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# Back to the Future: A Path to Progressive Reform of the U.S. International Income Tax Rules

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## Back to the Future: A Path to Progressive Reform of the U.S. International Income Tax Rules

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### I. INTRODUCTION

The income tax system which has served the United States well for over eight decades is under increasing attack from politicians, economists, business leaders, and tax academicians. Although the system

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arguably collects more money than any other tax system in the world and does so at the lowest cost of any system in the world,<sup>1</sup> numerous members of Congress and various other commentators argue that a radical overhaul of the system is required and that the system needs to be "torn out by its roots" and replaced by a national sales tax or other consumption-based tax system. The U.S. international tax rules have come under particularly strong attack, including assertions that these rules are interfering with the ability of U.S. multinational corporations to compete in the global economy and contributing to the continuing U.S. trade deficit.

Despite this overblown rhetoric, both fairness and administrative feasibility dictate that an income tax system will and should be retained as the primary tax base in the United States for the foreseeable future.<sup>2</sup> In my view, the prudent path to U.S. tax reform is to substantially improve the current income tax system by broadening the base and lowering rates, before embarking on a radical replacement of the current system with an unproven consumption tax.<sup>3</sup> This paper provides suggestions for the reform of certain areas of the U.S. international income tax rules under the assumption that the United States will retain an income tax system as its primary tax base.

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1. See, e.g., N. JEROLD COHEN, Remark at the College of William and Mary's Annual Tax Conference (Dec. 6-7, 1996), in *TAX ANALYSTS' DAILY TAX HIGHLIGHTS & DOCUMENTS*, Dec. 18, 1996, at 2942.

2. Obviously, given tight page limits for this paper, I cannot rehash the arguments for and against an income tax versus a consumption tax. As an aside, I believe that enactment of a consumption tax as a supplement to the income tax system is desirable and politically feasible. The revenue from such a consumption tax could be used to accomplish a number of desirable tax policy objectives, including reform and simplification of the income tax, full or partial corporate integration, and repeal of the regressive and ever-increasing payroll taxes. Moreover, adoption of a consumption tax as a supplement to, rather than replacement for, the income tax would allow U.S. policymakers to analyze how much revenue the consumption tax raises, the costs of implementing the tax for both taxpayers and the government, the distribution of the tax among different income levels, and the economic and social effects of the tax. The results of that study could then be used as the basis for gradual expansion of the role of the consumption tax and concomitant reduction of the role of the income tax as a revenue raising device if we decide that this is the appropriate policy move.

Additionally, I recognize that our current income tax system is really a hybrid, containing some elements that are closer to a consumption-based approach than to an income-based approach (e.g., the qualified pension plan provisions), and that further incremental shifts toward a consumption-based approach are likely to occur even if we retain an income tax as the principal tax base.

3. See generally Reuven S. Avi-Yonah, *The International Implications of Tax Reform*, 69 *TAX NOTES* 913 (1995) (discussing how adoption of any of the major consumption tax proposals currently on the table in Congress (e.g., the Archer-Lugar national sales tax proposal, the Arney-Shelby flat tax proposal, or the Nunn-Domenici graduated consumption tax proposal) would likely have a serious destabilizing effect on the international tax regime and could lead to unrestricted tax competition between the United States and other countries throughout the world).

## II. OVERVIEW

The current U.S. international tax system reflects the exercise of two types of taxing jurisdiction that are consistent with international tax norms, residence-based and source-based jurisdiction. In the case of U.S. persons (e.g., U.S. citizens, resident aliens, and domestic corporations), the United States exercises residence-based taxing jurisdiction and taxes such persons on their worldwide incomes. However, in the case of foreign source income, the United States cedes primary jurisdiction to the country of source and allows U.S. persons a foreign tax credit for the foreign income taxes paid on such income, thereby preventing international double taxation. In effect, the United States imposes only a residual tax on U.S. persons' foreign source income. However, pursuant to bilateral tax treaties entered into by the United States with various countries, the foreign treaty country eliminates, or substantially reduces, its tax on U.S. persons' portfolio income, such as interest and dividends, and eliminates its tax on business profits not attributable to a permanent establishment in the treaty country. The primary taxing jurisdiction over such income is thus ceded to the United States, the country of residence.

Generally, the U.S. rules for taxing the international income of U.S. persons reflect capital export neutrality. Under this capital export neutrality theory, U.S. persons pay the same total tax (U.S. and foreign tax) on all income, regardless of whether the income is earned in the United States or abroad. Therefore, the decision to invest in the United States or abroad is not made on the basis of tax considerations; instead, the investment is made wherever the pretax economic returns are greatest.<sup>4</sup>

Although the general preference in the U.S. tax system is for taxing U.S. persons on a residence basis and implementing capital export neutrality, significant departures from these principles exist. First, as a general rule, the United States still adheres to the deferral principle with respect to foreign source income earned by U.S. persons through foreign corporations, i.e., the U.S. shareholders are not taxed on their shares of the foreign corporation's foreign source income until that income is distributed to them or the U.S. shareholders sell their stock in the foreign corporation. This deferral principle is subject to a complex array of anti-deferral regimes that focus primarily on easily movable and low-taxed passive income, as well as certain tainted, tax-haven transactions. As discussed below, this deferral principle and its exceptions undermine the equity, efficiency, and simplicity of the tax system.

Second, the United States does not follow pure capital export neu-

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4. See, e.g., CHARLES H. GUSTAFSON, ROBERT J. PERONI & RICHARD CRAWFORD PUGH, *TAXATION OF INTERNATIONAL TRANSACTIONS* 17 (1997).

trality in the design of its foreign tax credit. Under pure capital export neutrality, a credit would be allowed for foreign taxes in excess of the U.S. rate, which would allow the foreign tax credit to offset U.S. taxes on U.S. source income. However, such an approach would enable foreign countries to erode U.S. taxing jurisdiction over U.S. source income and would amount to a U.S. subsidy of high-tax foreign countries. This approach would also allow foreign countries to maintain income tax rates above the U.S. rate without suffering the consequences of reduced investment by U.S. persons and would encourage foreign countries to impose discriminatorily higher taxes on U.S. persons.<sup>5</sup> Thus, since 1921, the United States has imposed an overall limit on the foreign tax credit. This limitation prevents the credit from offsetting U.S. taxes on U.S. source income.

An overall limit on the foreign tax credit, however, still permits U.S. persons to credit high foreign taxes in excess of the U.S. rate on one type of foreign source income against the U.S. tax on low-taxed or untaxed foreign source income. Consequently, this overall limit creates an incentive for U.S. persons with high-taxed foreign source income, usually from business operations in a foreign country, to move some of their other investment capital and business operations to low-tax foreign jurisdictions (instead of keeping the capital or business operations in the United States) in order to take advantage of these cross-crediting opportunities. Accordingly, between 1932 and 1976, a per-country foreign tax credit limit was used, either alone or in combination with an overall limit, which limited the credit to the U.S. tax on foreign source income on a country-by-country basis. Since repeal of the per-country limit, the United States has created a series of separate limits, currently set forth in section 904(d), sometimes called "basket limits," which apply the overall limit separately to certain categories of foreign source income.<sup>6</sup> These basket limits have added significant complexity to the tax system; yet, by retaining a general basket limit into which most foreign business income falls, they still have not solved the problem of preventing U.S. persons from cross-crediting high foreign taxes on foreign business income in excess of the U.S. rate against the U.S. tax on low-taxed foreign business income.

Third, the U.S. tax system contains a number of provisions favoring certain types of foreign source income of U.S. persons and other provisions disfavoring foreign business and investment activity. For exam-

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5. See, e.g., Daniel J. Frisch, *The Economics of International Tax Policy: Some Old and New Approaches*, 47 TAX NOTES 581, 583 (1990); Charles I. Kingson, *The Foreign Tax Credit and Its Critics*, 9 AM. J. TAX POL'Y 1, 56 (1991) [hereinafter Kingson, *The Foreign Tax Credit*].

6. See I.R.C. § 904 (1996).

ple, the FSC provisions and the title-passage rule for inventory property provide a tax subsidy for certain export activities of U.S. taxpayers. The foreign earned income exclusion in section 911 provides a tax subsidy for U.S. individual taxpayers who live and work abroad.<sup>7</sup> On the other hand, section 168(g)(1)(A) forces U.S. taxpayers to use a less advantageous cost recovery system for depreciable property used predominantly abroad,<sup>8</sup> thus providing a tax disincentive to foreign business investment. Moreover, Congress uses various tax penalty provisions to penalize foreign economic activities that it believes violate certain U.S. foreign policy objectives.

The U.S. taxation of foreign persons (e.g., nonresident aliens and foreign corporations) is more limited than that of U.S. persons. The United States exercises source-based taxing jurisdiction and imposes income tax only on certain types of U.S. source income realized by such persons, including U.S. source portfolio income such as interest, dividends, rent, and royalties, income from a U.S. trade or business, and gains from the sale of U.S. real property interests. The United States also taxes certain types of foreign source income of a foreign person if the income has a close connection to a U.S. trade or business. However, pursuant to bilateral tax treaties or, in some cases, unilaterally by statute, the United States often eliminates or reduces the U.S. tax on foreign persons' portfolio income such as interest, dividends, and royalties, and also eliminates the U.S. tax on foreign persons' business profits not attributable to a permanent establishment in the United States. Thus, the primary taxing jurisdiction over such income is ceded to the foreign country of residence. Moreover, with certain exceptions, foreign persons are generally not subject to U.S. tax on capital gains.<sup>9</sup>

The U.S. rules for taxing foreign persons generally reflect international norms and represent an appropriate exercise of source-based taxing jurisdiction. Although these provisions certainly need simplification, refinement, clarification, and modernization, given page and time constraints, that topic is not within the scope of this paper.<sup>10</sup>

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7. See I.R.C. § 911 (1996).

8. See I.R.C. § 168(g)(1)(A) (1996).

9. The exceptions principally include gains from the sale of U.S. real property interests and capital gains effectively connected with a U.S. trade or business.

10. These constraints also limit the depth with which I can present my analysis of reform of the U.S. international tax rules relating to U.S. persons.

For recent commentary on reforming the U.S. international tax rules relating to foreign persons, see generally AMERICAN LAW INSTITUTE, FEDERAL INCOME TAX PROJECT: INTERNATIONAL ASPECTS OF UNITED STATES INCOME TAXATION—PROPOSALS ON UNITED STATES TAXATION OF FOREIGN PERSONS AND OF THE FOREIGN INCOME OF UNITED STATES PERSONS (1987) [hereinafter ALI INTERNATIONAL TAX STUDY]; Yoseph M. Edrey, *Taxation of International Activity: FDAP, ECI and the Dual Capacity of an Employee as a Taxpayer*, 15 VA. TAX REV. 653

This paper will focus on certain key aspects of the U.S. rules for taxing the international activities of U.S. persons.

### III. THE PROPER PATH TO INTERNATIONAL TAX REFORM: REINFORCEMENT OF RESIDENCE-BASED TAXATION OF U.S. PERSONS

#### A. Introduction

In recent years, many business leaders, politicians, and commentators have taken the position that international tax policy should be driven by concerns about the competitiveness of U.S. multinational corporations in the global economy. These commentators maintain that the U.S. international tax system should be revised to implement capital import neutrality at least with respect to the taxation of active business income earned by U.S. multinationals abroad.<sup>11</sup> Capital import neutrality focuses on taxation in the host country; all firms operating in the same industry in a particular country bear the same level of tax.<sup>12</sup> Under this view, source-based taxation of active business income should be the norm and the residence country should adopt a territorial system of international taxation that would exempt foreign source business income of its multinationals from domestic taxation.<sup>13</sup>

This paper, however, explores and supports a contrary view. It assumes that residence-based taxing jurisdiction of U.S. persons' foreign source income is appropriate and that capital export neutrality should continue to be the main neutrality principle underlying the international tax rules of the United States. Consistent with these assumptions, the

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(1996); John S. Nolan, *United States Taxation of Foreign Investment in the United States*, 8 AM. J. TAX POL'Y 291 (1990); H. David Rosenbloom, *Toward a New Tax Treaty Policy For a New Decade*, 9 AM. J. TAX POL'Y 77 (1991).

11. See, e.g., GARY CLYDE HUFBAUER, U.S. TAXATION OF INTERNATIONAL INCOME: BLUEPRINT FOR REFORM 57-60 (1992).

12. See, e.g., GUSTAFSON, PERONI & PUGH, *supra* note 4, at 17.

13. Professor Reuven Avi-Yonah also argues for such an approach on the basis that it would substantially simplify the U.S. international tax system, rather than on capital import neutrality grounds. Reuven S. Avi-Yonah, *The Structure of International Taxation: A Proposal for Simplification*, 74 TEX. L. REV. 1301 (1996) [hereinafter *Avi-Yonah, Proposal for Simplification*]. However, in a more recent article, Professor Avi-Yonah seems to take a different approach and recognize that, in the light of the adoption of the check-the-box entity classification system, repeal of deferral of foreign source income of U.S. multinationals may be the appropriate way to simplify the U.S. international tax rules. Reuven S. Avi-Yonah, *To End Deferral As We Know It: Simplification Potential of Check-the-Box*, 74 TAX NOTES 219 (1996) [hereinafter *Avi-Yonah, Simplification Potential of Check-the-Box*].

For a provocative commentary arguing that both efficiency and equity principles support a territorial system of taxation, see Klaus Vogel, *World-wide vs. Source Taxation of Income—A Review and Reevaluation of Arguments*, in INFLUENCE OF TAX DIFFERENTIALS ON INTERNATIONAL COMPETITIVENESS 117 (1990).

United States should not adopt a territorial system for taxing international income. The way to reform the international tax rules is to bring the current system closer to a capital export neutrality ideal by making the following changes: repealing deferral with respect to all foreign income earned by U.S. shareholders through controlled foreign corporations and by any U.S. investors through passive foreign investment companies;<sup>14</sup> reforming and simplifying the foreign tax credit limit; adopting the worldwide fungibility approach for allocating and apportioning interest expense; repealing the inefficient export incentives in the Code such as the FSC provisions and the title-passage source rule for income from inventory sales; and repealing the foreign earned income exclusion in section 911. These changes would simplify the U.S. international tax rules and, more importantly, result in a U.S. international tax system that is more theoretically coherent and that better promotes economic efficiency.

B. *Reasons for Favoring Residence-Based Taxation and Rejecting the Adoption of a Territorial System*

A territorial system is fundamentally inconsistent with the prevailing concepts of fairness that underlie our income tax system. One of those key concepts is the notion of horizontal equity, i.e., that income taxes should be based on some measure of a taxpayer's ability to pay and that income tax liability should not vary based on the source of income. A residence-based system for taxing U.S. persons, which taxes a U.S. person on its worldwide income but allows a credit for foreign income taxes paid, is consistent with this principle because a U.S. person pays the same total income tax regardless of where the income is derived.<sup>15</sup> As stated by Hugh Ault and David Bradford: "[S]ince the source of income has no bearing on its validity as a measure of ability to

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14. For recent commentary calling for an end to deferral, see Avi-Yonah, *Simplification Potential of Check-the-Box*, *supra* note 13; Asim Bhansali, Note, *Globalizing Consolidated Taxation of United States Multinationals*, 74 *TEX. L. REV.* 1401 (1996); Robert A. Green, *The Future of Source-Based Taxation of the Income of Multinational Enterprises*, 79 *CORNELL L. REV.* 18 (1993); Joseph Isenbergh, *Perspectives on the Deferral of U.S. Taxation of the Earnings of Foreign Corporations*, 66 *TAXES* 1062 (1988); Steven E. Shay, *Revisiting U.S. Anti-Deferral Rules*, 74 *TAXES* 1042 (1996).

15. See, e.g., Peggy B. Musgrave & Richard A. Musgrave, *Fiscal Coordination and Competition in an International Setting*, in *INFLUENCE OF TAX DIFFERENTIALS ON INTERNATIONAL COMPETITIVENESS* 61, 74 (1990). In my analysis, I apply the horizontal equity analysis on a global basis; thus, I conclude that allowance of a properly designed foreign tax credit is consistent with the horizontal equity principle. Under a horizontal equity analysis applied only from a national perspective, foreign taxes would be treated as merely another cost of earning income and, hence, be only deductible and not creditable. However, such an approach would not adequately mitigate international double taxation and would discourage U.S. persons from investing abroad.



pay, the tax burden should be based on 'worldwide income.'"<sup>16</sup>

By contrast, a territorial system for taxing a U.S. person's foreign source income violates this principle because it exempts such income from U.S. tax altogether, and thus, does not base the taxpayer's tax liability on its ability to pay taxes.<sup>17</sup> A taxpayer can avoid tax liability by shifting investments abroad, thus undermining the basic theoretical base of the income tax system.<sup>18</sup> Moreover, adoption of the territorial system of taxation by the United States would likely lead to increased tax competition by countries adopting tax holidays or ineffective taxation at the source, thus undermining the fairness of international taxation viewed from a global perspective.<sup>19</sup>

Another key concept underlying our progressive income tax system is the notion of vertical equity. This principle focuses on the appropriate distribution of the income tax burden among those with different levels of economic income. A progressive rate structure, which has been part of our tax system in varying degrees for many years, is based on the concept that those with higher levels of income should pay tax at progressively higher rates on their top (marginal) dollars of income and that the income tax should be used for redistribution. Residence-based taxation is consistent with vertical equity because it bases a taxpayer's marginal rates on total worldwide income.<sup>20</sup> By contrast, the territorial system of taxing foreign source income is inconsistent with vertical equity because it does not include a taxpayer's foreign source income in the allocation of tax burdens among taxpayers with different levels of worldwide income. Moreover, if the exemption system does not include a domestic taxpayer's foreign source income in determining the taxpayer's marginal rates of tax, it further undermines vertical equity by allowing the taxpayer to pay lower marginal rates of tax on domestic source income. That is, a domestic taxpayer will pay tax at a lower marginal rate by dividing income between taxable domestic sources and exempt foreign sources than by earning all of the income in the country of residence.<sup>21</sup>

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16. Hugh J. Ault & David F. Bradford, *Taxing International Income: An Analysis of the U.S. System and its Economic Premises*, in *TAXATION IN THE GLOBAL ECONOMY* 11, 27 (Assaf Razin & Joel Slemrod eds., 1990).

17. See VITO TANZI, *TAXATION IN AN INTEGRATING WORLD* 76-78 (1995).

18. Since an exemption system explicitly ignores foreign sources of income in allocating the residence country's tax burden, even though that foreign income gives rise to a domestic taxpayer's ability to pay taxes, it is fundamentally inconsistent with the theoretical underpinnings of an income tax base.

19. See generally SOL PICCIOTTO, *INTERNATIONAL BUSINESS TAXATION* 46 (1992).

20. See, e.g., Green, *supra* note 14, at 29; U.S. TREAS. DEP'T, *BLUEPRINTS FOR BASIC TAX REFORM 99* (1977).

21. Some countries with exemption systems have mitigated this problem by including the

An ideal income tax system achieves economic efficiency if it is neutral in the allocation of economic resources among various economic activities. In the international tax context, capital export neutrality is most consistent with this concept of neutrality because under a capital export neutral tax system, U.S. taxpayers will determine the location of investments based on their pretax returns, not on the basis of tax considerations.<sup>22</sup> A residence-based tax system for taxing foreign source income, combined with a foreign tax credit for foreign taxes paid, best implements this neutrality principle. By contrast, a territorial system encourages taxpayers to shift their resources to investments in low-tax countries with lower pretax returns; thus, such a system is not economically efficient.<sup>23</sup>

Furthermore, arguments by proponents of the exemption system that a residence-based system for taxing international income undermines the international competitiveness of U.S. persons are fundamentally flawed. The actual effect of taxes imposed by an investor's country of residence on the ability of the investor to compete in the global marketplace has not been clearly established. If the investor is engaged in business in a competitive foreign market, the price that the investor can charge for its goods or services is primarily determined by the market situation, not the level of taxes that the investor bears in his or her country of residence. It is, therefore, unlikely that taxes imposed by the country of residence can have much effect on pricing, at least in the short run. From this perspective, the competitiveness claims made by proponents of the exemption system appear to be overstated.<sup>24</sup> In any event, to the extent that one believes that tax policy can and should be used to improve the international competitiveness of U.S. persons, the most economically efficient way to do so is to broaden the tax base and reduce U.S. tax rates across the board, rather than reduce U.S. tax rates

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taxpayer's foreign source income in the tax base solely for determining the taxpayer's rates of taxation on domestic source income. This feature, however, adds complexity to the exemption system and does not completely eliminate the fairness problem if the source country has lower tax rates than the residence country.

22. Traditional economic analysis generally supports a conclusion that capital export neutrality results in the most efficient international allocation of capital and maximizes worldwide economic welfare. See, e.g., STAFF OF JOINT COMM. ON TAX'N, 102D CONG., 1ST SESS., *FACTORS AFFECTING THE INTERNATIONAL COMPETITIVENESS OF THE UNITED STATES*, at 5 (1991) ("Economic analysis can demonstrate that for any capital import-neutral policy there is almost always a superior revenue-neutral capital export-neutral policy.").

23. See, e.g., Jane G. Gravelle, *Foreign Tax Provisions of the American Jobs Act of 1996*, 72 TAX NOTES 1165, 1166 (1996).

24. See, e.g., TIMO VIHHERKENTTA, *TAX INCENTIVES IN DEVELOPING COUNTRIES AND INTERNATIONAL TAXATION* 64 (1991).

to zero only on foreign source income.<sup>25</sup>

In addition, the territorial system of taxation may encourage source countries to impose undesirably low taxes on business income in order to compete for foreign capital. This competition may result in a "race to the bottom," with countries imposing less than optimal levels of taxes and providing less than optimal levels of public services.<sup>26</sup> Moreover, as suggested by Peggy Musgrave and Richard Musgrave, the movement of capital to low-tax jurisdictions "permits the owner who resides in a high-tax location to act as a free rider enjoying a high level of public services without contributing to their cost. As a result, voting patterns will be distorted, burdens will be shifted and an inefficient level of public provision will result."<sup>27</sup>

The various types of modern business activities, such as global trading, communications technologies, and electronic commerce, will move the international tax system toward greater emphasis on residence-based taxation in the future. These modern types of commerce do not fit easily within traditional notions of associating items of income and expense with a particular geographic location.<sup>28</sup> Accordingly, these modern types of commerce have undercut the rationale of source-based taxation and weaken the case for shifting the U.S. international tax system to a territorial system of taxing international income.

Another important argument against adopting an exemption system is the pressure it would create on legislators to provide additional source-based exemptions or preferences, which undermine the integrity of the tax reform process. Suppose that, as part of the tax reform process, Congress enacted an exemption system for the foreign source business income of U.S. persons, on the ground that such an exemption is necessary to enhance U.S. competitiveness in the global economy. How would Congress respond to other industries pleading for special tax assistance to compete in the modern economy? What line would Congress be able to defensibly draw here? How would Congress respond to the energy industry, which can make claims for special treatment on the ground that it is engaged in a risky endeavor that has immense importance to the U.S. economy? What about the high-tech industry which can make similar special claims? How can one make a valid argument

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25. Cf. STAFF OF JOINT COMM. ON TAX'N, 102D CONG., 1ST SESS., *FACTORS AFFECTING THE INTERNATIONAL COMPETITIVENESS OF THE UNITED STATES*, at 248 (1991).

26. For commentary on the harmful effects of international tax competition, see Charles E. McLure, Jr., *International Aspects of Tax Policy for the 21st Century*, 8 AM. J. TAX POL'Y 167 (1990).

27. See Musgrave & Musgrave, *supra* note 15, at 69.

28. See U.S. TREAS. DEP'T, *SELECTED TAX POLICY IMPLICATIONS OF GLOBAL ELECTRONIC COMMERCE* 23 (1996).

against creating special tax exemptions for all types of worthy industries once the concept of special tax treatment to enhance competitiveness is established?

Finally, a common argument in favor of the exemption system is its potential for reducing the complexity of the tax system. Yet, the alleged simplicity of the exemption system may be illusory. Any exemption system that Congress is likely to enact would probably not substantially simplify the U.S. international tax rules.

First, an exemption system would place great pressure on the source-of-income rules, as well as the rules for allocating and apportioning expenses. Under an exemption system, a taxpayer would have a tremendous incentive to engage in tax-motivated schemes which shift the source characterization (but not necessarily the economic factors of production) of income to a low-tax foreign jurisdiction.<sup>29</sup> Similarly, a U.S. taxpayer would have an incentive to shift the allocation and apportionment of deductions to U.S. source income to reduce its tax liability on such income. Of course, these same pressures exist under our current system, which uses the foreign tax credit to mitigate international double taxation. The point here is that these pressures, which complicate the existing international tax rules, would remain, and probably intensify, under an exemption system.

Second, an exemption system also places great pressure on the transfer pricing rules. U.S. taxpayers would be encouraged to engage in aggressive transfer pricing to shift income to low-tax foreign countries and thereby eliminate their U.S. tax liability on such income. Thus, adoption of an exemption system would not reduce the difficulty of policing transfer pricing abuses under the modified arm's length standard of existing law. Indeed, the pressure on the transfer pricing rules would likely intensify under a territorial system which provides a permanent exemption from U.S. tax for foreign source business income.

Third, an exemption system could include the rule used in some foreign countries' tax systems that income is exempt from residence country tax only if it incurs tax (or some specified minimum rate of tax) in the source country. If that approach were adopted, the difficulties of associating a foreign tax with a particular category of foreign source income would be necessary, thus continuing one of the complicating features of the current law foreign tax credit limits.

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29. See Hugh J. Ault, *Commentary*, 9 AM. J. TAX POL'Y 61, 65 (1991) (noting that we must examine any proposal for adopting a territorial system in "the context of the U.S. tax culture," a system with "aggressive taxpayers [and tax advisers] who play the rules to the limit"). Accordingly, it would be necessary to have detailed rules defining the scope of the exemption for foreign source income with appropriate anti-abuse rules that would not be simple either in theory or in practice.

Alternatively, the exemption system might be structured to apply only to active foreign business income, whether or not taxed in the source country, and not apply to foreign source passive income which would remain subject to U.S. tax. Such a modified exemption system would, of course, continue many of the complexities of the current law anti-deferral regimes and foreign tax credit rules, which require the sorting of foreign source income into various categories of income.

Under either of these modified exemption systems, there would be pressure for the United States to retain the foreign tax credit with respect to foreign source passive income or low-taxed foreign source income, since such income would still be exposed to taxation by both the United States and the source country. This would significantly reduce the simplification potential of the exemption system. Moreover, losses incurred in an exempt category of foreign source income should not be allowed to offset either U.S. source income or foreign source income in a non-exempt category (although Congress would undoubtedly face pressure to make exceptions to this rule); losses incurred in a non-exempt category would presumably offset U.S. source income. This would raise policy concerns similar to those that led to the enactment of section 904(f). Congress would have to decide whether to retain some version of that provision to deal with these concerns. Of course, retention of section 904(f), even in modified form, would reduce any simplicity gains achieved by the exemption system.

#### IV. ANTI-DEFERRAL REFORM

The deferral principle is one of the most significant elements complicating the U.S. international tax system. Under this principle, foreign source income earned by a U.S. person through a foreign corporation is generally not subject to U.S. tax until it is repatriated to the United States in the form of dividends or through a sale of the foreign corporation's stock by the U.S. person. To combat abuse of that principle, the United States has enacted a series of extremely complex and somewhat overlapping anti-deferral regimes, which have provided much work for tax attorneys, accountants, and treatise authors: (1) the foreign personal holding company provisions, enacted in 1937; (2) the controlled foreign corporation ("CFC") provisions, enacted in 1962; (3) the foreign investment company provisions, also enacted in 1962; and (4) the passive foreign investment company ("PFIC") provisions, enacted in 1986. In addition, two penalty taxes aimed at preventing accumulation of earnings at the corporate level to avoid the shareholder-level tax on dividend distributions—the personal holding company tax provisions and the accumulated earnings tax provisions—may apply to foreign corpora-

tions owned by U.S. persons. Yet, despite this myriad of complex anti-deferral regimes, the basic principle of deferral remains, a principle that substantially undercuts the fairness and efficiency of the U.S. tax system.

The deferral principle undercuts tax fairness by allowing U.S. persons to avoid paying current U.S. tax on their economic income earned through foreign corporations conducting business operations in low-tax foreign countries, while U.S. persons with the same amounts of economic income earned directly through a branch operation abroad or through a business conducted in the United States must pay current U.S. tax on their income. Moreover, the deferral principle encourages U.S. persons to shift investments to low-tax foreign countries in violation of capital export neutrality, thereby reducing worldwide economic welfare.

The complicated web of anti-deferral regimes of current law represents a compromise between ending deferral altogether and allowing deferral of income earned through foreign corporations without limitation. Congress has tinkered with the anti-deferral regimes over the years by tightening up the definition of Subpart F income in the CFC provisions and adding new anti-deferral regimes, as in 1986 with the introduction of the PFIC regime. The tinkering, however, has only made the system more complex without significantly eliminating the problems caused by the deferral principle.<sup>30</sup> As a result, a ridiculously complicated set of rules has evolved that makes deferral elective for the well-advised U.S. taxpayer and creates traps for the unwary.<sup>31</sup> For example, a U.S. corporation is likely to elect branch status for a foreign entity with income earned in a high-tax foreign country where a foreign tax credit will offset any U.S. tax on the income. A U.S. corporation is also likely to elect branch status for a foreign entity with losses so that the losses can offset the U.S. corporation's income.

The elective nature of the deferral principle has been fortified and made more explicit by the Treasury Department's recent adoption of the

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30. For a recent proposal for further incremental limitation of deferral for CFCs, see the well-meaning, but ineffective, American Jobs and Manufacturing Preservation Bill of 1996, introduced by Senator Byron Dorgan. This proposal is aimed at the so-called "runaway plant" problem and would end deferral on certain imported property income. This provision would add complexity to the already overly complex Subpart F regime, without substantially eliminating the detrimental economic effects of the deferral principle.

31. For discussion of those situations in which a U.S. person is likely to opt for termination of deferral by electing branch status for a foreign entity, see Avi-Yonah, *Simplification Potential of Check-the-Box*, *supra* note 13, at 220. See also NEW YORK STATE BAR ASS'N, TAX SECT., REPORT ON THE "CHECK-THE-BOX" CLASSIFICATION SYSTEM PROPOSED IN NOTICE 95-14 (1995); Michael L. Schler, *Initial Thoughts on the Proposed "Check-the-Box" Regulations*, 71 TAX NOTES 1679 (1996).

so-called check-the-box entity classification system.<sup>32</sup> Under this system, U.S. persons operating abroad through foreign entities other than *per se* foreign corporations, will more readily be able to elect deferral of U.S. tax on their foreign source income by choosing whether to have the foreign entities treated as corporations or partnerships (or branches in the case of an entity with a single owner) for tax purposes.<sup>33</sup> This essentially elective deferral system is unacceptable from a policy point of view and needs to be changed in order to accomplish any significant reform of the U.S. international tax system.

Less radical proposals have been advanced to simplify the anti-deferral regimes by expanding the definition of Subpart F income in the CFC provisions and combining the other anti-deferral regimes aimed primarily at passive income into one or two unified regimes.<sup>34</sup> These efforts might achieve some marginal improvement over the current law, but I believe that more radical reform of the anti-deferral regimes is necessary. At a minimum, it is time to repeal deferral for U.S. shareholders of CFCs and reformulate the PFIC provisions to constitute the only anti-deferral regime aimed primarily at passive income earned by U.S. persons through non-controlled foreign corporations.

Undoubtedly, U.S. multinationals and commentators who advocate the capital import neutrality standard would oppose any proposal to repeal deferral for CFCs on the ground that repealing deferral would substantially impair the international competitiveness of U.S. persons operating businesses abroad. They would argue that repeal of deferral would impose an extra cost (a current U.S. tax) on U.S. multinationals operating in low-tax foreign countries—a cost not borne by their competitors from countries which allow deferral or use a territorial system for taxing foreign source income—and, would, thus, erode their competitive position in the global economy. However, this argument assumes that firms from different countries have to pay the same tax rate in the

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32. See T.D. 8697, 1997-2 I.R.B. 22.

33. See, e.g., Avi-Yonah, *Simplification Potential of Check-the-Box*, *supra* note 13; Schler, *supra* note 31. This adoption of elective deferral in the entity classification regulations substantially undercuts one of the arguments made by some opponents of proposals to abolish deferral—that ending deferral will be a major revenue loser, given the collateral consequences of ending deferral. See Avi-Yonah, *Simplification Potential of Check-the-Box*, *supra* note 13, at 221.

Certain foreign entities are treated as *per se* corporations for federal tax purposes and cannot elect partnership classification under the check-the-box system. Treas. Reg. § 301.7701-2(b)(8) (1996). Nevertheless, for U.S. persons operating abroad through such entities, the less explicit and more complicated elective deferral techniques used before adoption of the check-the-box system should be available in many situations.

34. The other anti-deferral regimes aimed primarily at passive income are the foreign personal holding company provisions, the PFIC provisions, the foreign investment company provisions, and the accumulated earnings tax and personal holding company tax provisions, insofar as they apply to foreign corporations owned by U.S. persons.

host country for international investment to be allocated efficiently—an assumption that is incorrect. As stated by Jane Gravelle:

[Arguments against further restricting deferral focus] on a vague term—“competitiveness”—when what should really be considered is efficiency. There is no reason that firms from different countries need to pay the same tax rate in a location for investment to be allocated efficiently; the important thing is for a firm to face the same tax rate wherever its location. If firms face the same tax rate in each location and earn the same after-tax return in each location, their pretax return on their marginal investments will be equal. The pretax return measures the true economic productivity of capital.

We are operating in a second-best world because other countries, like ourselves, do not tax currently the returns of their firms in foreign jurisdictions. All marginal investments by foreign firms in tax haven countries, therefore, tend to have lower pretax returns than investments in higher tax rate countries. Regardless of what these other firms do, it is more efficient for our firms to move some investment back to the United States, when tax rates are lower abroad, if they are earning a lower rate of pretax return tax in the tax haven and thus are less productive than an investment in the United States.<sup>35</sup>

I would propose treating a CFC as a passthrough entity with respect to its U.S. shareholders.<sup>36</sup> U.S. shareholders of the CFC would be treated as if they earned a pro rata share of the CFC's gross income and expense and would currently include such income or expense in computing their own U.S. tax liability.<sup>37</sup> Each U.S. shareholder could claim a direct credit for the foreign taxes paid by the CFC during the year to the extent they constitute creditable taxes under section 901 or 903 (subject to the limit in section 904). Under this passthrough regime, a U.S. shareholder of a CFC, including a U.S. multinational corporation, would be allowed to reduce its taxable income by its pro rata share of the CFC's losses.

To determine each U.S. shareholder's pro rata share of the CFC's

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35. See Gravelle, *supra* note 23, at 1168 (responding to arguments made by Peter Merrill & Carol Dunahoo, 'Runaway Plant' Legislation: Rhetoric and Reality, 72 TAX NOTES 221 (1996)).

36. Adopting this proposal for ending deferral for CFCs would probably require renegotiation of the existing U.S. income tax treaties in order to avoid a serious “treaty override” problem. See, e.g., U.S. TREAS. DEP'T, INTERNATIONAL TAX REFORM: AN INTERIM REPORT 50 (1993) [hereinafter U.S. TREAS. DEP'T, INTERIM REP.]. In any event, the United States should seek to develop an international consensus among its major trading partners for repealing tax deferral on the foreign income of CFCs.

37. The current definitions of “U.S. shareholder” in section 951(b) and “controlled foreign corporation” in section 957 would be retained, as would the direct, indirect, and constructive ownership rules of section 958. Some modification of the constructive ownership rules would be desirable. For example, I would expand the family attribution rules to include attribution of stock from siblings.



income, losses, and foreign taxes, passthrough rules similar to those developed under Subchapter K would apply in modified form. Basis adjustments similar to those in section 705 would also apply to prevent double taxation of the CFC's earnings when they are distributed as a dividend, or when the CFC's stock is sold, and any losses flowing through from the CFC to the U.S. shareholder would be limited to the extent of the U.S. shareholder's basis in the CFC's stock, much like the section 704(d) limit on the deduction of partnership losses. Distributions from the CFC would be tax-free to the extent of the U.S. shareholder's basis in the CFC's stock, and any excess would be treated as gain from the sale of the CFC's stock.

This proposal would significantly simplify the Code's international tax provisions. First, the rules in sections 952 through 954, defining the various types of Subpart F income, could be repealed with respect to post-enactment earnings of CFCs because they would be unnecessary in a current inclusion regime encompassing all of the CFC's income. The policy rationales underlying sections 956 and 1248 would also no longer be valid and both of these complicated provisions could be repealed.

Second, the indirect foreign tax credit provisions in sections 902 and 960 could be repealed, at least with respect to post-enactment earnings of foreign corporations. Each U.S. shareholder of the CFC would obtain a direct credit for its pro rata shares of the foreign taxes paid by the CFC. Moreover, to eliminate the indirect credit rules for U.S. shareholders of foreign corporations that are not CFCs, U.S. persons owning at least 10 percent of the voting power of a foreign corporation that is not a CFC would be allowed to elect current inclusion treatment with respect to the foreign corporation and obtain a direct credit for their pro rata share of the foreign taxes paid by the foreign corporation.<sup>38</sup> To prevent a taxpayer from turning this election into a "heads I win, tails you lose" proposition for the Treasury, a U.S. person's election with respect to any particular foreign corporation would be revocable only with the consent of the IRS.

It might be argued that an individual U.S. shareholder of a foreign

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38. Thus, if no election were made, a 10-percent-or-more U.S. shareholder of a foreign corporation, that is not a CFC or PFIC, could continue to defer U.S. tax on the foreign corporation's earnings; however, the price of continued deferral would be no foreign tax credit for any foreign taxes paid by the foreign corporation.

Alternatively, as suggested by David Tillinghast in his response to this paper, if one wanted to expand my anti-deferral proposal, one could apply the CFC definition based on concentrated stock ownership (i.e., more than 50 percent of the voting power or value of the foreign corporation's stock) by U.S. or foreign 10-percent-or-more shareholders and require current inclusion by any 10-percent-or-more U.S. shareholder in such a foreign corporation. See David R. Tillinghast, 51 U. MIAMI L. REV. 1013, 1015 (1997). I view this suggestion as a friendly amendment to my anti-deferral proposal.

corporation should not be allowed to obtain a foreign tax credit for his or her share of the corporation's foreign taxes. By analogy to the rationale for not allowing an individual 10-percent shareholder of a foreign corporation to obtain an indirect foreign tax credit under current section 902, the argument would be that allowing the credit is fundamentally inconsistent with the double-taxation U.S. corporate tax regime and creates a bias in favor of foreign corporate investment over U.S. corporate investment. According to this premise, an individual would be limited to taking a deduction only for foreign taxes passing through from the foreign corporation. This is equivalent to disallowing a U.S. individual an indirect credit under current law because the individual reports his or her net share of the foreign corporation's after-tax foreign earnings when they are distributed.

I, however, would recommend allowing a U.S. individual to obtain a direct credit for his or her share of the foreign corporation's taxes. Under the current tax system, with check-the-box entity classification and limited liability companies, Subchapter S corporations, and the ability of many closely-held corporations to zero out their tax liability through deductible compensation, rent, and royalties paid to shareholders, double taxation of a business entity's income is an aberration, rather than the norm, except in the case of publicly traded entities. Moreover, since U.S. individuals would rarely own 10 percent or more of the stock of publicly traded foreign corporations, it is unlikely that this proposal would create any great disparity in the treatment of domestic and foreign publicly traded entities. In any event, one could argue that a 10-percent equity interest in a foreign corporation is more analogous to a branch, rather than a portfolio investment, even in the case of individual shareholders.

With respect to a U.S. person owning stock in a foreign corporation (no matter how small the ownership interest) that is not a CFC, but that earns primarily passive income, one anti-deferral regime should remain, patterned after the PFIC provisions of current law.<sup>39</sup> However, to simplify the PFIC rules, current inclusion of the PFIC's income should become mandatory.<sup>40</sup> The complex rules relating to the interest charge

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39. Moreover, as suggested by David Tillinghast in his response to this paper, certain revisions in the definition of a PFIC may be necessary and appropriate, for example, to avoid deterring U.S. portfolio investment in foreign start-up situations. *Id.* at 1016.

40. In the case of a foreign corporation that is a PFIC, but not a CFC, any 10-percent-or-more U.S. shareholder would have mandatory current inclusion; thus, the election for 10-percent-or-more U.S. shareholders of a foreign corporation that is not a CFC would not apply. Such 10-percent-or-more U.S. shareholders would be allowed a direct credit for their share of the PFIC's creditable foreign taxes, provided that they had sufficient information to establish the amount and creditability of such foreign taxes.

on excess distributions and the elective mark-to-market regime should be repealed.<sup>41</sup> If the U.S. person owning shares in the PFIC does not have sufficient information to use the current inclusion method, an alternative "deemed rate of return of method" could be used by multiplying the taxpayer's adjusted basis in the PFIC by a rate of return adjusted and published annually by the IRS (e.g., the rate of interest paid by the government on tax refunds plus two or three percentage points).<sup>42</sup> Alternatively, to avoid some of the criticisms advanced by David Tillinghast and others to this "deemed rate of return method," a U.S. person owning shares in a PFIC could be allowed to base the amount of the current inclusion on available financial information of the PFIC, as adjusted to reflect U.S. tax accounting principles for certain "material items" that could be "reasonably identified" by the U.S. person.<sup>43</sup>

As part of this proposal, the foreign personal holding company provisions and foreign investment company provisions would no longer be necessary and would be repealed. Moreover, the personal holding company tax provisions and accumulated earnings tax provisions would be amended to exempt foreign corporations from their reach.

Several problems with this proposal exist, which would require further analysis before this proposal could be enacted. Adopting this proposal would require complicated transition rules, which would necessitate the retention of many of the provisions of current law with respect to pre-enactment foreign corporate earnings. Moreover, as the Subchapter K provisions demonstrate, rules allocating the source and character of the income and expenses of an entity to its owners are complex in operation. Adopting this proposal would, undoubtedly, put great pressure on those allocation rules and raise many new issues concerning their application. Thus, one could argue that by increasing the number of cases in which the application of passthrough rules would be neces-

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For purposes of determining stock ownership in a PFIC under the proposed reformulated PFIC regime, attribution rules similar to those in current section 1297(a) would apply.

41. See Avi-Yonah, *Simplification Potential of Check-the-Box*, *supra* note 13, at 223; see also Michael J. McIntyre, *Collecting Current Tax From U.S.-Resident Individuals and U.S.-Based MNEs on Income Earned Through Foreign Entities*, 11 TAX NOTES INT'L 440, 444-45 (1996) [hereinafter McIntyre, *Collecting Current Tax*].

42. The rate should be set high enough to avoid creating any bias in favor of investment in foreign investment funds over domestic investment funds. McIntyre, *Collecting Current Tax*, *supra* note 41, at 445.

This "deemed rate of return" method could be patterned after a similar method used in New Zealand under its PFIC rules. For a discussion of the PFIC rules in New Zealand and several other countries, see Brian J. Arnold, *The Taxation of Investments in Passive Foreign Investment Funds in Australia, Canada, New Zealand and the United States*, in *ESSAYS ON INTERNATIONAL TAXATION* 5 (Herbert H. Alpert & Kees van Raad eds., 1993).

43. See Shay, *supra* note 14, at 1061.

sary, this proposal adds to the complexity of the U.S. international tax system.

I have two responses to that argument. First, any added complexity from the extension of passthrough rules to all U.S. shareholders of CFCs, and electing 10-percent U.S. shareholders of foreign corporations that are not CFCs, would be offset by the proposal's significant simplification of the international tax system in other respects through elimination of many of the provisions in Subpart F, simplification of the operation of the PFIC regime, elimination of the other anti-deferral regimes aimed at passive income, and elimination of the indirect credit provisions in sections 902 and 960. Second, with the adoption of an elective entity classification system, an extension of the application of the passthrough rules to U.S. persons owning interests in foreign entities is inevitable since more U.S. taxpayers are likely to operate abroad through foreign entities that will be classified as partnerships or unincorporated branches for federal tax purposes. Thus, adoption of the check-the-box entity classification system requires a rethinking and redesign of the Subchapter K rules for allocating the income and expenses (and liabilities) of an organization treated as a partnership for tax purposes among its members. These rules were designed for a different era, not the modern era in which flowthrough treatment through a variety of different types of business organization, including the domestic limited liability company, is widely used for both domestic and foreign activities.

My proposal would not achieve complete neutrality as to choice of entity in the international context. For example, under this proposal, a U.S. person who does not, actually or constructively, own at least 10 percent of the voting power of a foreign corporation would not be able to obtain passthrough treatment with respect to a foreign entity that is a *per se* foreign corporation under the new entity classification regulations. That person would defer any U.S. tax on foreign source income earned through the foreign corporation until the income was distributed as a dividend. This income would be taxed as ordinary income and carry no credit for the foreign taxes paid by the foreign corporation (even in the case of a U.S. corporate shareholder). By contrast, a U.S. person owning less than 10 percent of a foreign entity that is not a *per se* foreign corporation, and which has elected to be treated as a partnership for U.S. tax purposes, would be able to obtain passthrough treatment for the income and expenses of the entity and a direct foreign tax credit for the foreign taxes paid by the entity. Thus, in the case of an under 10-percent shareholder of a foreign entity who does not want deferral, a bias would still exist in favor of using an entity that is not a *per se*

foreign corporation. Of course, that bias exists under the elective deferral regime and indirect foreign tax credit provisions of current law.

Adoption of this proposal would likely generate numerous other potential collateral tax simplification benefits. For example, the adoption of this proposal should significantly reduce the number of outbound transfer pricing disputes and should reduce pressure on the section 367 rules as a backstop in preventing abuse of the deferral principle,<sup>44</sup> thus permitting simplification of those increasingly complex and incoherent rules.

In addition, this anti-deferral proposal opens the door to adopting the worldwide fungibility method of interest allocation for U.S. multinationals and their U.S. and foreign affiliates. Under the simplest approach to this allocation, the interest expense of U.S. and foreign affiliates would be combined. This aggregate amount of interest expense would be allocated to the worldwide income of the entire group, including the foreign affiliates, by reference to the assets of all members of the group. This method is not practical under current law, where deferral is still the general rule, and, hence, where moving interest deductions from a foreign affiliate to a U.S. parent is not feasible. However, this method would be workable in the passthrough regime for taxing CFCs discussed above. This approach to interest allocation would both simplify the tax law and improve economic efficiency by reducing the effect of tax considerations in the financing decisions of U.S. multinational corporations and their affiliates.<sup>45</sup>

## V. REFORMS RELATING TO THE FOREIGN TAX CREDIT PROVISIONS

### A. *Reform the Foreign Tax Credit Limit in Section 904*

Assuming that we do not move to a "pure" territorial system for taxing the foreign source income of U.S. persons, the foreign tax credit will remain a fundamental aspect of the U.S. international tax system.<sup>46</sup> The basic premise of the credit is sound—to prevent double taxation of foreign source income that would serve as a serious disincentive to foreign investment by U.S. persons, the United States grants a dollar-for-dollar credit to U.S. persons for qualifying foreign income taxes paid on

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44. See *id.* at 1061-62.

45. See U.S. TREAS. DEP'T, INTERIM REP., *supra* note 36, at 36-38.

46. Some proponents of the exemption approach argue that adoption of the exemption system would greatly simplify the U.S. international tax provisions because it would lead to repealing the complicated foreign tax credit provisions in the Code. See, e.g., Avi-Yonah, *Proposal for Simplification*, *supra* note 13, at 1354-59; see also HUFBAUER, *supra* note 11, at 136. As discussed earlier in the text, this would probably not hold true if, as is likely, only a modified exemption system were enacted.

foreign source income.<sup>47</sup> Moreover, as discussed above, despite the inconsistency with pure capital export neutrality notions, it makes sense for the United States to impose an overall limit on the credit to prevent foreign taxes in excess of the U.S. rate from reducing the U.S. tax on U.S. source income. It also makes sense for the United States to attempt to further refine the overall limit to prevent the cross-crediting of high foreign taxes on some foreign income against the U.S. tax on other low-taxed foreign income. Unless steps are taken to prevent such cross-crediting, a U.S. taxpayer with high-taxed foreign income has a tax incentive to shift investments to low-tax foreign countries in violation of capital export neutrality. The question is how best to achieve that goal in light of the administrative burdens that a multi-category foreign tax credit limit places on both taxpayers and the government.

One alternative for reform in this area is to adopt a per-country limit, with separate basket limits applied country by country, as was proposed by the Reagan Administration in 1984 and 1985.<sup>48</sup> Most foreign countries with a foreign tax credit limit use a per-country limit, and a per-country limit was used in the United States from 1932 to 1976, either alone or in combination with an overall limit. In 1986, Congress did not enact the Administration's proposal for a per-country foreign tax credit limit, in part, because it viewed the proposal as too complicated.<sup>49</sup> Yet, despite its complexity, a per-country limit with at least a separate passive basket for each country is appealing because it would be more

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47. One radical simplification proposal, consistent with national neutrality, would be to repeal the foreign tax credit and replace it with a deduction for foreign taxes. Such a proposal, if combined with a repeal of deferral for U.S. shareholders of CFCs, would make the source-of-income rules and the rules for allocating and apportioning deductions irrelevant for most U.S. persons, as well as eliminate most outbound transfer pricing issues. However, despite its potential for greatly simplifying the U.S. international tax system, I do not favor this approach because it would seriously discourage foreign investment by U.S. persons and undermine worldwide economic welfare (and, in the long run, undermine U.S. economic welfare as well). Moreover, since the deduction approach to mitigating double taxation is inconsistent with current international norms, the United States' adoption of such an approach would seriously undermine the stability of the international tax regime.

48. See generally 2 U.S. TREAS. DEP'T, *TAX REFORM FOR FAIRNESS, SIMPLICITY, AND ECONOMIC GROWTH* 360-63 (1984); U.S. TREAS. DEP'T, *THE PRESIDENT'S TAX PROPOSALS TO THE CONGRESS FOR FAIRNESS, GROWTH, AND SIMPLICITY* 385-96 (1985).

49. See, e.g., *ALI International Tax Study*, *supra* note 10, at 323-26, 328. Congress also believed that allowing some substantial cross-crediting within the general basket limit was "consistent with the integrated nature of U.S. multinational operations abroad." STAFF OF JOINT COMM. ON TAX'N, 99TH CONG., 1ST SESS., *GENERAL EXPLANATION OF THE TAX REFORM ACT OF 1986*, at 862 (1987). Moreover, Congress' rejection of the Reagan Administration's per-country foreign tax credit limit proposal in 1986 was based in part on its belief that adoption of such a proposal would undermine the "international competitiveness" of U.S. multinational corporations operating abroad. This "international competitiveness" argument against adopting a per-country limit suffers from all of the problems raised earlier in the text concerning such "international competitiveness" arguments generally.

effective in preventing cross-crediting than the basket limits of current law. Accordingly, such an approach merits further study to see whether a workable per-country limit can be formulated. The concerns about complexity may be overstated, particularly in a U.S. tax world where lookthrough rules are common and where the alternative is the complex separate basket limits of current law. Stated differently, how much more complicated is a per-country limit system than the basket limits of current law, particularly if only a passive income basket and a residual income basket are used in each country?<sup>50</sup>

The basket limit approach of current law is, of course, a compromise between an overall limit, which would place no limits on cross-crediting, and a per-item limit, which would place a separate limit on each item of foreign income receiving special tax treatment by a foreign country. If a per-country limit is not feasible, the question becomes whether we can improve on the current law compromise by both simplifying the basket limits and making them more effective in preventing the cross-crediting of high and low foreign taxes in situations where such cross-crediting and its distortive effects on economic behavior are most likely to occur. The following suggestions may help remedy the problem.

First, the passive income basket in section 904(d)(1)(A), which is aimed at preventing cross-crediting with respect to low-taxed and highly mobile income such as interest, dividends, rent, royalties, and other types of portfolio investment income, is an essential component of any foreign tax credit limit based on type of income.<sup>51</sup> One defect in the current passive income basket would be cured by expanding the passive income basket to include all royalties, as proposed by the Clinton Administration in 1993, since royalty income is usually subject to low rates of foreign tax. Under current law, certain related-person royalties and royalties derived in the active conduct of a trade or business are placed in the general income basket, which permits high foreign taxes on other business income to be cross-credited against this low-taxed income, thus often resulting in an effective zero rate of U.S. and foreign tax on such income.<sup>52</sup>

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50. Another alternative would be to separate the overall limit into only two separate baskets—a high-tax basket, which would include all foreign income taxed at a rate in excess of the U.S. rate or some specified percentage of the U.S. rate, and a low-tax basket, which would include all other foreign income. At first, this approach is appealing in terms of its apparent simplicity (only two baskets) and its ability to forestall cross-crediting; however, properly designed high-tax/low-tax baskets would be considerably complex in operation. See, e.g., ALI INTERNATIONAL TAX STUDY, *supra* note 10, at 328-32.

51. See I.R.C. § 904(d)(1)(A) (1996).

52. See Michael J. McIntyre, *Separate Basket Limitations in Theory and in Practice*, 70 TAX NOTES 1393, 1398 (1996) [hereinafter McIntyre, *Separate Basket Limitations*]; see also Julie

Another defect in the passive income basket is the special exception for export financing interest. This exception is another export incentive in the Code that complicates the foreign tax credit limit, undermines the fairness of the tax system, and most likely, has little effect on stimulating exports. Consequently, this special exception should be repealed and all export financing interest should be placed in the passive income basket.

Substantial simplification of the passive income basket would be achieved by eliminating the high-tax kickout.<sup>53</sup> The high-tax kickout removes from the passive basket foreign source passive income on which the effective foreign tax rate exceeds the top U.S. statutory rate and places such income in the general income basket. It has a worthy purpose; it eliminates any incentive for a U.S. taxpayer with high-taxed passive income to shift other passive investments to low-tax foreign countries for cross-crediting purposes. However, U.S. persons will rarely have high-taxed passive income since such income is usually taxed, if at all, at rates below the highest U.S. rate. The question is whether the relatively few situations in which the opportunities for cross-crediting in the passive income category will arise are sufficient to justify the administrative burden placed on taxpayers and the government by retention of this rule. Since the answer is probably negative, the high-tax kickout should be repealed as a simplification measure.<sup>54</sup>

The high withholding tax interest basket creates a separate basket limit for interest income subject to a foreign withholding tax or other gross basis tax of at least five percent.<sup>55</sup> This basket limit is aimed at removing a perceived incentive for certain U.S. creditors to make loans to foreign borrowers in countries which impose high withholding taxes on interest (rather than to U.S. borrowers), pass the high withholding tax on to the foreign borrower in the form of a higher interest rate, and credit the high withholding tax against other low-taxed income in the passive income basket.<sup>56</sup> The primary targets of this limit appear to be certain U.S. financial institutions; yet, the limit applies to all U.S. taxpayers with high withholding tax interest. It is unclear whether the cross-crediting problem to be solved with this basket limit is serious

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Roin, *Rethinking Tax Treaties in a Strategic World with Disparate Tax Systems*, 81 VA. L. REV. 1753, 1774-75 (1995).

53. See I.R.C. § 904(d)(2)(A)(iii)(III), 904(d)(2)(F) (1996).

54. See, e.g., David R. Tillinghast, *International Tax Simplification*, 8 AM. J. TAX POL'Y 187, 219-21 (1990) (suggesting that any problem areas involving related parties and back-to-back loans that seek to manipulate the interest allocation rules could be handled by authorizing the Treasury Department to create an anti-abuse rule in the regulations).

55. See I.R.C. § 904(d)(1)(B), 904(d)(2)(B) (1996).

56. See STAFF OF JOINT COMM. ON TAX'N, 100TH CONG., 1ST SESS., GENERAL EXPLANATION OF THE TAX REFORM ACT OF 1986, at 864-65 (1987).



enough to warrant the complexities caused by creating a special limit for such interest income. A more sensible approach might be to eliminate this special basket limit and include this interest income in the passive income basket for taxpayers that are not financial institutions, and in the financial services basket for taxpayers that are financial institutions.<sup>57</sup> On the other hand, in the unlikely event that the cross-crediting abuses involving high withholding tax interest are sufficiently serious to warrant a special basket limit, that basket limit should be applied only to taxpayers that are financial institutions.<sup>58</sup>

The separate limits for financial services income and shipping income are aimed at preventing low-taxed, active foreign business income from being combined with other types of high-taxed, foreign income in the general income basket. Since the income in these two baskets is rarely subject to foreign taxes in excess of the U.S. rate, one simplification option would be to eliminate these separate basket limits and place financial services income and shipping income in the passive basket.<sup>59</sup> However, retention of the shipping income basket might be necessary because a U.S. taxpayer could have high-taxed income from shipping operations in some countries or might have losses from such operations in the early years that should not be grouped with other low-taxed income in the passive income basket.<sup>60</sup>

If the proposal to repeal the FSC provisions discussed below were enacted, we would no longer need the separate basket limits in sections 904(d)(1)(F) through (H), at least at some time in the future. In any event, because these separate limits are aimed at preventing cross-crediting with respect to low-taxed foreign income, they could be combined with the passive income basket and achieve substantially the same purpose with less complexity.<sup>61</sup>

Adoption of my proposal to allow 10-percent-or-more U.S. shareholders to elect lookthrough treatment with respect to a non-controlled foreign corporation would permit repeal of the section 904(d)(1)(E) basket for dividends from each non-controlled section 902 corporation because that proposal would repeal the indirect credit in section 902 (at least for future years). Even if this anti-deferral proposal were not adopted, section 904(d)(1)(E) should be repealed and lookthrough rules

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57. See Tillinghast, *supra* note 54, at 229-30.

58. See U.S. TREAS. DEP'T, INTERIM REP., *supra* note 36, at 22.

59. See *id.* at 21. If the separate financial services income basket is retained, the exception for export financing interest should be repealed. Such interest should receive the same treatment as the financial service entity's other financial services income.

60. See Tillinghast, *supra* note 54, at 231.

61. See U.S. TREAS. DEP'T, INTERIM REP., *supra* note 36, at 21; see also Tillinghast, *supra* note 54, at 230-31.

similar to those in section 904(d)(3) should be applied to dividends from non-controlled foreign corporations.

Congress and the Treasury are properly concerned that oil-producing countries have an incentive to take advantage of the U.S. foreign credit system by imposing high foreign taxes on such income that are actually disguised royalties for the U.S. taxpayer's exploitation of the countries' natural resources. Although the dual-capacity regulations attempt to prevent these abuses of the foreign tax credit regime, they do not completely solve the problem. Thus, it is probably necessary to retain a special limit on the foreign taxes attributable to foreign oil and gas income, as defined in section 907;<sup>62</sup> but, for conceptual consistency, that limit should be converted into a separate basket limit in section 904(d), as proposed by the Clinton Administration in 1996 and 1997.

The remaining and most important issue is what to do about the general income basket. On one hand, proponents of capital import neutrality argue that U.S. taxpayers should be allowed to cross-credit high and low foreign taxes in the general basket because their foreign competitors from countries using a foreign tax credit system are allowed to cross-credit high and low taxes on foreign business income and those from countries with an exemption system are effectively allowed to do so. On the other hand, allowing cross-crediting in the general income basket encourages U.S. taxpayers with high-taxed foreign business income to shift other business operations to low-tax foreign countries. Consequently, this takes the pressure off high-tax foreign countries to reduce their tax rates to avoid discouraging U.S. investment. In effect, by allowing cross-crediting within the general income basket, the United States is subsidizing those foreign countries with tax rates on the business income of U.S. taxpayers in excess of the U.S. rate. Thus, these opportunities for cross-crediting in the general income basket move the U.S. international tax system away from the capital export neutrality principle and undermine the U.S. residence-based taxing jurisdiction. Adoption of my anti-deferral proposal would provide more opportunities for cross-crediting and more pressure would be placed on the general income basket. In fact, this proposal for repealing deferral will not have much effect in reinforcing the residence-based taxation of U.S. persons' foreign business income, unless steps are also taken to restrict the cross-crediting opportunities in the general income basket.<sup>63</sup>

As suggested by Professor Michael McIntyre, one possible way to

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62. See I.R.C. § 907 (1996).

63. Cf. Kingson, *The Foreign Tax Credit*, *supra* note 5, at 19 ("Repealing deferral might have real bite if the general limitation category did not treat high- and low-taxed business income as fungible.").

improve the capital export neutrality of the general income basket would be to divide the basket into a high-tax country general basket and a low-tax country general basket.<sup>64</sup> The high-tax country basket would include only the foreign source income in the general basket limit that is attributable to countries with which the United States has a modern tax treaty and that have tax rates comparable to, or higher than, the U.S. rates.<sup>65</sup> The low-tax country basket would include all other foreign source income in the general income basket.<sup>66</sup> Although this proposal would add complexity to the operation of the general income basket, unlike a high-tax/low-tax limit system, it would not require a U.S. taxpayer to determine effective foreign tax rates on its foreign source income.<sup>67</sup> It would substantially reduce the cross-crediting opportunities in the general income basket and, therefore, is an appealing device for fortifying the integrity of the foreign tax credit limit at an acceptable cost in terms of added complexity.

### B. *Recapture Treatment for Overall U.S. Losses*

Section 904(f) provides for the recapture of an "overall foreign loss" where a U.S. person sustains an overall foreign loss in one tax year which offsets U.S. source income in that year.<sup>68</sup> That provision requires that the U.S. person's foreign source income in later years be recharacterized as U.S. source income to the extent of the overall foreign loss.<sup>69</sup> Under current law, there is no similar recharacterization treatment for an overall U.S. loss that offsets foreign source income and reduces the taxpayer's foreign tax credit limit. U.S. source income in later years is not recharacterized as foreign source income to the extent of the overall U.S. loss.<sup>70</sup> This lack of parallel treatment for overall U.S. and foreign losses is inequitable and may result in excessive residual U.S. taxation of foreign source income.<sup>71</sup> The statute should be amended to provide that, to the extent an overall U.S. loss offsets foreign source income and reduces a taxpayer's foreign tax credit limit in a year,

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64. See McIntyre, *Separate Basket Limitations*, *supra* note 52, at 1398.

65. See *id.* The United States could refine the process further by requiring that the income be subject to some tax in the foreign treaty country to be includible in the high-tax country general basket. This would exclude from the high-tax country general basket foreign source business income that is not taxed at all by the source country because the U.S. taxpayer does not have a permanent establishment or fixed base to which the income is attributable.

66. See *id.*

67. See *id.*

68. See I.R.C. § 904(f) (1996).

69. See I.R.C. § 904(f)(1) (1996).

70. See U.S. TREAS. DEP'T, INTERIM REP., *supra* note 36, at 27.

71. *Id.* This report also suggests several alternative approaches that might simplify the treatment of losses for foreign tax credit purposes. *Id.* See also ALI INTERNATIONAL TAX STUDY, *supra* note 10, at 367-74.

U.S. source income in later years will be resourced as foreign source income for purposes of the foreign tax credit limit.

### C. *Adopt De Minimis Rule*

Regardless of the approach used in formulating the foreign tax credit limit for U.S. taxpayers with large dollar amounts of foreign tax credits (i.e., separate basket limits, a per-country limit, or a high-tax/low-tax limit), the complications of that formulation should not apply to taxpayers with relatively small dollar amounts of foreign tax credits. When applied to such taxpayers, the amount of revenue that is obtained from a full-scale application of the separate foreign tax credit limits is greatly outweighed by the compliance burden such limits place on taxpayers and the government. Accordingly, it would be desirable to enact a simplified, overall limit on the foreign tax credit that would apply to taxpayers whose creditable foreign taxes for a taxable year do not exceed a specified amount (e.g., \$10,000).<sup>72</sup> As suggested by David Tillinghast, this simplified limit should be mandatory, not elective.<sup>73</sup> Elections may require alternate computations which undercut the simplicity gains from adoption of the de minimis rule and increase the revenue loss from the rule due to self-selection problems.<sup>74</sup>

### D. *Repeal Special 90-Percent Cap on the Foreign Tax Credit for Alternative Minimum Tax Purposes*

The existence of an alternative minimum tax system, in effect an alternative tax system with different rules and tax rates than our regular income tax system, is an embarrassing admission of the failure of our legislative process to produce a fair and economically efficient income tax system. Hopefully, repeal of the alternative minimum tax system would be possible as part of a major tax reform effort. This effort would broaden the base by directly eliminating and reducing tax preferences, and thereby undercut the theoretical justifications for the minimum tax system. Whether or not the entire alternative minimum tax system is repealed, section 59(a)(2), which contains the special 90-percent cap on the foreign tax credit for alternative minimum tax purposes, should be repealed. The limit is arbitrary (what is the basis for a ninety percent limit?), has little or no policy justification, adds complexity to foreign tax credit planning and compliance, and is inconsistent with the capital export neutrality standard which underlies the foreign tax credit. The

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72. See, e.g., Tillinghast, *supra* note 54, at 233-34.

73. See *id.* at 234.

74. *Id.*

foreign tax credit provisions should be simplified by eliminating this provision.

## VI. THE TRANSFER PRICING PROBLEM

Resolving the intercompany transfer pricing dilemma is an important issue related to many of the other issues discussed in this paper.<sup>75</sup> For many years, experts in the United States and throughout the world have been vigorously debating the proper conceptual approach to resolving this issue—broadly speaking, the arm's length pricing standard, or a formulary apportionment method. That debate will likely continue for some time into the future. Although a detailed discussion of transfer pricing issues is beyond the scope of this paper, I provide the following limited comments on the transfer pricing problem.

### A. *Move Toward Apportionment Methodology*

Based on my own professional experiences and my study of the fine work of Professors Reuven Avi-Yonah, Jerome Hellerstein, Stanley Langbein, and numerous other knowledgeable commentators,<sup>76</sup> I am persuaded that, in many situations, the arm's length standard does not work well either in theory or in practice.<sup>77</sup> Accordingly, the greater use of apportionment methodology by the United States and its trading partners is likely to be a major component of the long-term answer to the international transfer pricing dilemma.<sup>78</sup> I recognize, however, that the

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75. One leading commentator has stated that "intercompany trade accounted for nearly a third of world manufacturing trade and a quarter of world trade in the 1980's." Reuven S. Avi-Yonah, *The Rise and Fall of Arm's Length: A Study in the Evolution of U.S. International Taxation*, 15 VA. TAX REV. 89, 152 (1995) [hereinafter Avi-Yonah, *The Rise and Fall of Arm's Length*]. Another article recently stated that almost one-half of all transnational business and investment activity in the developed countries of the world involves transactions between related parties. Ernst & Young, LLP, *Ernst & Young 1995 Transfer Pricing Documentation Survey*, 72 TAX NOTES 1025, 1025 (1996).

76. See, e.g., Avi-Yonah, *The Rise and Fall of Arm's Length*, *supra* note 75; see also Jerome R. Hellerstein, *Federal Income Taxation of Multinationals: Replacement of Separate Accounting With Formulary Apportionment*, 60 TAX NOTES 1131 (1993); Louis M. Kauder, *Intercompany Pricing and Section 482: A Proposal to Shift From Uncontrolled Comparables to Formulary Apportionment Now*, 58 TAX NOTES 485 (1993); Stanley I. Langbein, *The Unitary Method and the Myth of Arm's Length*, 30 TAX NOTES 625 (1986); Stanley I. Langbein, *A Modified Fractional Apportionment Proposal for Tax Transfer Pricing*, 54 TAX NOTES 719 (1992).

77. The traditional arm's length standard does not work because it ignores the economic reality of the interdependence and integration of the business operations of multinational enterprises and because, in many transfer pricing situations, there are no comparable uncontrolled transactions on which to base a theoretically correct arm's length price. The decline in the viability of the traditional arm's length standard is likely to intensify in the future as a greater proportion of global trade involves high technology goods for which no market analogues exist. See Avi-Yonah, *The Rise and Fall of Arm's Length*, *supra* note 75, at 152.

78. In a U.S. international tax system of the type that I favor, based on capital export neutrality, and which uses a foreign tax credit as the primary device for mitigating international

U.S. tax authorities have invested significant resources in successfully developing an international consensus in favor of establishing the arm's length standard as the international norm for transfer pricing. Therefore, they are not likely to explicitly abandon that standard anytime soon. They sincerely believe that the arm's length standard, at least in a broad sense, is theoretically correct and are justifiably concerned that such abandonment would undermine the United States' credibility in the international tax community. Instead, the movement of the United States toward greater use of formulary apportionment is an evolutionary process. It is a process evidenced by the gradual weakening of the traditional arm's length standard in the regulations, which rely much less on comparables and focus more on achieving arm's length results, and which adopt profit split methodology where functions are highly interrelated and cannot readily be evaluated on a separate basis.<sup>79</sup> The IRS's use of global apportionment in the context of Advance Pricing Agreements involving global trading of commodities and derivative financial products also evidences this process.<sup>80</sup>

For formulary apportionment to become a realistic alternative to the arm's length standard, much work has to be done on a multilateral basis. The United States and its major trading partners must agree on the appropriateness of formulary apportionment and on design issues relating to the formulary method, including, most importantly, when the method would apply and what elements would be used in the formulae for different types of businesses.<sup>81</sup> Unless we achieve international consensus, adoption of formulary apportionment on a unilateral basis by the United States would undermine our tax treaty program and distort the worldwide allocation of investment capital by overtaxing some taxpayers and undertaxing others. Consensus on these issues is unlikely to occur anytime soon, even if the United States develops its own proposal for formulary apportionment.<sup>82</sup> Consequently, the United States and its

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double taxation, one could make greater use of apportionment methodology for determining the source of income from U.S. multinationals' international transactions for foreign tax credit and anti-deferral purposes. This would substantially reduce the role of the separate transaction, arm's length approach to transfer pricing and the complex source-of-income and allocation-and-apportionment-of-deduction rules of current law. See generally Asim Bhansali, Note, *supra* note 14.

79. See generally Avi-Yonah, *The Rise and Fall of Arm's Length*, *supra* note 75, at 140-47.

80. See I.R.S. Notice 94-40, 1994-1 C.B. 351, 352.

81. See generally U.S. GEN. ACCOUNTING OFFICE, INTERNATIONAL TAXATION: PROBLEMS PERSIST IN DETERMINING TAX EFFECTS OF INTERCOMPANY PRICES 724 (1992); Joann M. Weiner, *Using the Experience in the U.S. States to Evaluate Issues in Implementing Formula Apportionment at the International Level*, 13 TAX NOTES INT'L 2113 (1996).

82. Moreover, as a practical matter, much more analysis of the likely effect of adoption of formulary apportionment on U.S. tax revenues and on the costs of administration and compliance for taxpayers and the government would be necessary before the United States would likely

trading partners have little choice but to continue taking steps to make the modified arm's length standard more workable in practice.

### B. *Self-Assessment in the Transfer Pricing System*

Historically, the government's enforcement of the arm's length method has not eliminated the opportunities for transfer pricing abuse. It has only led to time-consuming and costly audits and litigation disputes that have placed a major strain on the tax system. In an era of declining resources for the IRS, it will not be possible for the government to expand its traditional methods of dispute resolution in the transfer pricing area (i.e., audits and litigation) to the level that would be necessary to significantly improve enforcement of the arm's length standard through traditional techniques. Accordingly, during recent years, the United States has increasingly moved in the transfer pricing area toward what amounts to a self-assessment transfer pricing system, in the form of more extensive documentation requirements and stringent penalties under section 6662(e).<sup>83</sup> This is a necessary development if the current transfer pricing rules are going to be more successful in preventing international tax avoidance and preserving the U.S. tax base for both outbound and inbound international transactions. However, unless some international consensus on these documentation requirements is reached, multinational enterprises are justifiably concerned that they will face the burden of complying with a different set of documentation requirements in each country in which they do business. Accordingly, the United States must work through the OECD to develop an international consensus on the use and nature of such documentation requirements.<sup>84</sup>

In addition, one of the most promising developments in recent years in the U.S. tax system has been the increasing use of non-litigation, alternative dispute resolution techniques, particularly in the transfer pricing area. The much heralded Advance Pricing Agreement ("APA") is an important device for resolving transfer pricing questions in advance of litigation. This technique should be expanded to the extent that declining IRS resources permit. Greater use of multilateral APAs should increase the level of international tax compliance and help eliminate international double taxation.<sup>85</sup> However, the APA process is a

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undertake any serious work toward developing an international consensus in favor of greater use of formulary apportionment.

83. See I.R.C. § 6662(e) (1996).

84. See, e.g., Joseph H. Guttentag, Remarks at George Washington University/IRS Annual Institute on International Taxation (Dec. 12, 1996), in *TAX ANALYSTS' DAILY TAX HIGHLIGHTS & DOCUMENTS*, Dec. 16, 1996 at 2828.

85. John Lyons, the U.S. competent authority, has stated that about 80 percent of all APA agreements in the U.S. inventory are multilateral APAs. See *id.* at 2830.

time and resource consuming process. It is important that the results of that process be better utilized to provide guidance to the large number of taxpayers who are unable to afford an APA. Accordingly, the IRS should abandon its position that APAs are exempt from Freedom of Information Act disclosure and should begin publishing APAs in redacted form with all taxpayer-identifying and proprietary information deleted.<sup>86</sup>

### C. *Effect of Repealing Deferral and Reforming Foreign Tax Credit Limit*

Making the current transfer pricing rules more workable depends, in part, on the status of reforms in other areas of the U.S. international tax system. Enacting my proposals outlined above for repealing deferral for U.S. shareholders of CFCs and reform of the foreign tax credit limit would, probably substantially, reduce the number of outbound transfer pricing controversies arising under section 482. Since a CFC's income would be currently taxed to its U.S. parent corporation, there would be much less incentive for the U.S. parent to engage in abusive transfer pricing practices. This is particularly true if, under a tightened general income basket limit, the U.S. parent would have reduced cross-crediting opportunities with respect to high-taxed and low-taxed foreign business income.

## VII. REPEAL EXPORT INCENTIVES IN THE CODE

### A. *Repeal FSC Provisions*

The FSC provisions are export subsidies that are administered through the tax system.<sup>87</sup> These provisions violate horizontal and vertical equity by reducing or eliminating the U.S. tax on a particular type of economic income and thereby interfere with an appropriate allocation of the tax burden based on the taxpayers' relative abilities to pay taxes. These provisions distort the economic behavior of U.S. taxpayers in violation of capital export neutrality because they serve as a disincentive for foreign production in situations where non-tax considerations would dic-

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86. The IRS's refusal to publish the APAs after they have been issued has led some commentators to describe the APA process as "[t]axation by secret negotiation and agreement," which is inconsistent with democratic ideals and undercuts the appearance of integrity and evenhandedness that is essential to a tax system that relies heavily on self-assessment. See Dale W. Wickham & Charles J. Kerester, *New Directions Needed for Solution of the International Transfer Pricing Tax Puzzle: Internationally Agreed Rules or Tax Warfare?*, 56 TAX NOTES 339, 354 (1992).

87. For example, Gary Hufbauer has estimated that "the FSC export incentive may have boosted the value of US exports by between \$4.4 billion and \$6.6 billion in 1990." HUFBAUER, *supra* note 11, at 126.



tate a foreign location for such production. They also add tremendous complexity to the tax system by adding a number of complicated Code sections and many pages of regulations with detailed requirements for implementing this tax subsidy. Moreover, because they represent an export subsidy that attempts to distort international trade flows, the FSC provisions violate the spirit (although arguably not the letter) of our obligations under the General Agreement on Tariffs and Trade.

Furthermore, the provisions are an ineffective trade subsidy that arguably have, at best, a minimal effect on improving U.S. trade balances. In a world of floating exchange rates, any stimulation in exports resulting from the FSC provisions is offset over time by a stimulation of imports caused by adjustments in the exchange rate for the U.S. dollar which make imported goods cheaper for U.S. customers to purchase.<sup>88</sup> Therefore, these provisions do not effectively achieve the purposes for which they were established. Any serious effort at international tax reform should include repeal of this wasteful tax subsidy.<sup>89</sup>

Another collateral benefit of repealing these provisions is that it would send a message that Congress is serious about reducing the role of the tax system in channelling economic behavior into favored types of economic endeavors. By contrast, retention of these provisions, in response to special pleading by U.S. exporters, would make it difficult for Congress to eliminate tax subsidies that favor other industries, such as the various tax incentive provisions in the natural resource area. This would make a serious base broadening effort in other areas of the Code more difficult.

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88. See, e.g., McIntyre, *Collecting Current Tax*, *supra* note 41, at 445; see also Shay, *supra* note 14, at 1061.

89. One argument advanced in favor of the FSC provisions, and the predecessor DISC provisions, is that U.S. exporters are disadvantaged relative to U.S. taxpayers that can locate their production facilities abroad in low-tax foreign jurisdictions and obtain the benefits of deferral; thus, a bias in the tax system exists in favor of moving production facilities abroad. The FSC and DISC provisions are intended in part to offset this bias. Thus, if, as proposed in this paper, deferral is completely repealed for U.S. shareholders of CFCs, the FSC provisions would no longer be needed as a counterweight to deferral and could be repealed. Shay, *supra* note 14, at 1061.

Critics of immediate repeal of the FSC provisions argue that unilateral repeal of the FSC provisions by the United States, while other exporting countries continue to provide tax-favored treatment of export income, would amount to self-destructive unilateral trade disarmament. For example, Gary Hufbauer proposes that U.S. repeal of the FSC provisions be implemented on a selective basis as the United States reaches bilateral or multilateral agreement on harmonized treatment of export earnings. HUFBAUER, *supra* note 11, at 147. However, the validity of this argument depends on the effectiveness of the FSC provisions in increasing U.S. exports, a matter on which there is a wide divergence of opinion.

### B. *Modify Inventory Sales Source Rule*

One of the important international tax reforms effected by the Tax Reform Act of 1986 was the adoption of section 865, which sources gain from the sale of personal property to the residence of the seller, subject to a number of exceptions. A major exception was made, however, for sales of inventory property by U.S. exporters, for which the title-passage rule was retained. Congress retained the title-passage rule, in large part, as a tax subsidy for such exporters. In the case of an exporter who manufactures the property in the United States and sells the property to a foreign customer, regulations issued in 1996 arbitrarily allocate 50 percent of the gain from the sale of the manufactured property to the sales function. If title to the property is passed to the foreign customer abroad, that fifty percent sales portion of the income will be treated as foreign source income.<sup>90</sup> The exporter may elect to use an independent factory or production price to determine the amount of sales income if such a price is available.<sup>91</sup>

This foreign source sales income is unlikely to bear any foreign income tax; therefore, the result of the title-passage source rule is to create untaxed, foreign source, general limit income that can absorb high foreign taxes imposed on the U.S. exporter's other foreign source, general limit income. These rules undercut the proper functioning of the foreign tax credit limit and allow a taxpayer to use cross-crediting to reduce its U.S. tax liability. These rules distort economic behavior by favoring export sales over domestic sales. They use a test for determining the source of the export sales income (title passage), which has little or no nexus to the economic activities giving rise to the income.

Congress should repeal the title-passage rule for gain from inventory sales in sections 865(b), 861(a)(6), and 862(a)(6), and treat gain from inventory sales of U.S. sellers as U.S. source income under the residence-of-the-seller source rule in section 865(a). An exception to the residence-of-the-seller rule should be made in the case of a U.S. seller that has an office or fixed place of business in a foreign country to which the inventory sale is attributable (i.e., the foreign office materially participated in the sale). In this case, the sales portion of the income should be foreign source income. This exception should not apply if the property is sold for use, disposition, or consumption in the United States, in which case the gain from the inventory sale should be entirely U.S. source income. Moreover, any income from an inventory sale to an affiliate of the U.S. exporter should be treated as U.S. source income

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90. See Treas. Reg. § 1.863-3(b)(1) (1996).

91. See Treas. Reg. § 1.863-3(b)(2) (1996).

under the residence-of-the-seller rule. In the case of an exporter who manufactures and sells the inventory, the income from the sale should be allocated between the production and sales functions based on a formula that more accurately reflects the production portion of the income, unless the taxpayer properly establishes an independent factory or production price and elects to use that method. In the usual case, the 50/50 formula in the current regulations probably overallocates income to the sale function.

### VIII. REPEAL FOREIGN EARNED INCOME EXCLUSION

Section 911 is an example of a tax preference provision in the U.S. international tax system that distorts economic behavior in violation of capital export neutrality, undermines the fairness of the tax system, and adds considerable complexity to the system.<sup>92</sup> It should be repealed.

A more appropriate way to tax U.S. citizens and resident aliens living and working abroad is to include all of their income in the U.S. tax base, but allow a foreign tax credit for foreign income taxes paid on their foreign source income. That division of the tax base fairly recognizes the primary right of the foreign country where a U.S. citizen or resident alien resides to impose a tax on that taxpayer's income from sources within that country, but also preserves the United States' residual right to tax its U.S. citizens and resident aliens.

There are three basic arguments in favor of repeal of section 911. First, the provision distorts economic and social behavior by encouraging U.S. citizen and resident alien employees to choose their place of residence and work based upon tax considerations. It distorts international labor flows by encouraging mobile U.S. workers to relocate to low-tax foreign jurisdictions and reduce their worldwide income tax burden. It also distorts the location of U.S. business operations abroad because, to the extent that the exemption allows U.S. employers to reduce salaries of U.S. workers living abroad, it subsidizes the U.S. employer, rather than the employee (who obtains the same amount of after-tax salary income). This causes a diversion of business operations by U.S. employers to the low-tax foreign jurisdictions in violation of capital export neutrality.

Second, using ability-to-pay principles, the provision violates tradi-

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92. See generally GUSTAFSON, PERONI & PUGH, *supra* note 4, at 308-09; 1 Joel D. Kuntz & Robert J. Peroni, *U.S. International Taxation* ¶ B1.04[1] (1992); Charles I. Kingson, *A Somewhat Different View*, 34 *TAX LAW.* 737 (1981); Philip F. Postlewaite & Gregory E. Stern, *Innocents Abroad? The 1978 Foreign Earned Income Act and the Case for its Repeal*, 65 *V.A. L. REV.* 1093 (1979); Renee Judith Sobel, *United States Taxation of its Citizens Abroad: Incentive or Equity*, 38 *VAND. L. REV.* 101 (1985). But see John D. Maiers, *The Foreign Earned Income Exclusion: Reinventing the Wheel*, 34 *TAX LAW.* 691 (1981).

tional horizontal and vertical equity principles by providing a lower tax burden for those U.S. individuals living and working abroad than for U.S. individuals with the same amount of compensation income who live and work in the United States. Alternatively, using benefits principles of taxation, the provision violates fairness by allowing U.S. citizens and permanent resident aliens to retain the benefits of their citizenship or resident alien status without paying their fair share of the costs of providing those benefits. The underlying assumption of this argument is that U.S. citizenship or resident alien status confers substantial benefits on the citizen or resident alien wherever they live. They receive the collective benefits accorded from U.S. government expenditures for national defense, foreign affairs and foreign aid, and general government expenditures. Another significant value of U.S. citizenship is the ability to return to the United States without limitation and enjoy the legal, economic, and social institutions of this country. Exemption of U.S. citizens' and resident aliens' foreign source income from U.S. tax allows them to be "free riders" with respect to these benefits provided by the U.S. government.<sup>93</sup>

Finally, section 911 adds complexity to the tax system. To take advantage of the provision, a taxpayer must meet a series of fact-oriented tests to establish his or her status as a "qualified individual:" determine the amount of earned income from foreign sources; apply the \$70,000-per-year limit (prorated for the number of qualifying days during the year); determine the amount of housing cost; avoid various other restrictions on the exclusion; and properly make the exclusion elections.

Since most countries do not impose tax on the foreign source income of their nonresident citizens, it could be argued that the United States should not assert residence-based taxing jurisdiction over the foreign source income of U.S. citizens and resident aliens who are living and working abroad. This argument rests on the notion that the political allegiance to the United States that citizenship or legal immigration status confers is not a sufficiently strong nexus to justify the imposition of a U.S. income tax (without actual U.S. residence). This argument further assumes that nonresident U.S. citizens or legal aliens receive sufficiently fewer U.S. government benefits than those received by resident U.S. citizens and legal aliens to justify an exemption from U.S. tax on their foreign source income. However, that argument supports a complete U.S. tax exemption for all foreign source income realized by U.S. citizens and resident aliens living abroad, not a limited exemption for foreign earned income, plus certain housing costs. Accordingly, under

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93. See, e.g., Pamela B. Glan, *The Concept of an Independent Treaty Foreign Tax Credit*, 38 TAX L. REV. 1, 62-66 (1982).

this view, section 911 does not go far enough and should be replaced with a provision exempting the foreign source income of U.S. citizens and resident aliens living abroad. An expanded section 911 exclusion, however, would be difficult to administer and would require a careful formulation of the tests for "qualified individual" status to prevent abuse of the exclusion.

#### IX. REEVALUATE THE USE OF TAX PROVISIONS AS A PENALTY MECHANISM

A number of international tax provisions were enacted to penalize certain behavior viewed by Congress as inconsistent with various foreign policy or international trade policy objectives (e.g., the anti-boycott provisions in sections 908 and 952(a)(3)). Like their statutory siblings, the tax expenditure provisions, these provisions complicate the tax system and place the wrong governmental agency, the IRS, in charge of administering the penalty regime.<sup>94</sup> Although I generally favor direct sanctions, rather than tax penalty provisions, as the means for implementing the international trade or foreign policy goals of the United States, I do not propose repealing all of these provisions. Instead, in connection with reform of the international tax rules, a careful study of these provisions is warranted. Such provisions should be retained on a provision-by-provision basis only if the advantages of using a tax penalty provision over direct sanctions is clearly demonstrated. That is, in my view, the presumption should be against using tax penalty provisions as a means of achieving non-tax foreign policy or trade policy objectives.

#### X. CONCLUSION

As we approach the twenty-first century, it is time to get serious about income tax reform and simplification. Before abandoning an income tax system that is the envy of the world, we should try to reform that system into a more broad-based system with lower, overall rates. Let's start this reform effort with the U.S. international tax rules and seek to build a U.S. international tax system that more fully reflects capital export neutrality principles and a residence-based system of taxing the international income of U.S. persons. Specifically, we should repeal deferral for U.S. shareholders of CFCs and consolidate the other anti-deferral regimes into a revised PFIC regime; reform and simplify the foreign tax credit provisions; repeal the FSC provisions and the title-

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94. For a policy critique of tax penalty provisions generally, see Eric M. Zolt, *Deterrence Via Taxation: A Critical Analysis of Tax Penalty Provisions*, 37 UCLA L. REV. 343 (1989).

passage rule for export sales; and repeal the foreign earned income exclusion. In other words, let's return to the progressive agenda of earlier international tax reform efforts, including the tax reform movements that resulted in the enactment of the Revenue Act of 1962 and the Tax Reform Act of 1986, which were aimed at improving the equity and efficiency of the U.S. international income tax rules.