and the United States would receive no tax; and (3) the Z corporation will accumulate the profits in the transaction because the purchase price was understated and the selling price was overstated and, therefore, the low-tax jurisdiction will receive the tax. Through this intracompany pricing mechanism, the X corporation will be able to minimize the international tax liability on the transnational business transaction by accumulating profits in a low-tax jurisdiction.

The line between tax avoidance (legal) and tax evasion (illegal) is often difficult to draw, particularly in the area of international taxation. Certainly, the potential burden of double taxation will encourage aggressive tax minimization planning. Moreover, the problems of access to financial information, definitional inconsistencies and the inability to enforce national tax judgments in foreign courts will further compound the ability of tax authorities to enforce national tax laws. *See generally* H. BALTER & J. GUIDOTTI, *TAX FRAUD AND EVASION* §§ 2.01-2.05 (5th ed. 1983); 1 B. BRACEWELL-MILNES & M. WISSELINIK, *INTERNATIONAL TAX AVOIDANCE* 27-63, 191-309, 333-47 (1979); Note, *Transnational Evasion of United States Taxation*, 81 HARV. L. REV. 876 (1968); van Hoorn, *supra* note 1; Gordon, *Tax Havens and Their Use by United States Taxpayers—An Overview*, in *TWELFTH ANNUAL INSTITUTE ON INTERNATIONAL TAXATION* 191, 261-63 (Practicing Law Institute 1981) [hereinafter cited as Gordon Report].

A tension exists between the burden of double taxation and the related problems of fiscal evasion. A coherent and consistent national or international resolution of the two difficulties may, ultimately, be impossible. This is so because, theoretically, “the greater the administrative reach [of national tax laws], the more concern with [the burden] of double taxation by the taxpayer; the greater the relief from double taxation, the greater the desire of government to extend its administrative reach.” Trelles, *supra* note 7, at 345.

¹⁹ See Norr, *supra* note 4, at 434-37.

²⁰ Shoup, *Taxation of Multinational Corporations*, in 1 *INTERNATIONAL ASPECTS*, *supra* note 6, at 45-48; Norr, *supra* note 4, at 433.

quent Code provisions.”²¹ Some scholars have argued that these limitations are voluntarily self-imposed and that theoretically they are neither compelled by the U.S. Constitution²² nor by principles of international law.²³ Other scholars, however, have argued that “[t]he right to tax aliens is a prerogative of the sovereign state—a prerogative which is limited by rules of customary and conventional international law.”²⁴

Even granting that there are no constitutional or international law limits on the power of the United States to exercise its tax jurisdiction, a critical distinction must be noted between the power to impose a tax and the related power to enforce and collect the tax. Although the power of the United States to impose a tax on extraterritorial activity may be limitless, in practice the inability to enforce and collect the tax operates as a practical limitation of the arbitrary extension of a nation’s tax jurisdiction.²⁵

The United States imposes the incidence of taxation on U.S. citizens, resident alien individuals and domestic corporations on their worldwide income.²⁶ The United States imposes the incidence of taxation on non-resident alien individuals and foreign corporations²⁷ on U.S. source income,²⁸ or income that is “effectively connected with the conduct of a trade or business within the United States.”²⁹ A corollary to this holds that nonresident alien individuals and foreign corporations are not taxed on foreign source income, nor on income that is not effectively connected

²¹ 2 INTERNATIONAL ASPECTS, *supra* note 6, at 4. For an overview of U.S. tax jurisdiction regarding international business transactions see generally 1 R. RHOADES & M. LANGER, *supra* note 6, at §§ 1.11-1.14; B. BITTKER & L. EBB, *supra* note 6, at 30-112; J. BISCHER & R. FEINSCHREIBER, *supra* note 6, at 5-11; P. MCDANIEL & H. AULT, *supra* note 6, at 36-38. For a general discussion of the constitutional and international law limits regarding the taxation of foreign income see *supra* note 4.

²² Choate, Hurok & Klein, *supra* note 4, at 444.

²³ Norr, *supra* note 4, at 431.

²⁴ Albrecht, *supra* note 4, at 185. See Liebman, *Note on the Tax Treatment of Joint Venture Income Under Subpart F: An Addendum*, 32 BUS. LAW. 1819, 1825-26 (1977).

²⁵ The extraterritorial application of national tax laws raises procedural problems of recognition and enforcement of judgments: “[F]or no country ever takes notice of the revenue laws of another.” Holman v. Johnson, 1 Cowp. 341, 343, 98 Eng. Rep. 1120, 1121 (1775). See Note, *The Nonrecognition of Foreign Tax Judgements: International Tax Evasion*, 1981 U. ILL. L. REV. 241 (1981); see also Atik, *The Problem of Reciprocity in Transnational Enforcement of Tax Judgments*, 8 YALE J. WORLD PUB. ORD. 156 (1981) (the author proposes a refined concept of reciprocity called “structural reflection” which embodies principles of comity and elements of compatibility as a replacement for the norm of non-enforcement in the transnational tax judgment area).

²⁶ I.R.C. §§ 1, 11, 61 (1983).

²⁷ *Id.* §§ 871, 881, 882, 7701(a)(3), (4), (5), 7701(b).

²⁸ *Id.* § 861 (defines U.S. source income); *Id.* § 862 (defines income from sources without the United States); *Id.* § 871(a) (imposes tax on nonresident alien individuals for U.S. source income); *Id.* § 881 (imposes tax on foreign corporations for U.S. source income).

²⁹ *Id.* § 871(b)(1) (for nonresident alien individuals); *Id.* § 882(a)(2) (for foreign corporations); *Id.* § 864(c) (general rule).

with the conduct of a trade or business within the United States.³⁰ Income of nonresident alien individuals and foreign corporations which satisfies the "effectively connected" test is taxed at normal rates on a net basis,³¹ and ordinary deductions permitted to a domestic taxpayer are also permitted to a foreign taxpayer.³² However, income which fails the "effectively connected" test but satisfies the "United States source" test is taxable at a fixed thirty percent rate on the gross amount received.³³

B. Double-Taxation

The cumulative effect of the national taxation of worldwide income is the double taxation of foreign source income.³⁴ The income is taxed initially in the source country on the basis of the territoriality principle and, additionally, the income is taxed in the home country on the basis of the domiciliary principle. A tax regime that imposes the burden of double taxation operates as a disincentive to international trade and may even encourage active, aggressive tax minimization planning.³⁵

Despite this problem, no multilateral or international law regime has been established for the satisfactory prevention of double taxation or the concomitant problem of international tax avoidance. However, bilateral treaties that effectively provide for the prevention of double taxation have been negotiated, primarily between developed countries.³⁶ In the absence of a bilateral treaty, unilateral national measures are the primary means of preventing the double taxation that results from the imposition of tax incidence of a worldwide basis.³⁷ Such unilateral measures, however, operate solely to the disadvantage of the enacting countries.³⁸

The United States utilizes a unilateral measure in order to alleviate the burden of double taxation. The United States employs a dollar-for-dollar foreign tax credit,³⁹ which is available to citizens and domestic

³⁰ This exclusion is implicit in the express enumeration of the scope of taxable income for nonresident alien individuals and foreign corporations in I.R.C. §§ 871 and 881-882. Resident alien was redefined in 1984. I.R.C. § 7701(b)(3) (1984) (discusses the use of a "substantial presence test" and a "closer connection" analysis).

³¹ See *supra* note 29.

³² Such deductions, however, are limited "only if and to the extent that they are connected with income which is effectively connected with the conduct of a trade or business within the United States." I.R.C. §§ 873(a), 882(c)(1) (1983).

³³ *Id.* §§ 871(a), 881(a).

³⁴ See *supra* note 5.

³⁵ See *supra* note 18.

³⁶ See *supra* note 7.

³⁷ Generally, European countries grant an exemption for foreign taxes, while Anglo-American countries and Japan rely on a foreign tax credit mechanism. See L. KRAUSE & K. DAM, *supra* note 4, at 114-15.

³⁸ See Trelles, *supra* note 7, at 349-50; Owens, *supra* note 7, at 431-33.

³⁹ See *supra* note 6.

corporations for "any income, war profits, and excess profits taxes paid or accrued during the taxable year to any foreign country."⁴⁰ Therefore, U.S. taxpayers get a domestic tax credit for foreign taxes which are paid. "The purpose of the foreign tax credit is to eliminate double taxation of foreign-source income. In effect, the foreign tax is treated as a down payment on the domestic taxpayer's U.S. tax liability with respect to that income."⁴¹ In other words, the United States taxes foreign source income the same as it taxes domestic income; however, the United States grants a generous credit for foreign taxes which are paid.

Apart from treaties, this is the primary means used for the reduction of the burden of double taxation.⁴² Unlike treaties, however, which are negotiated on a bilateral basis, the foreign tax credit is a unilateral measure that subordinates U.S. taxation of foreign source income to the foreign tax. Moreover, the effectiveness of the foreign tax credit as a means of reducing or eliminating the burden of double taxation is limited.⁴³ Double taxation will continue for income subject to foreign taxes which are not within the enumeration of the foreign tax credit provision.

C. *The Problem of Deferral*

The United States taxes the income of corporations and their shareholders separately.⁴⁴ The result of this scheme is that the corporation, as an entity, is taxed initially on the corporate income⁴⁵ and, if it then declares a dividend distribution out of after-tax income, this is taxable to the shareholder.⁴⁶ Although the corporate entity is taxed on accumulated earnings, the shareholder is generally not taxed on such earnings;⁴⁷ rather, the shareholder is taxed only on cash or disproportionate dividends received.⁴⁸ This regime applies equally to U.S. shareholders of domestic and foreign corporations.⁴⁹

The benefit of deferral arises for U.S. shareholders of foreign corporations with non-U.S. source and non-effectively connected income as a

⁴⁰ I.R.C. § 901(b) (1983).

⁴¹ B. BITTKER & J. EUSTICE, *supra* note 6, at § 17.11 (17:31).

⁴² *See supra* note 7.

⁴³ Trelles, *supra* note 7, at 349-50.

⁴⁴ I.R.C. §§ 301-16 (1983). *See generally* B. BITTKER & J. EUSTICE, *supra* note 6, at §§ 1.01-1.08.

⁴⁵ I.R.C. §§ 11, 61 (1983). *See generally* B. BITTKER & J. EUSTICE, *supra* note 6, at §§ 5.01-5.07.

⁴⁶ I.R.C. § 61(a)(7) (1983).

⁴⁷ *But see supra* note 9. By imposing the incidence of taxation on the shareholder of a controlled foreign corporation regardless of whether a dividend is declared or the earnings are repatriated, Subpart F operates, essentially, as an exception to the classical system of U.S. corporate taxation.

⁴⁸ *Eisner v. Macomber*, 252 U.S. 189 (1920).

⁴⁹ *See supra* note 46. *But see supra* note 9.

result of the potential disparity in national corporate tax rates.⁵⁰ Although the corporate tax structures and rates of many developed countries are similar to that of the United States, large tax differentials still exist, particularly for tax havens (low-tax jurisdictions).⁵¹ Since the U.S. corporate tax on worldwide income is not imposed until the profits of the foreign corporation are repatriated to the United States, the foreign corporation with U.S. shareholders need not pay the U.S. tax on worldwide income as long as the profits are accumulated in the foreign corporation.⁵²

Clearly, the benefit from deferral is most pronounced when the foreign corporation is organized in a low-tax jurisdiction. Moreover, MNE's can manipulate intracorporate transactions in order to accumulate worldwide profits in a subsidiary foreign corporation located in a low-tax jurisdiction and thereby avoid foreign and U.S. tax altogether.⁵³ Therefore, the significant potential benefit of deferral available to the U.S. shareholders of foreign corporations operates as a strong incentive, all other considerations being equal, to initially invest U.S. capital in foreign operations and, subsequently, to reinvest earnings from such operations in additional foreign operations.⁵⁴

III. SUBPART F

The goal of tax neutrality is to place an equal tax burden on both foreign and domestic investment, so that tax consequences do not affect business decisions. At the same time, however, the congressional decision to impose a tax often incorporates a conscious policy decision to

⁵⁰ Since the incidence of U.S. taxation is not imposed on the shareholder until the dividend is received, the tax on the non-U.S. source and non-effectively connected income of a foreign corporation is not imposed until the income is repatriated to the United States. As long as the foreign corporate tax rate is lower than the U.S. corporate tax rate, the foreign corporation will receive the benefit of deferral until the income is repatriated.

For example, assume a U.S. MNE, the X corporation, has a wholly-owned subsidiary, Y corporation, which pays a foreign tax at a rate of ten percent whereas the X corporation pays a U.S. tax at a rate of forty-six percent. Until the profits of the Y corporation are repatriated, the tax differential of thirty-six percent will not be due. Furthermore, if the profits are never repatriated, but are merely reinvested in other foreign operations, the incidence of U.S. taxation is delayed further.

⁵¹ Tax Havens are low or no tax jurisdictions. They are further characterized by: (1) strong secrecy laws; (2) modern banking facilities; (3) modern communication facilities; (4) lack of currency controls; (5) self-promotion as tax minimization jurisdictions; and (6) favorable tax treaties for tax reduction. See generally 1-3 W. DIAMOND & D. DIAMOND, *TAX HAVENS OF THE WORLD* (1984); M. LANGER, *PRACTICAL INTERNATIONAL TAX PLANNING* (1979); 1 B. BRACEWELL-MILNES & M. WISSELINK, *supra* note 18, at 67-118; Gordon Report, *supra* note 18; Pugh, *The Deferral Principle and U.S. Investment in Developing Countries*, in *UNITED STATES TAXATION AND DEVELOPING COUNTRIES* 267 (R. Hellawell ed. 1980).

⁵² See *supra* note 50.

⁵³ See *supra* note 18.

⁵⁴ In fact, rarely are "all other considerations equal." See *supra* note 10.

encourage or discourage particular business activity such that the tax consequences *do* affect business decisions. Any examination of Subpart F and any consideration of alternatives to Subpart F must reflect the tension between notions of tax neutrality and notions of conscious tax policy.

The deferral mechanism operates to favor investments in foreign operations over domestic operations, particularly when the relative difference between the U.S. and the foreign tax rate is high. Additionally, the deferral mechanism discourages the repatriation of profits.⁵⁵ The complete elimination of deferral for the aliquot share of a U.S. shareholder's interest in a foreign corporation is within the congressional power.⁵⁶ The double taxation resulting from such a unilateral measure would, however, impose a serious burden on the foreign operations of U.S. MNE's relative to local foreign business operations and foreign business operations of foreign MNE's that benefit from deferral.⁵⁷ Nevertheless, in 1962 Congress enacted Subpart F,⁵⁸ which was a partial elimination of deferral for certain kinds of income of certain kinds of foreign corporations.

The Subpart F provisions were enacted in response to the perception that the benefit of deferral disproportionately favored foreign investment. Subpart F terminates deferral and thereby promotes tax neutrality as between foreign and domestic investment by U.S. MNE's. In addition, Subpart F reflects a policy of generating U.S. government tax revenue by taxing U.S. MNE's on some of their worldwide income prior to repatriation while preventing abusive international tax avoidance and removing the tax incentive to engage in foreign investment.

⁵⁵ Since the repatriation of profits triggers the incidence of U.S. taxation, U.S. MNE's have little incentive to do so, absent any compelling statutory provisions.

⁵⁶ See generally *supra* notes 2-4, 21-25 and accompanying text. Practically, however, Congress is limited by considerations of administration and enforcement, and the foreign corporation must be subject to some U.S. control. Furthermore, it is more feasible to impose such a tax on U.S. shareholders of foreign corporations, rather than imposing the tax directly on the foreign corporation. See L. KRAUSE & K. DAM, *supra* note 4, at 11-13.

⁵⁷ See Lynn & Wiacek, *Keep "Deferral": U.S. Shareholders Should Not Be Taxed on Foreign Corporation Income Before They Receive It* (1978), reprinted in 3 INTERNATIONAL ASPECTS, *supra* note 6, at 132-47. But see *Federal Tax Reform for 1976: A Compendium 77* (Surrey, Pechman, & McDaniel eds. 1976), reprinted in 3 INTERNATIONAL ASPECTS, *supra* note 6, at 147-59 [hereinafter cited as Surrey, Pechman & McDaniel]; P. MUSGRAVE, UNITED STATES TAXATION OF FOREIGN INVESTMENT INCOME 143-46 (1969).

⁵⁸ Revenue Act of Oct. 16, 1962, Pub. L. No. 87-834, § 12(a), 76 Stat. 960, 1006. For an overview of the mechanics of Subpart F see generally Feinschreiber, *supra* note 9; 1 R. RHOADS & M. LANGER, *supra* note 6, at §§ 3.01-3.06; B. BITTKER & J. EUSTICE, *supra* note 6, at §§ 17.30-17.34.

A. *Mechanics of Subpart F*

Subpart F extends the U.S. tax jurisdiction to certain foreign corporations which are deemed to be controlled⁵⁹ by U.S. shareholders.⁶⁰ Generally, foreign corporations are not subject to U.S. tax unless their income is U.S. source income or is effectively connected with a U.S. trade or business.⁶¹ Under Subpart F, however, the U.S. shareholders of a controlled foreign corporation (CFC)⁶² are currently taxed on their aliquot share of certain designated foreign source income⁶³ accumulated by the CFC.⁶⁴ This operates as a partial, limited exception to the deferral mechanism. Moreover, it is a limited exception to the usual U.S. corporate tax system in which a shareholder is taxed only on cash or disproportionate dividends received, and not on corporate income.

The exception, however, is a narrow one. A CFC for the purposes of Subpart F is defined as "any foreign corporation of which more than 50 percent of the total combined voting power of all classes of stock . . . is owned [actually or constructively] by . . . United States shareholders."⁶⁵ Presumably, if U.S. shareholders had more than fifty percent control of a foreign corporation, they could then compel a dividend to cover any current tax on U.S. shareholders. Additionally, the foreign corporation must be a CFC "for an uninterrupted period of thirty days or more during any taxable year."⁶⁶ For the purposes of Subpart F, a U.S. shareholder⁶⁷ is a U.S. person⁶⁸ who owns or is deemed to own ten percent or

⁵⁹ I.R.C. § 957(a) (1983).

⁶⁰ *Id.* §§ 951(b), 7701(a)(8).

⁶¹ See *supra* notes 26-33 and accompanying text.

⁶² I.R.C. § 957(a) (1983).

⁶³ I.R.C. § 951(a) (1983).

⁶⁴ Such a regime would seem to violate the Supreme Court's holding in *Eisner v. Macomber*, 252 U.S. 189 (1920), that a shareholder cannot be taxed, under the Sixteenth Amendment, on a corporation's issuance of a stock dividend based on accumulated profits. *Eisner v. Macomber* "remains the most important statement of the Supreme Court on the relationship between the income of a corporation and the income of its shareholders. Moreover, since the decision was based on an interpretation of the word 'income' in the sixteenth amendment it raises important constitutional limitations with respect to [the relationship between] the taxation of corporations and [the taxation of] shareholders." Gabinet & Coffey, *The Implications of the Economic Concept of Income for Corporation-Shareholder Income Tax Systems*, 27 CASE W. RES. L. REV. 895, 897 (1977). Nevertheless, Subpart F has not been held to be unconstitutional. In fact, the Tax Court in *Estate of Leonard E. Whitlock*, 59 T.C. 490 (1972), *aff'd*, 494 F.2d 1297 (10th Cir. 1974), rejected a due process challenge to the Subpart F provisions.

For an overview of the constitutional and international law limits on Congressional taxing power see generally *supra* notes 2-4.

For a discussion of the constitutionality of Subpart F see Horwich, *The Constitutionality of Subpart F of the Internal Revenue Code*, 19 U. MIAMI L. REV. 400 (1965); L. KRAUSE & K. DAM *supra* note 4; Hufbauer & Foster, *supra* note 10, at 19-21.

⁶⁵ I.R.C. § 957(a) (1983).

⁶⁶ *Id.* § 951(a)(1) (1983).

⁶⁷ *Id.* §§ 951(b), 7701(a)(8).

more⁶⁹ of the CFC.

These provisions operate to narrow the application of Subpart F. Only certain U.S. persons that are stock owners qualify as U.S. shareholders under the "ten percent or more" requirement for Subpart F purposes; and only certain foreign corporations satisfy the "more than 50 percent" requirement for Subpart F purposes. Only "ten percent or more" shareholders may be utilized to satisfy the "more than 50 percent" control requirement for Subpart F purposes.

"Subpart F is aimed at closely held foreign corporations. It is not designed to affect corporations where voting control is broadly held, nor is it designed to affect foreign corporations that are controlled by nonresident aliens."⁷⁰ Additionally, the application of Subpart F is limited to certain types of designated income,⁷¹ and there are also express exclusions.⁷² The number of qualifications and exceptions contained within the Subpart F provisions, which limit its application, suggests that the provisions are not intended to terminate deferral entirely, but rather to terminate the abusive, manipulative exploitation of the benefit of deferral.

Subpart F does not raise the problem of double taxation⁷³ of foreign source income because it contains a liberal foreign tax credit provision which applies to first, second and third tier foreign corporations.⁷⁴ Nev-

⁶⁸ *Id.* §§ 957(d), 7701(a)(30).

⁶⁹ *Id.* §§ 951(b), 958(b).

⁷⁰ See 1 R. RHOADES & M. LANGER, *supra* note 6, at § 3.02[4][a](1).

⁷¹ U.S. shareholders of foreign corporations that are CFC's for an uninterrupted period of thirty days during any taxable year shall include in their gross income the sum of: (1) the pro rata share of the corporation's Subpart F income; (2) the pro rata share of previously excluded Subpart F income withdrawn from investment in less developed countries; (3) the pro rata share of previously excluded Subpart F income withdrawn from foreign base company shipping operations; and, (4) the pro rata share of the corporation's increase in earnings invested in U.S. property. I.R.C. § 951(a)(1). Subpart F income of a CFC is defined in § 952(a) (1983) as the sum of: (1) the income derived from the insurance of U.S. risks (I.R.C. § 953); (2) the foreign base company income (I.R.C. § 954); (3) income attributable to international boycotts; and, (4) amounts of illegal payments which would be unlawful under the Foreign Corrupt Practices Act of 1977.

⁷² I.R.C. §§ 951(d), 952(c), 954(b), 957(c), 957(d), 959(a), 960(a), 964(b), 970 (1983).

⁷³ See *supra* notes 34-43 and accompanying text.

⁷⁴ I.R.C. § 960 (1983). See generally van Hoorn, *supra* note 1; Choate, Hurok and Klein, *supra* note 4; L. KRAUSE & K. DAM, *supra* note 4; Sherfy, *supra* note 5; P. MCDANIEL & H. AULT, *supra* note 6; Hufbauer & Foster, *supra* note 10; Gordon Report, *supra* note 18; Lynn & Wiacek, *supra* note 57; Surrey, Pechman & McDaniel, *supra* note 57; Smith, *Taxation of Foreign Business Income - The Changing Objectives*, in TAXATION OF FOREIGN INCOME 241-55 (Tax Institute of America 1966).

The economic impact on the national economy of our tax policy on foreign source income is an essential consideration in reaching a decision regarding the proper approach. Some of the general considerations are: (1) the impact of deferral on U.S. foreign investment; (2) the impact of deferral on U.S. government revenue; (3) the impact of double taxation on U.S. foreign investment; (4) the impact of double taxation on fiscal evasion, and hence U.S. government revenue; (5) the impact of Subpart F on U.S. foreign investment; and (6) the impact of Subpart F on fiscal evasion, and hence

ertheless, the policy of terminating deferral in order to prevent international tax avoidance and thereby promote greater tax neutrality is subject to debate. Moreover, the Subpart F provisions are excessively complex and in need of reform and simplification.

IV. ALTERNATIVES TO SUBPART F

The Subpart F provisions were enacted to generate U.S. government revenue by taxing U.S. MNE's on some of their worldwide income prior to repatriation, thereby terminating deferral and preventing abusive international tax avoidance. Any alternative to Subpart F, therefore, ought to similarly remove the disproportionate tax incentive favoring foreign investment, while at the same time not discouraging foreign investment altogether. The revenue-generating tax system should neither encourage nor discourage foreign investment over domestic investment. Rather, the tax system should be neutral so that business decisions are based upon non-tax factors in a freely competitive world marketplace. The consideration of potential modifications to the existing regime, established for the taxation of foreign source income, implicitly highlights the tension between a tax system that encourages or discourages foreign investment on the one hand and a tax system that neither encourages nor discourages foreign investment on the other.

A variety of proposals have been made regarding Subpart F.⁷⁵ Alternatives to the existing Subpart F regime will now be examined in light of the following general criteria: (1) the desire for simplification; (2) the need for administrative convenience; (3) the need for predictability; (4) the prevention of international tax avoidance; (5) the prevention of double taxation; and, (6) the desire for pure tax neutrality.⁷⁶

Simplicity and administrative convenience serve the interest of the taxpayer by reducing the cost of tax planning, preparation and compliance (i.e., record keeping and legal/accounting fees). Similarly, they serve the interest of the tax collector by reducing the cost of tax administration and enforcement. Predictability serves the interest of the taxpayer by allowing improved tax planning and it serves the interest of the tax collector by allowing more accurate revenue projections. The prevention of international tax avoidance serves the interests of the various national taxing systems that rely on corporate income taxation to fund

U.S. government revenue. An empirical study of these factors is outside the scope of this Note. For an example of the economic arguments based on the previous considerations *see generally supra* note 57; O'CONNOR, AN INQUIRY INTO THE FOREIGN TAX BURDEN OF U.S. BASED MULTINATIONAL CORPORATIONS (1980).

⁷⁵ *See* O. BROWNLEE, TAXING THE INCOME FROM U.S. CORPORATION INVESTMENTS ABROAD (1979). *See generally supra* note 74.

⁷⁶ This Note does not include an empirical analysis. However, the various alternatives will generally be considered in terms of expanding the application of Subpart F. *See supra* note 74.

governmental activity. The elimination of double taxation removes a potential disincentive to international trade. Lastly, tax neutrality promotes an efficient allocation of resources in a freely competitive world marketplace.

Changes may be made in the taxation of foreign source income in two basic ways: (1) various minor changes may be made to tighten or loosen the application of Subpart F and to simplify the requirements of the existing regime; and, (2) complete alternatives to the existing regime may be enacted.⁷⁷

A. *Changes Within the Existing Regime*

One of the major criticisms of Subpart F is that it is unnecessarily complex.⁷⁸ The examination of the following collection of alternative modifications will implicitly assume that it is preferable to have a simple, easily administered rule to prevent tax avoidance and double taxation and to promote tax neutrality—even if the rule ends up being underinclusive and/or overinclusive.⁷⁹

Initially, within the existing statutory framework, it is possible to satisfy the general criteria set out above by modifying the controlled foreign corporation requirements.⁸⁰ The existing “more than fifty percent of the total combined voting power”⁸¹ requirement currently operates as a disincentive for U.S. MNE’s to establish majority control of a foreign corporation. This occurs because a U.S. MNE with an equity position of forty-nine percent or less retains the benefit of deferral and is not subject to current U.S. taxation under the Subpart F provisions. In this regard, the effect of Subpart F comports with the trend in many countries to require majority local participation in foreign investment. However, while Subpart F does seek to eliminate deferral, it does not seek to dis-

⁷⁷ These changes may be accomplished: (1) administratively; (2) judicially; (3) legislatively; and, (4) by treaty, either bilaterally or multilaterally.

⁷⁸ See *supra* note 12.

⁷⁹ In the case of Subpart F a clear, simple black-letter rule tends to be arbitrary in application. For example, a fifty-one percent U.S. shareholder of a foreign corporation is taxed currently on the aliquot share of accumulated profits of the foreign corporation, whereas a forty-nine percent shareholder continues to receive the benefit of deferral. I.R.C. § 951(a)(1) (1983). This result may in fact be justified by the ability of a U.S. shareholder with fifty-one percent (i.e. control) to declare a dividend sufficient to finance the tax liability. Additionally, a ten percent shareholder of a CFC is subject to the Subpart F provisions, whereas a nine percent shareholder is not. The rationale for the disparate treatment cannot be explained. Hence, the present Subpart F provisions are not only complex, but also arbitrary. Elimination of some of the complexities of Subpart F would not make the provisions less arbitrary, but it would make their application simpler as well as more predictable and uniform.

⁸⁰ I.R.C. § 957(a) (1983). See Gordon Report, *supra* note 18, at 341.

⁸¹ I.R.C. § 957(a) (1983).

courage U.S. foreign investment or to restrict U.S. foreign investment to disadvantageous equity positions.

In order to expand the scope of Subpart F and to alleviate the disincentive to majority participation, the "more than 50 percent of the total combined voting power"⁸² requirement could theoretically be reduced, although such a reduction may raise constitutional problems.⁸³ Some U.S. courts have indicated that actual control of a foreign corporation is the proper test.⁸⁴ Congress, however, has failed to alter the control requirements of Subpart F,⁸⁵ despite the existence of a reduced control requirement for CFC's with "income derived from the insurance of United States risks . . . if the gross amount of premiums or other considerations . . . exceeds 75 percent of the gross amount of all premiums or other consideration."⁸⁶ The reduced control requirement for CFC's engaged in the insurance business suggests either that a reduced control requirement does not raise constitutional problems or that the taxation of U.S. shareholders of a CFC is outside the scope of the *Eisner v. Macomber* doctrine.⁸⁷

Congress, therefore, could expand the scope of Subpart F by changing the CFC control requirement to an "actual control" test or, in the alternative, by reducing the CFC control requirement to twenty-five percent or less. Reducing the control requirement would expand the class of foreign corporations with U.S. shareholders that are subject to current U.S. taxation under Subpart F. Expanding Subpart F would further eliminate deferral and promote tax neutrality between foreign and domestic investment by U.S. shareholders with minority positions in foreign corporations.

The practical problem with reducing the control requirement is that U.S. minority shareholders would be subject to current U.S. taxation on accumulated earnings of the foreign corporation despite an inability to

⁸² *Id.*

⁸³ The problem here is whether U.S. shareholders without control could compel a dividend to cover the tax on undistributed profits. See generally *supra* note 64. For an excellent discussion of the constitutional issues raised by Subpart F, and particularly the potential constitutional problem resulting from a reduced control test, see Liebman, *The Tax Treatment of Joint Venture Income Under Subpart F: Some Issues and Alternatives*, 32 BUS. LAW. 341, 359-88 (1977).

⁸⁴ The courts were concerned with U.S. MNE's who decontrol their interests in foreign subsidiaries to below fifty percent in order to avoid the application of Subpart F, but retain actual control. *Garlock Inc. v. Commissioner*, 58 T.C. 423 (1972), *aff'd*, 489 F.2d 197 (2d Cir. 1973), *cert. denied*, 417 U.S. 911, 94 S. Ct. 2608 (1974); *Kraus v. Commissioner*, 59 T.C. 681 (1973), *aff'd*, 490 F.2d 898 (2d Cir. 1974); *Koehring Co. v. United States*, 583 F.2d 313 (7th Cir. 1978). *But see* CCA, Inc. v. Commissioner, 64 T.C. 137 (1975).

⁸⁵ I.R.C. § 957(a) (1983). See also Liebman, *supra* note 24, at 1821-25.

⁸⁶ I.R.C. § 957(b) (1983) (the reduced control requirement is "twenty-five percent of total voting power").

⁸⁷ 252 U.S. 189 (1920).

effectuate a distribution to finance the tax. Such a regime is inapposite to the classical system of corporate taxation required by the Supreme Court in *Eisner v. Macomber*.⁸⁸ The existing "more than 50 percent" control requirement of Subpart F arguably satisfies *Eisner v. Macomber*, since the shareholders could compel a dividend to cover any current tax. Congress has already enacted certain statutory exceptions to the classical system of corporate taxation,⁸⁹ and many commentators have argued in favor of completely terminating this system and adopting the integrated approach to corporate taxation.

Under Subpart F, only "ten percent or more" shareholders may be utilized to satisfy the "more than 50 percent" control requirement.⁹⁰ The category of U.S. shareholders for Subpart F purposes could be expanded by reducing the "ten percent or more" requirement to five percent or less. This change would expand the class of shareholders to which Subpart F applies and, consequently, would expand the class of foreign corporations to which Subpart F applies.⁹¹ Expanding the scope of Subpart F by reducing the shareholder requirement would minimize the existing tax benefit of deferral available to shareholders of CFC's with less than ten percent control. The reduced shareholder requirement would promote greater tax neutrality between foreign and domestic investment. If the minimum shareholder requirement were eliminated altogether, tax administration would be simplified.

The practical problem with reducing the shareholder requirement is that a shareholder with a small equity position in a CFC will not likely be able to manipulate the business activities of the CFC to effectuate a distribution or to reduce overall tax liabilities through intracorporate pricing mechanisms. On the other hand, under the current Subpart F provisions, a shareholder with a small equity position receives the benefit of deferral.

Additionally, the requirement that a foreign corporation be a CFC "for an uninterrupted period of thirty days or more during any taxable year"⁹² could be reduced or eliminated. Instead, a CFC could be taxed under Subpart F for the period when the control requirements are satis-

⁸⁸ *Id.* See *supra* note 64.

⁸⁹ See, e.g., I.R.C. § 531 (1983) (accumulated earnings tax). See generally B. BITTKER & J. EUSTICE, *supra* note 6, at §§ 8.01-8.09; B. BITTKER & L. EBB, *supra* note 6, at 327-28.

⁹⁰ I.R.C. § 951(b) (1983). See *supra* notes 67-69 and accompanying text. See also Gordon Report, *supra* note 18, at 341.

⁹¹ I.R.C. §§ 951(b), 958(b) (1983). See *supra* note 70 and accompanying text. The current Subpart F provisions do not apply to shareholders with less than ten percent of the CFC. Therefore, a foreign corporation with ten U.S. shareholders each holding nine percent (i.e., a total of ninety percent voting control) is not subject to Subpart F; whereas, a foreign corporation with five U.S. shareholders each holding eleven percent (i.e. total of fifty-five percent voting control) is subject to Subpart F.

⁹² I.R.C. § 951(a) (1983).

fied. This change would further expand the class of CFC's to which Subpart F applies and would promote simplicity, predictability and administrative convenience.

Another general method for expanding the application of Subpart F is to eliminate many of the relief provisions which exempt certain classes of income from the provisions of Subpart F.⁹³ The current Subpart F provisions do not tax the income of a CFC if it is established that "neither the creation or organization of such controlled foreign corporation . . . nor . . . the transaction giving rise to such income . . . has as one of its significant purposes a substantial reduction of income . . . taxes."⁹⁴ The inclusion of a "tax reduction motive" test in this context is meaningless; all business decisions will minimize tax to maximize profits. Even if there is no purpose to reduce tax, the effect of the benefit of deferral to favor foreign investment over domestic investment by U.S. MNE's remains the same. The elimination of this exemption, particularly for CFC's which are organized in low-tax jurisdictions, would greatly ease the administrative burden of revenue authorities and simplify the application of the provisions of Subpart F.⁹⁵

Moreover, the provision which excludes Subpart F treatment when foreign base company income is less than ten percent of the gross income of a CFC⁹⁶ could be reduced or eliminated altogether. The provision which applies Subpart F treatment to the entire gross income of a CFC when the foreign base company income exceeds seventy percent⁹⁷ could also be modified so that the de minimus figure for Subpart F treatment is fifty percent or less. If adopted, each of these modifications to the existing regime for the taxation of foreign source income would expand the application of Subpart F, thereby minimizing the favored treatment of foreign investment provided by the benefit of deferral.

The taxation of foreign source income under Subpart F could be expanded by reducing the CFC control requirement, eliminating the shareholder control requirement and eliminating many of the relief provisions contained in Subpart F. These modifications would promote greater tax neutrality by expanding the scope of Subpart F and thereby terminating the benefit of deferral. Moreover, the expansion of particular provisions of Subpart F would reduce the opportunity for interna-

⁹³ This could be accomplished by eliminating the designated income categories of I.R.C. § 951(a) and, instead, imposing current U.S. tax on U.S. shareholders for their aliquot share of income of a CFC. Additionally, the following express exemptions included with the current Subpart F provisions could be modified or eliminated: I.R.C. §§ 951(d), 952(c), 954(b), 957(c), 957(d), 959(a), 960(a), 964(b), 970 (1983).

⁹⁴ I.R.C. § 954(b)(4) (1983).

⁹⁵ See Liebman, *supra* note 83, at 390-95.

⁹⁶ I.R.C. § 954(b)(3) (1983).

⁹⁷ *Id.*

tional tax avoidance. Thus, the costs of tax planning and compliance would be reduced, and tax collection would be simplified.

However, to the extent that the double taxation burden arising from expanding the scope of Subpart F is not mitigated by the foreign tax credit, these modifications will discourage U.S. MNE's from engaging in foreign trade due to the potentially excessive tax liability. Additionally, these modifications may result in U.S. MNE's being at a competitive disadvantage with their foreign counterparts that retain the benefit of deferral. At the same time, though, the expansion of the Subpart F provisions would eliminate the incentive to defer the repatriation of earnings and profits from U.S.-owned foreign corporations. Although these modifications would promote greater tax neutrality and improved predictability for both the taxpayer and tax collector through simplification, none would achieve the goal of significantly simplifying Subpart F.

B. Significant Simplification of Subpart F

In order to achieve a significant simplification of Subpart F, it is necessary to enact statutory provisions that are clear and concise. Such rules may necessarily be underinclusive and overinclusive.⁹⁸ However, such rules will be predictable.

One possibility in this regard is to eliminate the designated income categories for a CFC.⁹⁹ This would greatly simplify the Subpart F provisions and eliminate some of the subjective elements of the current regime which requires the allocation of income into certain designated categories. Under this modification, the U.S. shareholders of a foreign corporation that satisfied the CFC requirements would be currently taxed on their aliquot share of *all* accumulated earnings, not merely those categories designated in the statute. The harshness of this result would be mitigated by the foreign tax credit, and it would have its greatest impact in low-tax jurisdictions where the benefit of deferral is the greatest due to the large tax rate differential between the U.S. and the foreign corporate tax rate.

This proposal is equivalent to the complete termination of deferral for a CFC. The effect would be to end the abusive tax minimization uses of the deferral mechanism, particularly in low-tax jurisdictions, and to encourage the repatriation of profits. The problems under the existing regime, however, are that eliminating the designated income categories may: (1) encourage U.S. MNE's to decontrol and take minority positions in foreign operations;¹⁰⁰ (2) encourage foreign governments to in-

⁹⁸ See *supra* note 79.

⁹⁹ See *supra* note 93.

¹⁰⁰ See *supra* notes 80-87 and accompanying text. Such a move to decontrol may in the long run harm U.S. MNE's operating overseas because they will lose management control over their

crease local taxes when they realize that the U.S. MNE is not benefiting from the low-tax concession; and, (3) harm U.S. MNE's in comparison to foreign competitors, since foreign MNE's may continue to benefit from deferral.¹⁰¹

The benefits of deferral are not as advantageous for CFC's organized in high-tax jurisdictions. Therefore, it might be preferable to adopt a regime for the taxation of foreign source income which focuses on the nature and location of the CFC¹⁰² and to abandon the U.S. regime which focuses on designated categories of "tainted income."¹⁰³ If this approach were adopted, and a foreign corporation was a CFC organized in a statutorily designated jurisdiction, Subpart F would apply and the U.S. shareholder would be currently taxable on the aliquot share of income.

Such a "designated jurisdiction" approach would be both underinclusive and overinclusive in terms of the abusive use of deferral to avoid taxation. Some of the currently taxable income of the CFC would be foreign source income that is legitimately connected with the active conduct of a trade or business located in the designated jurisdiction (i.e. overinclusive). However, excessive income accumulated in a non-designated, high-tax jurisdiction, that is not as high as in the United States, would avoid the impact of the Subpart F provisions and continue to get the benefit of deferral (i.e. underinclusive).

The "designated jurisdiction" approach would essentially impose an irrebuttable presumption of tax-avoidance purpose for U.S. shareholders engaged in business activities through the use of CFC's in designated low-tax jurisdictions. Although there are certain legitimate (i.e. non-tax avoidance) motives for organizing foreign subsidiaries in low-tax jurisdictions,¹⁰⁴ the primary benefit is the minimization of tax liability. By imposing a strong or irrebuttable presumption of tax avoidance purpose and shifting the burden of proof to the taxpayer, U.S. shareholders of a CFC organized in a low-tax jurisdiction would be automatically and entirely subject to current taxation on their aliquot share of income of the CFC, unless the shareholder could prove that the foreign source income of the

foreign financial investments. Foreign majority shareholders may then operate the business in a manner that is inconsistent with the best interest of U.S. MNE's that are minority shareholders.

¹⁰¹ See generally Note, *Comparative Analysis of Systems of Domestic Taxation of Controlled Foreign Corporations*, 14 VAND. J. TRANSNAT'L L. 99 (1981); Rosensweig, *United States International Tax Treaty Policy with Respect to Foreign Imputation Systems of Corporate-Shareholder Taxation*, 13 N.Y.U. J. INT'L L. & POL. 729 (1981).

¹⁰² See Note, *supra* note 101, at 131-48.

¹⁰³ By focusing on the location of CFC's, rather than types of income, Subpart F would become, in effect, inapplicable to relatively high tax jurisdictions. See Note, *supra* note 101, at 169; Gordon Report, *supra* note 18, at 337-39.

¹⁰⁴ Some of these are: (1) to avoid currency and other controls; (2) to minimize risk of expropriation of business assets; (3) to shield assets from political oppression; and, (4) to maintain financial privacy. See Gordon Report, *supra* note 18, at 205-09, 224-26.

CFC was legitimately connected with a trade or business in the designated jurisdiction.¹⁰⁵ Furthermore, such a regime would begin to solve the access to information problem faced by U.S. tax authorities when auditing the returns of CFC's,¹⁰⁶ thereby promoting administrative convenience.

Another alternative which would simplify the provisions of Subpart F is to employ a "minimum distribution" approach.¹⁰⁷ The benefit of deferral encourages foreign investment and discourages the repatriation of profits. Subpart F operates as a partial termination of deferral for a CFC. Subpart F is not intended to discourage foreign investment, but rather to remove the tax incentive favoring foreign investment. The "minimum distribution" approach would require a CFC to repatriate a fixed percentage of earnings or be subject to current taxation under Subpart F. The "minimum distribution" approach "would require that deferral be eliminated unless a firm conformed to a minimum distribution schedule, with the schedule relating the minimum repatriation ratio to the difference between the U.S. tax rate and the rates of the country of operation."¹⁰⁸ The proposal would essentially terminate deferral for CFC's and then grant exceptions if a certain distribution level is satisfied. This would greatly simplify the mechanics of Subpart F and would also solve the information gathering problem associated with CFC's.

Another alternative, which is related to the one just examined, is to employ an "unreasonable accumulation" approach.¹⁰⁹ Since the deferral mechanism discourages the repatriation of profits to the United States, CFC's tend to retain and accumulate funds overseas beyond their ordinary business needs. The benefit of such accumulation is particularly pronounced for the passive income of CFC's organized in low-tax juris-

¹⁰⁵ For example, Japan taxes shareholders on their aliquot share of undistributed profits of CFC's in "designated jurisdictions" unless the following five requirements are met:

- (1) [t]he foreign subsidiary must have a fixed place of business in the tax haven, (2) the foreign subsidiary's business operations in the tax haven must be independently managed and controlled by a local staff, (3) the foreign subsidiary's principal business must not consist of holding securities, licensing industrial property rights, know-how, or copyrights; or, leasing shipping vessels or aircraft, (4) dividends received from designated tax haven subsidiaries must not exceed 5% of the foreign subsidiary's total current revenues, and (5) the majority of the foreign subsidiary's business must be conducted in the tax haven; or, in the case of banks and sales, trust, securities, insurance, shipping, and air freight companies, more than 50% of the volume in the foreign subsidiary's principal line of business during the fiscal year must be transacted with unrelated parties.

Special Tax Measures Law (sozei tokubetsu sochiho), art. 66-6(2)(i) (1978), cited in Note, *supra* note 101, at 144-45.

¹⁰⁶ Many low-tax jurisdictions have secrecy laws which prevent the IRS from scrutinizing the financial records of CFC's. See *supra* note 51.

¹⁰⁷ See L. KRAUSE & K. DAM, *supra* note 4, at 99.

¹⁰⁸ *Id.*

¹⁰⁹ See *id.* at 19-21; Task Force, *supra* note 9, at 408.

dictions. There is no compelling reason to organize a CFC in a low-tax jurisdiction to hold properties, such as patents or securities, which merely receive passive income, other than to avoid the current incidence of U.S. tax.

The "unreasonable accumulation" approach would impose the incidence of U.S. tax on levels of retained earnings that exceed an amount reasonably necessary for the conduct of the foreign trade or business. Such a regime would, therefore, encourage either the repatriation of earnings or the reinvestment of earnings in foreign operations, or both, because there would no longer be a tax benefit from accumulating earnings in a CFC. Moreover, this approach would simplify the taxation of foreign source income and would be easy to administer. The problem with this approach is that U.S. MNE's could retain the benefit of deferral and avoid current taxation by continuously reinvesting profits overseas. As a result, however, the goal of tax neutrality would not be achieved.

C. Complete Alternatives to Subpart F

Several alternatives to Subpart F may accomplish the objective of preventing the most blatant abuses of deferral associated with low-tax jurisdictions. These alternatives will now be considered.¹¹⁰

1. Section 482 Allocation of Income Doctrine

One weapon which the revenue authorities might employ in the place of Subpart F is to allocate income among related corporate entities engaged in international business transactions.¹¹¹ Under section 482,¹¹² U.S. revenue authorities have the power to scrutinize transactions between related organizations and to allocate income and prices on an arm's length basis. Income of a CFC organized in a low-tax jurisdiction could be allocated to reflect prices in a competitive market. Thus, U.S. revenue authorities could collect a tax on the income allocated to the U.S. shareholder of the CFC. This power would enable the revenue authorities to overcome some of the most abusive methods of international tax avoidance.

The accumulation of profits by CFC's organized in low-tax jurisdictions is accomplished through such mechanisms as: (1) artificial intra-

¹¹⁰ See O. BROWNLEE, *supra* note 75.

¹¹¹ See generally Kauder, *Taxation of Domestically Controlled Foreign Corporations: A Comparative Study of Subpart F and Section 482*, 14 VILL. L. REV. 260 (1969) [hereinafter cited as *Comparative Study*]; Surrey, *Reflections on the Allocation of Income and Expenses Among National Tax Jurisdictions*, 10 LAW & POL'Y INT'L BUS. 409 (1978); Kauder, *International Allocations of Income: Problems of Administration and Compliance*, 9 J. INT'L L. & ECON. 1 (1974); Note, *Multinational Corporations and Income Allocation Under Section 482 of the Internal Revenue Code*, 89 HARV. L. REV. 1202, 1204-06 (1976).

¹¹² I.R.C. § 482 (1983).

corporate pricing mechanisms; (2) manipulating management and service fees; and, (3) transferring passive income-producing assets to the CFC. Under section 482, revenue authorities could scrutinize intracorporate transactions to determine whether income is being reasonably allocated. If the transaction is related to a legitimate business objective and reflects arm's length bargaining, then the income of the CFC would retain the benefit of deferral until repatriated. If, however, the transaction is a sham and fails to reflect arm's length bargaining, then revenue authorities could allocate income on the basis of arm's length economic activity, in which case the benefit of deferral would be unavailable. The principal distinction between the approach of Subpart F and the approach of section 482 is that "Subpart F accepts the critical transactions as they are devised by the parties and taxes them at the shareholder level if they meet the statutory definitions, while under section 482 the transactions are recast and indeed may be disregarded for tax purposes."¹¹³

Under section 482, a tax reduction motive is not relevant. Rather, the important inquiry is whether the business transaction would have occurred under arm's length bargaining. This determination, however, is not an easy one. The problem with allocating income under section 482 is that initially the revenue authorities will have difficulty gaining access to the financial information of the CFC. Secondly, it is very difficult to determine a true arm's length price.¹¹⁴ Therefore, determining an arm's length price is administratively inefficient and may be economically inefficient from a tax revenue perspective (i.e., costs of administration exceed increased revenue). Moreover, allocating income under section 482 does not achieve predictable results because the taxpayer does not know what arm's length price will be determined by the revenue authorities.

2. Unitary Tax Approach

As a complete alternative to the separate entity theory utilized by section 482, the taxation of the foreign source income of U.S. MNE's could be accomplished by a unitary tax system.¹¹⁵ This method treats groups of affiliated corporations as a single business with, essentially, a single balance sheet. The allocation of income under the unitary tax method is generally accomplished through the use of a mechanical formula based upon a combination of the factors of production (i.e., payroll, assets and land).¹¹⁶ The formula operates to automatically allocate

¹¹³ See *Comparative Study*, *supra* note 111, at 266.

¹¹⁴ Often no market exists for the goods or services at issue and there is the added problem of allocating research and development, fixed costs, management and consulting costs, etc.

¹¹⁵ See Note, *supra* note 111, at 1223-31.

¹¹⁶ It may be, however, that the unitary tax will operate to allocate income from the CFC in a low-tax jurisdiction to the foreign country where mining, production or manufacturing occurred, rather than allocating the income to the United States where the MNE headquarters is located.

income of the MNE among the various tax jurisdictions in proportion to the percentage of total income generated within the respective jurisdictions.

The United States, therefore, could proportionately tax the worldwide income of U.S. MNE's based upon the formula, thereby eliminating the need for Subpart F. In contrast to the policy of promoting arm's length negotiation under section 482, the unitary tax treats a group of related corporations as a unitary business. "Since all [MNE] subsidiaries [would be] considered to be parts of the same unitary business, intercompany transactions [would not] produce a real economic profit or loss and [would] therefore be eliminated from tax consideration."¹¹⁷ In effect, the United States would currently tax that proportion of the MNE's worldwide income which is allocated to the United States under the formula.

The theoretical appeal of such a method is its general fairness to tax jurisdictions (depending on the formula selected), its predictability and its relative simplicity compared to the provisions of Subpart F. Moreover, the unitary tax approach does not present the administrative difficulties that are present when determining arm's length pricing under section 482. However, the unitary approach raises new administrative difficulties. First, selecting an objectively reasonable formula which properly allocates income would be difficult. Second, the unitary approach would require corporate groups to keep an entirely new and separate set of books for the whole corporate group. Moreover, in the absence of an international agreement on a uniform, equitable formula, the unitary tax approach would likely raise problems of double taxation, as each nation selected allocation formulas that favored their productive contribution to the income of the MNE.

3. Treaties

One of the major criticisms of Subpart F is that by partially eliminating deferral and imposing a current tax on shareholder's aliquot share of the undistributed earnings of a CFC, Subpart F discourages U.S. MNE's from engaging in foreign operations.¹¹⁸ The unilateral termination of deferral would promote tax neutrality, prevent international tax avoidance and increase U.S. tax revenue. In the long run, however, such unilateral measures would operate as a disincentive for U.S. MNE's to engage in foreign operations.

Foreign competitors who retain the benefit of deferral gain a competitive advantage from the unilateral termination of deferral by the United States. The advantage arises because local foreign businesses are only subject to local tax, and foreign MNE's that receive the benefit of

¹¹⁷ See Note, *supra* note 111, at 1206.

¹¹⁸ See Lynn & Wiacek, *supra* note 57.

deferral are only subject to local tax, whereas the U.S. MNE would be subject to both the local tax and the U.S. tax.

The adoption, therefore, of any or all of the previous proposals as a means of effectuating the termination of deferral, solely on a unilateral basis, may ultimately result in reduced revenue to the U.S. treasury because U.S. MNE's will no longer be able to compete as effectively in international trade. Thus, the United States should seek to establish a treaty regime, or series of executive agreements, which would facilitate the collective elimination of deferral for western, industrialized capital-exporting states.¹¹⁹ If established, such a regime would promote tax neutrality between foreign and domestic investment, while eliminating the inherently uncompetitive aspect of unilateral action. A potential limitation to the collective elimination of deferral through a treaty regime is that a tax policy based on the existence of tax treaties raises the following general problems: (1) favorable bilateral treaties encourage "treaty shopping;" (2) the negotiation process is inordinately slow; and, (3) treaties cannot increase the U.S. taxation of U.S. persons. On the other hand, tax treaties benefit taxpayers through increased predictability, greater uniformity and reduced tax liability.

Although a treaty is the supreme law of the land,¹²⁰ a tax treaty alone could *not* replace Subpart F and terminate the effect of deferral by imposing a current tax on the income of a CFC. This is because the Constitution prevents treaties from being used to raise revenue by increasing the tax burden of U.S. persons.¹²¹ Rather, the general function of tax treaties is to allocate and reduce the tax burden of the citizens of the signatory nations. In other words, treaties do not increase taxes, but rather they mutually reduce the taxes for the citizens of the respective signatory states. Treaties lower foreign tax rates for U.S. persons who invest in countries with which the United States has treaties, thereby encouraging U.S. MNE's to engage in international trade. Moreover, U.S. treaty policy has likely facilitated foreign investment in the United States by lowering tax rates for the citizens of U.S. treaty partners who invest in the United States.

A treaty, therefore, has no effect on how the United States taxes its citizens, nor on how the other signatory taxes its citizens. In this regard,

¹¹⁹ See generally Gordon Report, *supra* note 18, at 232-33, 349-51, 414-18.

¹²⁰ The U.S. Constitution provides that the President of the United States "shall have power, by and with the Advice and Consent of the Senate, to make treaties . . . U.S. CONST. art. II, § 2, cl. 2. Moreover, "[A]ll Treaties made . . . shall be the supreme law of the Land. . . ." U.S. CONST. art. VI, cl. 2.

¹²¹ "All Bills for raising revenue shall originate in the House of Representatives. . . ." U.S. CONST. art. I, § 7, cl. 1.

for example, the U.S. Model Income Tax Treaty¹²² contains a savings clause which provides that “[n]otwithstanding any provision of this Convention . . . a Contracting State may tax its residents . . . and . . . its citizens, as if their Convention had not come into effect.”¹²³ Furthermore, the U.S. Model Income Tax Treaty provides that “[t]his Convention shall not restrict in any manner any exclusion, exemption, deduction, credit or other allowance now or hereafter accorded. . . .”¹²⁴ Thus, tax treaties have not been negotiated in order to alter the way the United States taxes its own citizens.

Traditionally, the U.S. government’s interest in the negotiation of tax treaties has been threefold: (1) to prevent double taxation;¹²⁵ (2) to minimize fiscal evasion;¹²⁶ and, (3) to simplify tax administration.¹²⁷ Whether the U.S. tax treaty program has accomplished these objectives is subject to debate.¹²⁸ Nevertheless, the U.S. government could effectively supplement our national tax system’s unilateral response to the problem of deferral through the inclusion of a “deferral provision” in existing or future tax treaties by which the United States would agree with the tax treaty partner to mutually terminate deferral. Such a provision would encourage a more uniform approach to the problem of deferral while eliminating the potential disadvantage to U.S. MNE’s that arises from the unilateral termination of deferral. Each signatory could agree to impose a current tax on their respective CFC’s, subject to a credit for foreign taxes paid. Thus, MNE’s would no longer be able to take advantage of the inherent limitations on the power of national tax jurisdictions to tax international business transactions.

In this way, complete minimization of international tax (i.e., an “international tax loophole” in which no country receives tax revenue from MNE’s due to, e.g., intracompany pricing mechanisms) could be prevented through collective, partial or complete, termination of deferral on a uniform basis. This would prevent the harm arising from unilateral tax measures. In fact, many of the major western, industrialized capital exporting countries have enacted some form of tax system that is analogous

¹²² See United States Model Income Tax Treaty (1977), reprinted in 3 R. RHOADES & M. LANGER, *supra* note 6, at § 15.02.

¹²³ *Id.* at § 15.02[1](3).

¹²⁴ *Id.* at § 15.02[1](2).

¹²⁵ Tax treaties eliminate double taxation primarily through the uniform definition of: (1) source rules; (2) residence; (3) permanent establishment; (4) income; (5) profits; (6) dividends; (7) interest; (8) royalties; (9) capital gains; and, (10) creditability of taxes. See 3 R. RHOADES & M. LANGER, *supra* note 6, at § 15.02.

¹²⁶ Tax treaties attempt to prevent fiscal evasion through exchange of information and competent authority provisions which promote administrative convenience for the tax authorities and predictability for taxpayers. *Id.*

¹²⁷ *Id.* at § 15.02(26).

¹²⁸ See Owens, *supra* note 7. But see Trelles, *supra* note 7.

to Subpart F.¹²⁹ Encouraging international uniformity through a series of tax treaty amendments or executive agreements should, therefore, not be difficult.

V. CONCLUSION

The Subpart F provisions focus on the most abusive tax avoidance associated with low-tax jurisdictions, by taxing controlled foreign corporations (CFC's) on designated income. Although the provisions are effective as a partial termination of the benefit of deferral, they are excessively complex and in need of reform and simplification. In order to promote greater tax neutrality and to prevent international tax avoidance, the provisions of Subpart F could be expanded and simplified by: (1) reducing the control test for CFC status to twenty-five percent; (2) reducing the shareholder test to five percent or less; (3) adopting a "designated jurisdiction" approach; (4) imposing a strong, if not irrebuttable, presumption of tax avoidance purpose for CFC's organized in low-tax jurisdictions; and, (5) eliminating the "designated income" approach of Subpart F and taxing all CFC income, subject to the foreign tax credit for foreign taxes paid. However, these modifications are not without their limitations.

In fact, the current international regime for the taxation of multinational enterprises (MNE's) by national tax jurisdictions is characterized by both practical and legal inadequacies. The taxpayer who is engaged in international business transactions faces the potential burden of double taxation, while tax authorities must address the problem of international tax avoidance. National responses to these problems have largely been ineffective due to the inconsistency of the various national approaches. Thus, in order to promote tax neutrality and prevent international tax avoidance, the United States must seek to establish a uniform, international scheme for the taxation of MNE's. Reliance on international agreements to provide for the uniform taxation of all international business transactions is the best method to accomplish these objectives.

¹²⁹ See Note, *supra* note 101.

