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Current United States International Tax Developments

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I. Introduction

This paper will summarize the current United States international tax developments. The first section will relate to the pending United States-Canada Income Tax Convention and Protocols. The second section will relate to current United States tax treaty negotiations, particularly those that are of relevance to Canada. The third section will relate to the current legislation developments in the United States affecting international taxation.

II. United States-Canada Income Tax Convention and Protocols

A. *Background*

The revised United States-Canada Income Tax Convention was signed on September 26, 1980 (Treaty). It was amended by a Protocol signed on June 14, 1983 and another Protocol signed March 28, 1984. Though the Treaty was the subject of a hearing by the Senate Foreign Relations Committee in September, 1981, further consideration was delayed at that time because of objections to provisions contained therein relating to the Foreign Investment in Real Property Tax Act of 1980, and provisions relating to nondiscrimination, mineral royalties and foreign tax credits. Certain of these issues were resolved in the Protocol signed June 14, 1983.

Thereafter, other problems arose with respect to the taxation by Canada of U.S. offshore contractors, both as a result of the introduction by the Canadian government of proposed legislation entitled "The Income Tax Convention's Interpretation Act," on June 23, 1983 which was intended to override the *Melford* case, and as a result of a change in U.S. law to allow taxation of social security benefits received by, among others, Canadian residents. Concerns of the United States with respect to the Canadian Taxation of offshore contractors and with respect to the proposed legislation have been resolved, respectively, by a Competent Authority Agreement entered between the competent authorities of the United States and Canada relating to the Canadian taxation of U.S. off-

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shore contractors dated January 26, 1984, and by certain amendments made by the Canadian government to its revised Income Tax Conventions Interpretation Act, released April 5, 1984. The last remaining issue involving the taxation of social security-type benefits was resolved by the March 28, 1984 protocol.

B. Treaty Hearing

On April 24, 1984, the Treaty and accompanying Protocols were the subject of a hearing before the Senate Foreign Relations Committee. It is anticipated that the Committee will favorably report on the Treaty on May 8, 1984 and shortly thereafter the Senate will ratify the Treaty, thereby permitting entry into force of certain provisions of the Treaty later this year.

At the hearing, the staff of the Joint Committee on Taxation, in its prepared testimony, raised several issues relating to the Treaty which are of note. The issues which were discussed are summarized as follows:

1. Nondiscrimination—the treatment of Canadian corporations owned by U.S. shareholders;

2. Natural resource income—the effect of the Treaty on such type of income;

3. Benefits under the Canadian integrated tax system—the precedential effect of Canada not extending its imputation credit to U.S. residents in the Treaty;

4. Canadian investment in U.S. real property—the deviation of the Treaty rules from those contained in the Foreign Investment in Real Property Tax Act;

5. Exempt organizations—the Treaty exemptions granted to exempt organizations;

6. Foreign tax credit—the granting by the United States of an independent treaty credit for various Canadian taxes, as well as the effect of the Canadian Petroleum and Gas Revenue Tax on creditability;

7. The granting of deductions to United States persons - the granting of Treaty deductions to United States taxpayers not permitted under the U.S. Internal Revenue Code, i.e., charitable deductions for contributions to Canadian charities and convention deductions;

8. Anti-treaty shopping provisions—the scope of the limitation of benefits article;

9. Exemption for social security payments to Canadian residents—the fact that the Second Protocol provides an exemption from tax where such tax was recently enacted by Congress;

10. Denial of Canadian tax deductions for advertising carried by U.S. broadcasters; and

11. Canadian legislation interpreting treaties.

It should be noted that the staff of the Joint Committee recognized the importance of the ratification of the Treaty. The staff, however, was also concerned with the complexity, specificity and resulting length of recently negotiated income tax treaties by the United States, an example of which is the Treaty. The prepared testimony reflected this concern as follows:

> It would be useful for the Committee to remind the negotiators that, as indicated above, tax treaties have two, and only two main purposes: the mitigation of double taxation, and the prevention of tax avoidance and evasion. It often appears that the fact that treaties are general efforts at minimizing double taxation rather than many Internal Revenue Codes is obscured. As our Internal Revenue Code has shown, attempting to deal in a very specific and highly technical way with every problem leads to greater and greater complexity. The more complex the rules become the easier it is for taxpayers to manipulate them to avoid tax, which in turn leads to disrespect for the tax system generally. We are concerned that the fine-tuning seen in recent treaties is an extension of that trend to treaties, and that attempts at meshing precisely two complex systems will lead not to the elimination of double taxation but rather to elimination of tax in both countries.
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> While we do not recommend any specific action on these treaties with respect to the complexity issue, we believe that tendency toward complexity is something that should be avoided in the future.

C. Selected Comments

The Competent Authority Agreement between the United States and Canada signed January 26, 1984, illustrates vividly that the concerns of an industry group can have an effect upon the bilateral relations between the United States and a treaty partner. The International Association of Drilling Contractors, an industry group representing U.S. offshore drilling contractors, had expressed great concern over various provisions contained in the Treaty (as well as other treaties) affecting their industry. Of particular concern was the short threshold, three months, for determining whether a permanent establishment exists. In addition, the application of the Canadian "balancing charge" upon the removal of business property from Canadian territory was alleged to cause serious competitive disadvantages vis-a-vis comparable Canadian contractors and thereby discrimination under the Treaty. Concurrent with but coincidential in timing to this issue was the introduction of the Income Tax Convention's Interpretations Act which would have retroactively defined Canada to include the Canadian continental shelf. These issues were of sufficient concern that the industry group did not believe the pending Convention was in their best interest and they indicated that they would take steps to oppose it.

However, all concerned parties—the industry group, the United States Treasury Department and the Canadian tax authorities—were interested in resolving the issues, and over a six-month period, an agreement was hammered out which, although it did not modify the short permanent establishment threshold, provided a fair and appropriate regimen of taxation for U.S. drilling contractors in Canada. In effect, if a U.S. taxpayer elects a lesser rate of depreciation, it will not be subject to the balancing charge. Moreover, the Canadian government has amended its Income Tax Conventions Interpretation Act so that its provisions will apply prospectively for taxable years ending June 23, 1983. This amendment is appropriate specifically with respect to various U.S. industry groups and generally as a matter of principle.

III. United States Tax Treaty Policy and Negotiations

The United States continues to be actively involved in the negotiation and renegotiation of income, estate and gift tax treaties. Set forth below is a current listing of the countries with which the United States is actively negotiating. Unless otherwise stated, the treaties referred to below relate to income taxes.

1. Treaties Ratified by the United States

Argentina
Bangladesh
Germany—Estate & Gift Tax
Israel

2. Treaties Heard by Senate Foreign Relations Committee on April 26, 1984

Canada—Treaty and Protocols
Denmark—Treaty and Protocol
Denmark—Estate and Gift Tax
France—Protocol
Sweden—Estate and Gift Tax

3. Treaties Signed but Awaiting Hearings

China
Cyprus
Italy—Treaty and Protocol

4. Treaties Under Negotiation

Austria
Barbados
Belgium
Finland—Income and Estate and Gift Tax
Germany
Indonesia
Ireland

Italy—Estate and Gift Tax
Netherlands
Netherlands Antilles
Sri Lanka
Sweden
Switzerland
Thailand
Tunisia

IV. Proposed Legislation

This portion of the paper summarizes in general terms certain of the provisions of the Tax Reform Act of 1984 (the House Bill), as approved by the House of Representatives on April 11, 1984, and the Deficit Reduction of 1984 (the Senate Bill), as approved by the Senate on April 13, 1984, relating to international taxation. The summary is taken in large part from the explanations as provided by the House Committee on Ways and Means and the Senate Finance Committee. No attempt is made to discuss in detail the variations in similar provisions of the House and Senate bills. It is anticipated that the conference to resolve differences in the House and Senate bills will take place in May.

1. Foreign Earned Income. (Section 19 of both the House and Senate Bills).

Under present law, the maximum amount of income earned abroad excluded from taxable income is $80,000 for 1983, and is scheduled to increase in $5,000 annual increments to a permanent level of $95,000 in 1986. The bills freeze the amount of the exclusion at $80,000 until 1988 and increase it in $5,000 annual increments to $95,000 in 1990.

2. Resident Aliens. (Section 451 of the House Bill; not included in the Senate Bill).

The bill modifies current law by providing objective standards for determining whether an alien individual is a resident of the United States for federal income tax purposes. Under these standards, an individual who spends 183 days or more in the United States in any year or over a three-year period (based on a weighted average of days) will generally be treated as a U.S. resident. A permanent resident for immigration purposes will be treated as a U.S. resident, also. The provision is generally effective for taxable years beginning after 1984.

3. Treatment of Community Property Income of Nonresident Aliens. (Section 452 of the House Bill).

The bill prevents married nonresident aliens from using the community property laws of their home country to split income for U.S. tax purposes. More specifically, the bill treats the earned income of one spouse, the trade or business income of one spouse, the partnership share of trade or business income of one spouse, or the community income from the separate property of one spouse as the income of that spouse, regardless of any community property laws. That spouse will be subject to U.S. tax at the regular graduated rates applicable to married persons filing separate returns when such income is effectively connected with the conduct of a U.S. trade or business. This provision will apply to taxable years beginning after December 31, 1984.

4. Certain Transfers of Appreciated Property to Foreign Corporations. (Section 132 of the House Bill; section 122 of the Senate Bill).

Under present law, certain transfers by a U.S. person of appreciated assets to a foreign corporation in a tax-free organization, reorganization or liquidation transaction is taxable if the Internal Revenue Service rules that one of the principal purposes of the transfer is the avoidance of federal income tax. Under Internal Revenue Service guidelines, generally, transfers of property used in the active conduct of a foreign trade or business are not subject to a "toll charge." However, transfers of assets containing built-in gain (such as inventory and accounts receivable) are generally subject to a "toll charge."

Judicial interpretation of the principal purpose test has reduced the ability of the Internal Revenue Service to administer section 367. In addition, the Internal Revenue Service's current ruling policy permits the tax-free transfer of intangible property abroad with the resultant potential for deferral of income until repatriation, irrespective of the fact that the transferor has obtained significant U.S. tax benefits from deducting and/or crediting the development expenditures. Finally, the courts have rejected the Internal Revenue Service's requirement contained in Revenue Ruling 78-201 and progeny that certain losses incurred by a foreign branch of a U.S. person be recaptured upon the incorporation of the foreign branch.

Under the bill, the rules governing transfers of appreciated property abroad are amended to delete the ruling requirement and provide for gain recognition without regard to purpose, unless the property is transferred for use in an active trade or business abroad. Similar to current practice, certain transfers of assets containing built-in gain are automatically subject to tax. Transfers of stock are subject to the active trade of business test. In addition, the transfer of an intangible is subject to tax as if the intangible were sold for payments which are contingent upon the productivity, use, or disposition of such property. Generally, the intangibles rule does not apply to good will or going concern value developed by a foreign branch. Finally, the current Internal Revenue Service policy on incorporations of foreign branches is codified.

Under the House version, the provision applies to transfers after January 1, 1985; under the Senate version, there is a similar effective date with a transition rule for transfers or exchanges with respect to which a ruling request was filed with the Internal Revenue Service before March 1, 1984.

5. Decontrol of Foreign Corporations. (Section 133 of the House Bill; section 123 of the Senate Bill).

Under present law, when a U.S. taxpayer who is a 10 percent or more shareholder of a controlled foreign corporation sells or exchanges stock in a taxable transaction, the gain is treated as ordinary (dividend) income to the extent of the shareholder's pro rata share of the corporation's post-1962 accumulated earnings and profits. A U.S. corporation that disposes of stock by distributing it as a dividend-in-kind or in the course of liquidation, in a transaction eligible for nonrecognition treatment to the distributing U.S. corporation, is also required to include in income its share of post-1962 accumulated earnings and profits, limited to the extent of gain. Taxpayers have taken the position that section 1248 does not apply if a controlled foreign corporation that is wholly owned by a U.S. corporation issues new shares for shares of the U.S. corporation. If this position were sustained, such a transaction could lead to permanent exemption from U.S. corporate tax of the earnings of the controlled foreign corporation accumulated prior to the exchange.

Under the bills, certain exchanges by a controlled foreign corporation of its newly issued stock for shares of its U.S. parent corporation are treated as sales or exchanges by the U.S. parent of stock in the controlled foreign corporation. The provision applies as of the date of enactment.

6. Stapled Stock. (Section 456 of the House Bill; not included in the Senate Bill).

The bill contains provisions regarding so-called stapled stock. It provides generally that if a foreign and domestic corporation are stapled entities, the foreign corporation generally will be treated as domestic. In addition, if two domestic corporations are stapled entities, each will be treated as domestic. If two domestic corporations are stapled entities, each will be treated as owning the other. These provisions are generally effective on the date of enactment with special transition rules for entities stapled on or before June 30, 1983.

7. Withholding on Dispositions by Foreigners of United States Real Property Interests. (Section 141 of the Senate Bill; not included in the House Bill).[1]

Under the Foreign Investment in Real Property Tax Act of 1980 (the

[1] H.R. 5326, 98th Cong., 2d Sess. (1984), recently introduced by Representative Gib-

Act), foreign persons who dispose of U.S. real property interests generally are required to pay tax on any gain realized on the disposition. The Act provides for enforcement of the tax on foreign persons through a system of information reporting designed to identify foreign owners of U.S. real property interests.

The bill generally allows replacement of the information reporting system with a withholding system at a rate of 20 percent for individuals and 28 percent for corporations. Generally, the bill requires withholding of a certain portion of the sales price by a transferee of U.S. real estate, any agent of a transferee, or any settlement officer or transferor's agent (hereinafter collectively referred to as the withholding agent) where U.S. real estate is acquired from a foreign person. Withholding generally is required only if the withholding agent knows (or has received notice from the transferor or his agent) that the transferor is a foreign person. The bill provides for exemptions from withholding in certain cases including that in which the transferee is to use the real property as his principle residence and the purchase price is $200,000 or less. This provision will be effective for payments with respect to dispositions made more than 30 days after the date of enactment.

8. Repeal of 30 Percent Withholding Tax on Certain Interest Paid to Foreign Persons. (Section 142 of the Senate Bill; not included in the House Bill).

Under present law, a U.S. tax of 30 percent collected through withholding at the source is generally imposed on the gross amount of U.S. source income including interest, dividends, rents, royalties, and similar payments to foreign persons if the payments are not effectively connected with a U.S. trade or business conducted by the foreign person. Statutory exemptions from the tax are provided in certain situations. In addition, U.S. tax treaties may reduce or eliminate the tax on interest paid to treaty country residents.

The bill provides for a phase out of the 30 percent tax on interest paid on certain portfolio indebtedness by U.S. borrowers to nonresident alien individuals and foreign corporations. The rate of tax will be reduced to five percent for interest received after the date of enactment; thereafter, the rate of tax will be reduced to four percent in 1985, three percent in 1986, two percent in 1987, and one percent for the period January 1 to June 30, 1988. Effective July 1, 1988, the tax on interest received by nonresident alien individuals and foreign corporations on portfolio indebtedness will be repealed. However, the 30 percent tax on such interest will be retained in certain cases where the foreign person is related to the U.S.

bons, would impose a withholding obligation upon the disposition of a U.S. real property interest, but at a 10 percent rate. A synopsis of the bill is found at 130 CONG. REC. H2233 (daily ed. Apr. 3, 1984).

obligor, where the foreign person is controlled by U.S. persons, or where the foreign person is a bank.

9. Recharacterization of U.S. Income as Foreign Income. (Section 141 of the House Bill; section 128 of the Senate Bill.).

Under present law, the United States taxes the worldwide income of U.S. taxpayers. However, to prevent double taxation, the United States grants a foreign tax credit, generally with respect to the generation of foreign source income. U.S. taxpayers can cause certain income (such as interest and insurance premiums) to be characterized as foreign source income by utilizing a foreign corporation, with the consequence that this foreign source income may avoid U.S. taxation through the application of the foreign tax credit. The bills prevent this planning technique. Under the bills, if a 50 percent U.S. owned foreign corporation, 10 percent (or more) of whose gross income is U.S. source income (including U.S. business income), pays interest or dividends to a U.S. taxpayer, a pro rata portion of the payment will be treated as U.S. source income. Generally, the bills apply with respect to income earned by paying corporations after the date of enactment; the Senate version has transition rules.

10. Recharacterization of Interest Income as Dividend Income. (Section 142 of the House Bill; section 129 of the Senate Bill).

Under present law, a U.S. taxpayer's foreign source interest income is subject to a separate foreign tax credit limitation that prevents foreign taxes on non-interest income from offsetting U.S. tax on foreign interest income and vice versa. U.S. taxpayers have sought to circumvent this rule by utilizing foreign subsidiaries to earn foreign source interest income (for example, by depositing money in a foreign bank rather than the U.S. taxpayer depositing such funds in the same foreign bank). When the U.S. taxpayer is taxed on the earnings of its foreign subsidiary, its income is dividend income, not interest income, and such recharacterized income is not generally subject to a separate foreign tax credit limitation, thereby permitting the U.S. corporate recipient to utilize the overall foreign tax credit limitations with respect to computing its U.S. tax on such income.

The bills treat foreign dividends as interest to the extent that the paying corporation's earnings and profits arise from interest. This rule applies only if 10 percent or more of the paying corporation's earnings and profits for the three taxable years preceding the taxable year in which the dividend is paid arise from interest, provided such corporation is U.S. owned, i.e., 50 percent of vote or value. The provisions in each bill generally apply to income earned by paying corporations after the date of enactment, with special transition rules.

11. Use of Territories to Avoid U.S. Tax. (Section 137 of the House

Bill; not included in Senate Bill).

Under present law, payments of U.S. source interest, dividends, and other passive income to foreign investors are generally subject to a 30 percent U.S. tax collected through withholding at the source. The United States does not tax payments of passive income to corporations organized in Guam, the Northern Mariana Islands, or the U.S. Virgin Islands.[3] Some argue that U.S. and foreign persons can utilize their jurisdiction to, in effect, avoid the U.S. and territorial tax on payments of certain income to foreigners.

Under the bill, interest, dividends, and other passive income paid from U.S. sources to corporations organized in Guam, the Marianas, or the Virgin Islands are subject to U.S. tax unless the bulk of the recipient's gross income is from territories and unless the bulk of its beneficial owners are local residents. The provision applies with respect to payments made after March 1, 1984.

12. Source of Transportation Income. (Section 136 of the House Bill; section 125 of the Senate Bill).

Under present law, in general, the United States taxes the worldwide income of U.S. persons subject to a foreign tax credit. In general, the United States does not tax the foreign source income of foreign persons (such as foreign corporations). Under present law, transportation income can be nearly entirely foreign source even if the transportation is between two U.S. points, provided the route of transport lies primarily outside the United States' three mile territorial limit.

Under the bills, income earned from transportation that begins and ends in the United States (or U.S. possessions) is treated as U.S. income. Income earned from transportation includes services income and leasing income from ships, airplanes, and containers used in connection with ships and airplanes. The effective date is the date of enactment.

13. Foreign investors—Original Issue Discount and Coupon Stripping. (Section 134 of the House Bill; section 124 of the Senate Bill).

Under present law foreign investors that acquire pure original issue discount (OID) corporate bonds—those with no payment of interest until maturity—can defer U.S. taxation until they surrender the bonds at maturity. The rules governing timing of income inclusion for foreign investors holding corporate OID debt differ in some respects from those governing income inclusion for U.S. investors. As for foreign holders of debt originally issued at a discount by obligors other than corporations and

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[3] Temporary Treasury regulations subject dividends and interest paid by territorial corporations utilized for this purpose to territorial withholding tax. Guam is presently contesting these regulations in court.

governmental entities, existing law is unclear.

The bills conform the timing of income inclusions for foreign investors to that applicable to comparable U.S. investors, except that there is no inclusion for foreign investors until actual receipt of payment. The bills also conform the treatment of noncorporate debt to the treatment of corporate debt. These provisions generally apply to payments made on or after the 60th day after the date of enactment.

The Internal Revenue Code does not contain specific rules governing foreign investors who sell or surrender stripped bonds or who sell stripped coupons. The bills generally conform the rules governing foreign investors to those governing U.S. investors, except that there is no inclusion for foreign investors until actual receipt of payment. Thus, foreign investors will treat stripped coupons and stripped bonds as being OID instruments. These provisions will apply generally to payments made on or after the 60th day after enactment.

14. Foreign Investment Companies. (Sections 139 and 140 of the House Bill; sections 127 and 130 of the Senate Bill).

Under present law, taxpayers contend that a foreign corporation that is widely held by U.S. persons may establish a subsidiary to invest in U.S. commodities markets without any of the parties incurring current U.S. tax. They also contend that when the U.S. shareholders eventually dispose of their shares in the foreign corporation they will be subject to tax at only the capital gains rate. The bill will expand the scope of the foreign investment provisions to include commodities trading, and thereby cause gains from such investments to be taxed as ordinary income. This provision applies generally to sales or exchanges on or after October 31, 1983, with special transition rules.

The bills will, in certain cases, seek to apply the accumulated earnings tax to earnings from U.S. investments in cases where a tiered structure is utilized, provided such structure is U.S. controlled, i.e., 50 percent or more of vote or value. That is, if a lower tier entity derives 10 percent or more of its earnings and profits form U.S. sources, dividends and/or interest paid to another U.S. controlled affiliate will be treated as U.S. source income by the recipient company for accumulated earnings tax purposes. These provisions apply generally to distributions received on or after May 23, 1983 with a special transition rule.

15. Insurance of Related Parties by a Controlled Foreign Corporation. (Section 136 of the Senate Bill; not included in the House Bill).

Under present law, income that a controlled foreign corporation earns from insuring U.S. risks is currently taxable to its U.S. shareholders; income earned from insuring non-U.S. risks of a related party may not be currently taxable. The bill provides that, for purposes of determining foreign base company services income (which is also currently taxable to U.S. shareholders of a controlled foreign corporation), any services performed with respect to any policy of insurance or reinsurance covering risks of a related party will be treated as having been performed in the country in which the insured risk is located. This provision will apply to taxable years of foreign corporations beginning after the date of enactment.

16. Excise Tax on Insurance Premiums Paid to Foreign Insurers and Reinsurers. (Section 135 of the Senate Bill; not included in the House Bill).

Generally, present law imposes an excise tax on premium payments for the direct insurance or reinsurance of U.S. risks with foreign insurers or reinsurers. The bill conforms the tax rate on reinsurance to that imposed on direct insurance depending on the character of the U.S. risk covered, but imposes an excise tax only once—on retained premiums received by foreign insurers or reinsurers—when the U.S. risk is insured or reinsured outside the United States. The excise tax on the insurance or reinsurance of U.S. casualty risks by a foreign insurer will be four percent of premiums paid; for U.S. life, accident or health, or annuity risks, the excise tax will be one percent of the premiums paid. In addition, the bill adopts a withholding provision for the excise tax. This provision will apply generally to premium payments made after the date of enactment.

17. Ordinary Income Treatment Under I.R.C. § 1248. (Section 454 of the House Bill; not included in the Senate Bill).

The bill clarifies the rules with respect to the taxation of the previously untaxed earnings and profits of a controlled foreign corporation at ordinary income rates when its U.S. owner disposes of the shares or liquidates the corporation. It prevents a subsequent double taxation of those earnings and profits and possible double crediting of associated foreign taxes. It also treats direct ownership of a controlled foreign corporation for purposes of I.R.C. § 1248 income inclusion similar to indirect ownership. These provisions are generally effective for transactions occurring after the date of enactment, with the provision for a special retroactive election.

18. Coordination of Subpart F with Foreign Personal Holding Company Provisions. (Section 455 of the House Bill; section 131 of the Senate Bill).

The bills coordinate the foreign personal holding company rules with the controlled foreign corporation rules. They provide that shareholders of a controlled foreign corporation (that is also a foreign personal holding company) are subject to the controlled foreign corporation rules to the extent that income taxable under those rules exceeds income taxable under the foreign personal holding company rules. This provision applies to taxable years beginning after the date of enactment.

19. Foreign Personal Holding Company Attribution Rules. (Section 453 of the House Bill; section 131 of the Senate Bill).

The bills clarify the family attribution rules for determining when a foreign corporation is a foreign personal holding company. They also prevent avoidance of U.S. tax by interposition of a foreign trust or another foreign entity between a foreign personal holding company and a U.S. taxpayer. The Senate version also includes a provision to the effect that certain dividends received from same country corporations are not treated as "bad" income for the foreign personal holding company provisions. The House provisions generally apply to taxable years beginning after 1983; the Senate version applies to taxable years of corporations beginning after March 15, 1984 with a special transition rule similar to that contained in the House bill.

20. Extension of Moratorium on Application of Research and Experimental Expense Allocation Regulations. (Section 873 of the Senate bill; not included in the House bill).

In determining foreign source taxable income for purposes of computing the foreign tax credit limitation, taxpayers are required to allocate and apportion expenses between foreign source income and U.S. source income. Rules for allocating and apportioning research and other expenses are set forth in Treasury Regulation § 1.861-8.

In the Economic Recovery Tax Act of 1981 (ERTA), Congress directed the Treasury Department to study the impact of its section 861 regulations relating to the allocation and apportionment of research and development expenditures to foreign source income with respect to the foreign tax credit. Congress also provided that for a taxpayer's first two taxable years beginning after the date of enactment of ERTA (August 13, 1981), all research activities conducted in the United States are to be allocated or apportioned to sources within the United States. This two-year moratorium on the application of the research and experimental expense allocation rules of Treasury Regulation § 1.861-8 does not apply to subsequent taxable years.

The bill generally extends for two more years the moratorium on the application of the Treasury research expense allocation rules. The extension is effective to a taxpayer's taxable years beginning before August 14, 1985.

21. Foreign Sales Corporations. (Sections 501-505 of the Senate Bill; not included in House bill).

Present law provides a system of tax deferral for a Domestic International Sales Corporation (DISC) and its shareholders. A DISC is a domestic subsidiary of generally a U.S. person engaged in exporting. The income attributable to exports may be apportioned between the parent and the DISC using special favorable pricing rules.

The bill provided for the establishment of a foreign sales corporation (FSC) which typically will be a foreign incorporated subsidiary of a U.S. parent corporation engaged in exporting. To qualify as a FSC, a corporation will have to be organized under the laws of a jurisdiction outside the U.S. customs area which has entered into an adequate exchange of information and meet certain foreign presence requirements.

The provisions of the bill will apply to the export income of a FSC if it is managed outside the United States and if some economic processes of the transaction take place outside the United States. In addition, the proposal will apply to the export income of a small FSC attributable to up to $5,000,000 of export receipts whether or not its management or economic processes are foreign.

Under the optional administrative pricing rules, a FSC may earn the greater of 17 percent of the combined taxable income that it and a related party derived from an export transaction, or 1.83 percent of the gross receipts from the transaction.

The bill will exempt a portion of the export income of a FSC from U.S. tax. If a transaction is subject to one of the administrative transfer pricing rules, the exempt portion will be 17/23 of the FSC's income from the transaction. The rest of export income (including generally 6/23 of the FSC's income) will be subject to U.S. tax. Dividends from export income paid by a FSC to a U.S. corporate shareholder will be tax-exempt at the corporate shareholder level.[3]

Companies may continue to use the present DISC rules for up to $10 million of export receipts but will be required to pay interest income (and the previously untaxed income of an Export Trading Company (ETC) if such company elects to discontinue operating as an ETC) as having been previously taxed, so that tax of those amounts would be forgiven.

This provision will apply to transactions after December 31, 1984.

22. Factoring Trade Receivables. (Section 131 of the House Bill; section 131 of the Senate Bill).

Under present law, if a seller who sells goods for the buyer's receivable (a transferable debt) sells that receivable to a controlled foreign corporation at a discount, the income may be eligible for deferral. Moreover, the seller may be able to structure the transactions so as to generate for-

[3] The amount of foreign trade income which may be exempt from U.S. tax is effectively reduced by the application of the section relating to tax preferences. This provision also reduces the tax benefit from a DISC. Section 45 of the Senate bill; not included in the House Bill.

eign source income that may be able to be sheltered by excess foreign tax credits. In addition, it may be possible for the controlled foreign corporation that buys receivables from its U.S. parent to avoid the rule of section 956 relating to investments in U.S. property.

Under the bills, when a controlled foreign corporation receives cash for a receivable that (1) it bought from a related person, and (2) which the related person had taken in exchange for inventory, the U.S. shareholder is taxed on such factoring income under the Subpart F provision. Generally the bills treat income from a related U.S. person's receivables as U.S. source income. The bills also treat payments of cash from a controlled foreign corporation to a related U.S. person for receivables arising from the U.S. person's sales of inventory as an investment in U.S. property. Thus, payments of cash for receivables will cause the U.S. shareholder to pay tax on such amounts. However, with respect to source and investments in U.S. property, the Senate bill provides certain different rules for certain export receivables. First, factoring of such receivables will not cause an investment in U.S. property. Second, income from factioning export receivables will be treated as half U.S. source and half foreign source. The provision will apply to accounts receivable and evidences of indebtedness transferred after March 1, 1984 in taxable years ending after that date.

23. Treatment of Certain Related Party Transactions. (Section 168 of the House Bill; section 180 of the Senate Bill).

The bills amend the related party rules (section 267) so that a taxpayer would generally be placed on the cash method of accounting for purposes of deducting business expenses and interest owed to a related party cash basis taxpayer. These rules will be extended to amounts accrued by a partnership to its partners and vice versa.

Also, the bill extends the loss disallowance and accrual provisions to transactions between corporations which are members of a controlled group of corporations, using a 50 percent control test. This provision will not apply to transactions with a controlled DISC under the House bill. The Senate bill defers losses on transactions between controlled corporations, rather than disallowing them as under the House bill.

These provisions generally will apply to taxable years beginning after 1983. However, the provisions will not apply to (1) interest on indebtedness incurred on or before September 29, 1983, or incurred pursuant to a contract binding on that date and all times thereafter and (2) other expenses made pursuant to a contract which was binding on September 29, 1983, and at all times thereafter.

24. Foreign Collapsible Corporations. (Section 138 of the House Bill; section 126 of the Senate Bill).

Under present law, sales of inventory yield ordinary income, not capital gain. Collapsible corporation's assets typically include inventory. Generally, a shareholder's gain on the sale of liquidation of a collapsible corporation is ordinary income rather than capital gain. However, if a collapsible corporation consents under I.R.C. § 341(f) to recognize ordinary income on disposition of its inventory the shareholder obtains capital gain treatment on the sale or liquidation of the corporation. In the case of the consenting foreign corporation, enforcement of the consent may be impractical.

Under the bills, to the extent provided in regulations, foreign corporations are ineligible to make consents under section 341(f). The effective date is the date of enactment.

25. Recapture of Foreign Oil Losses. (Section 612(e) of the House Bill; not included in the Senate Bill).

The bill makes clear that taxpayers can elect recapture of one kind of loss (oil or non-oil) over a period shorter than eight years.

26. Definition of Foreign Oil Related Income. (Section 612(f) of the House Bill; not included in the Senate Bill).

The bill supplements the definition of foreign base company oil related income by specifying that the term also includes foreign oil related income as defined in I.R.C. § 907(c)(3). The terms will include certain dividends, interest, deemed distributions under the Subpart F rules, and partnership income. The term will include these amounts only to the extent they constitute foreign oil related income; the term will not include amounts that constitute foreign oil and gas extraction income.

27. Treasury Study on Foreign Taxation of Certain U.S. Services. (Section 889 of the Senate Bill).

The bill directs the Treasury Department to study the practices of foreign countries that impose taxes on the basis of services that are performed in the United States, including the status of treaty negotiations with such countries, and options to alleviate the resulting double tax burden on U.S. taxpayers. The Treasury Department is to report on the results of its study to the Senate Committee on Finance and the House Committee on Ways and Means no later than August 31, 1984.

This provision of the bill will be effective on the date of enactment.

28. Tax-Exempt Entity Leasing. (Sections 31-33 of the House Bill; sections 21 & 22 of the Senate Bill).

In general, the bills reduce the tax benefits available for certain property that is leased to or otherwise used by tax-exempt entities. Under the bills, tax-exempt entities include the United States, any State or local governmental unit, possessions of the United States, and most agencies and instrumentalities of any of the foregoing. The term also includes organizations (other than farmers' cooperatives described in Code section 521) exempt from United States income tax and certain organizations that were formerly exempt. The term also includes certain foreign persons or entities.

The bills generally require that Accelerated Cost Recovery System (ACRS) or other depreciation deductions for property used by tax-exempt entities be computed using the straight line method over a recovery period equal to the greater of the present class life of the property under the Asset Depreciation Range (ADR) system (40 years in the case of 15 year real property) or, in the case of property subject to a lease, 100 percent (125 percent in the case of 15 year real property) of the term of the lease. In the case of 15 year real property, this provision applies to the extent of use of a type or types specified in the bill, but only if more than 20 percent of the property is so used. Special depreciation rules are provided for certain high technology property which is tangible personal property.

The bills also provide criteria for determining whether a transaction that is structured as a service contract or other arrangement (including a partnership or other pass-through entity) should be treated as a lease for purposes of the depreciation and investment credit provisions of the bills. The rehabilitation credit will be denied for real property that is subject to the slower depreciation rules provided by the bills, but only if the rehabilitation expenditures are, or acquisition of the building to be rehabilitated is, financed in whole or in part with the proceeds of obligations the interest on which is exempt from Federal income tax under section 103(a).

The depreciation provisions of the bills do not apply to property leased for a short term, as defined in the bills.

The bills generally apply to property placed in service by the taxpayer after May 23, 1983, and to property used under an agreement entered into after that date. However, transition rules are provided.

29. Simplification of Income Tax Credits. (Sections 481-486 of the House Bill; sections 850-854 of the Senate Bill).

In general, the bills group existing income tax credits into logical categories and provide uniform tax liability limitations and carryover rules. First, personal credits are allowed; second, credits including the foreign tax credit are allowed. Business credits (i.e., the investment tax credit, targeted jobs credit, alcohol fuels credit, and ESOP credit) will be consolidated into one credit and allowed up to 100 percent of the first $25,000 of tax liability and 85 percent of the remaining, with a 3 year carry back and a 15 year carry forward on a first in first out basis. The provision applies for taxable years beginning after 1983.

30. Earnings and Profits. (Section 197 of the Senate bill; not in-

cluded in the House bill).

Under present law, distributions from a corporation are generally treated as dividends only if they are paid out of current or accumulated earnings and profits. A corporation's earnings and profits may be substantially less than its "true," or economic income because many of the tax rules applicable in determining taxable income are applicable to a greater or lesser extent in determining earnings and profits.

The bill makes a number of changes in the definition of earnings and profits to conform such concepts more closely to true economic income. The bill also makes provisions for the effect on earnings and profits of redemptions. With several exceptions, the provisions are effective for taxable years beginning after the date of enactment.