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THE PROPER APPROACH FOR TAXING THE INCOME OF FOREIGN CONTROLLED CORPORATIONS

*Robert J. Peroni**

Professor H. David Rosenbloom has written a provocative and thoughtful paper on international tax reform,[1] which proposes a limited exemption system for foreign business profits attributable to permanent establishments in certain specific foreign countries having comprehensive rules of income taxation (hereinafter referred to as "listed foreign countries"). His exemption proposal, if adopted in its purest form, would alter substantially our current international tax rules by eliminating the foreign tax credit provisions as well as the anti-deferral regimes of current law. His proposal would exempt from U.S. income tax a U.S. person's business profits attributable to permanent establishments in listed foreign countries. He would end deferral completely for the income earned by certain U.S. shareholders through controlled foreign corporations by disregarding the foreign corporation for tax purposes. Such income would be exempt from U.S. income tax if in the nature of business profits attributable to permanent establishments in listed foreign countries. All other foreign source income, including foreign business profits not eligible for the exemption system, as well as all foreign source passive income, would be

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* Robert Kramer Research Professor of Law, The George Washington University Law School. Copyright © 2001 by Robert J. Peroni. All rights reserved. The author thanks J. Clifton Fleming, Jr. and Stephen Shay, for the many discussions that we have had on various aspects of anti-deferral reform and other international tax policy issues in preparing our jointly-authored works on anti-deferral reform. This response to David Rosenbloom's paper draws in part from the ideas presented in those works (cited in footnote 3 below), in my earlier article published in the Miami Law Review (also cited in footnote 3 below), and in a response that I prepared, Robert J. Peroni, *Deferral of U.S. Tax on International Income: End It, Don't Mend It—Why Should We Be Stuck in the Middle With Subpart F*, 79 TEX. L. REV. 1609 (2001), to a paper authored by Keith Engel, *Tax Neutrality to the Left, International Competitiveness to the Right, Stuck in the Middle With Subpart F*, 79 TEX. L. REV. 1658 (2001), and was discussed at a University of Texas Law School Roundtable on November 3, 2000.

1. H. David Rosenbloom, *From the Bottom Up: Taxing the Income of Foreign Controlled Corporations*, 26 BROOK. J. INT'L L. 1525 (2001) [hereinafter Rosenbloom Paper].

taxable currently to U.S. persons if such income were earned directly, through a partnership, limited liability company, or other entity that is treated as transparent for federal income tax purposes, or through a ten-percent-or-more interest (*i.e.*, a "United States shareholder," as defined in section 951(b) of the Internal Revenue Code) in a controlled foreign corporation (as defined in section 957). International double taxation would be mitigated through a deduction (rather than a credit) for foreign taxes paid on the taxable foreign source income not qualifying for the exemption system. Professor Rosenbloom's exemption proposal is based on considerations of equity, efficiency, and complexity, rather than concerns about capital import neutrality/international competitiveness and the alleged need for U.S. multinationals to be provided with special tax treatment of foreign source income in order to be able to successfully compete in the global economy. His proposal attempts to balance his seeming preference (based on equity and efficiency considerations) for a residence-based, capital export neutral international tax system,[2] with the need for a substantial reduction in the complexity of the international tax rules. In the end, he is willing to tolerate some significant equity and efficiency losses in order to achieve what he hopes will be even more substantial simplicity gains.

My overall assessment is that this is a proposal worthy of careful and serious consideration. As should be clear from my prior publications,[3] I share Professor Rosenbloom's preference for a residence-based, capital export neutral international tax system and I agree with his unassailable premise that properly designed tax rules must take into account and balance concerns about equity, efficiency, and complexity. I probably would

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2. Professor Rosenbloom eschews the use of the term "capital export neutrality" (calling it a "banality") to describe the theory that underlies his proposal. *See* Rosenbloom, *supra* note 1, at 1531. But much of the analysis on pages 1534 through 1541 of his paper would be more consistent with capital export neutrality than with capital import neutrality. *See id.* at 1534-41.

3. *See, e.g.*, J. Clifton Fleming, Jr., Robert J. Peroni & Stephen E. Shay, *Deferral: Consider Ending It, Instead of Expanding It*, 86 TAX NOTES 837 (2000) (also published as *An Alternative View of Deferral: Considering a Proposal to Curtail, Not Expand, Deferral*, 20 TAX NOTES INT'L 547 (2000)); Robert J. Peroni, *Back to the Future: A Path to Progressive Reform of the U.S. International Income Tax Rules*, 51 U. MIAMI L. REV. 975 (1997); Robert J. Peroni, J. Clifton Fleming, Jr. & Stephen E. Shay, *Getting Serious About Curtailing Deferral of U.S. Tax on Foreign Source Income*, 52 SMU L. REV. 455 (1999).

strike the balance more in the direction of equity and efficiency than Professor Rosenbloom would, but we are in substantial agreement on our underlying premises. I also share Professor Rosenbloom's belief that the time has come for serious consideration of a radical overhaul of our international tax rules; particularly those relating to deferral and the foreign tax credit provisions.[4] As discussed below, while my first choice would be a different overhaul than the one that Professor Rosenbloom proposes, my second choice would not be the status quo (even if incrementally improved). Instead, I would favor a carefully designed, non-elective exemption system. In my mind, the current, incoherent compromise between capital export neutrality and capital import neutrality that is reflected in the absurdly complicated and ineffective subpart F rules is not an acceptable option in the 21st Century. Moreover, the subpart F provisions are beyond repair and no amount of incremental tinkering will fix them. Instead, it is time to consider seriously tearing those rules out from their roots and replacing them with something new.

I start my own analysis of the proper tax treatment of foreign controlled corporations with the belief that the primary function of the income tax system (including the international tax provisions) should be to raise revenue for the government's direct expenditure programs in an equitable and efficient manner.[5] I recognize, however, that complexity concerns require some sacrifice of fairness and efficiency concerns. Stated differently, I believe that tax rules generally should attempt to define the income tax base so as to distribute the tax burden based on ability-to-pay considerations and should neither favor nor disfavor foreign business and investment activities.[6] I am, therefore, quite skeptical of tax provisions that are designed to favor one type of economic activity or investment over another

4. In its recently-released study of Subpart F, the Treasury Department made no specific recommendation concerning the reform of Subpart F, but did note that Subpart F needs to be revised to deal with the modern forms of commerce and with the gaps in its current coverage. *See* U.S. TREAS. DEP'T, THE DEFERRAL OF INCOME EARNED THROUGH U.S. CONTROLLED CORPORATIONS: A POLICY STUDY 98-99 (2000) [hereinafter U.S. TREAS. DEP'T, DEFERRAL STUDY].

5. *See* Robert J. Peroni, *Deferral of U.S. Tax on International Income: End It, Don't Mend It—Why Should We Be Stuck in the Middle With Subpart F*, 79 TEX. L. REV. 1609 (2001).

6. *See id.*

type of economic activity or investment, and skeptical of claims that any particular type of economic activity needs special tax treatment in order to compete effectively in the marketplace.[7]

Absent compelling policy considerations to the contrary, tax rules should not be formulated to direct the allocation of economic resources to one economic activity rather than another, and the federal income tax system should not be in the business of picking winners and losers in terms of business and investment choices, including decisions concerning the location (domestic or foreign) of such businesses and investments.[8] In the international tax context, this means that if the pre-tax economic return on an investment abroad exceeds the pre-tax economic return on an investment in the United States, then economic efficiency generally is increased by a taxpayer's decision to move some of her investments abroad and the international tax rules should not interfere with that decision.[9] Accordingly, the central function of the international tax rules should be to attempt to ensure that double taxation (a tax on the same income by both the residence country and the source country) does not discourage the taxpayer from engaging in a cross-border transaction if it makes economic sense to do so.[10] On the other hand, if the pre-tax economic return on a foreign investment is lower than the pre-tax economic return on an investment in the United States, then economic efficiency generally is promoted by a taxpayer's decision to keep the investment activity in the United States, and the international tax rules should not provide an incentive for the taxpayer to shift the investment to the foreign country by providing a preferential tax treatment of income earned in the foreign country.[11] An international tax system based on the capital export neutrality norm generally seems to have less distortive effects on economic behavior than one based on the capital import neutrality norm because the taxpayer pays the same total tax (domestic and foreign), regardless of whether she invests at home or abroad, at least in the circumstance where the source country's tax rate does not exceed the resi-

7. *See id.*
8. *See id.*
9. *See id.*
10. *See id.*
11. *See* Peroni, *supra* note 5.

dence country's tax rate.[12] Thus, in an international tax system based on the capital export neutrality norm, economic considerations, rather than tax considerations, primarily will drive a taxpayer's choice of location (domestic or foreign) for investment.[13]

By contrast, an international tax system based on the capital import neutrality norm encourages a taxpayer to locate investments and business activities in foreign countries that impose low rates of tax and encourages source countries to offer tax incentives in order to attract the investments of such a taxpayer.[14] In other words, capital import neutrality encourages taxpayers to place a premium on tax considerations in determining where to locate an investment.[15] In fact, the proponents of capital import neutrality often argue that the residence country must exempt domestic persons from tax on foreign source income in order for those persons to be able to compete in the country of source.[16] Under an international tax

12. *See id.* I am not a capital export neutrality purist because I support the longstanding provisions of U.S. tax law that limit a taxpayer's allowable foreign tax credit to the taxpayer's pre-foreign tax credit U.S. tax liability on the foreign source income. *See id.* By contrast, pure capital export neutrality theory would hold that a taxpayer should be allowed to take a foreign tax credit for creditable foreign taxes even if the credit exceeds the taxpayer's pre-foreign tax credit U.S. tax liability on the foreign source income. *See id.* The United States has a legitimate interest in preserving its taxing jurisdiction over U.S. source income and granting a foreign tax credit for foreign taxes in excess of the taxpayer's pre-foreign tax credit U.S. tax liability on foreign source income would be tantamount to allowing a foreign tax credit to offset U.S. tax liability on U.S. source income. *See id.* In addition, the primary function of the foreign tax credit is to ameliorate international double taxation and no double taxation exists to the extent that the foreign tax exceeds the taxpayer's U.S. tax liability on the foreign source income. *See id.* Finally, allowing a foreign tax credit for foreign taxes in excess of the U.S. tax rate would provide an incentive for source countries to impose taxes on U.S. persons in excess of the U.S. rate, without suffering the adverse consequences of loss of foreign investment. *See, e.g.,* Donald J. Rousslang, *Deferral and the Optimal Taxation of International Investment Income,* 53 NAT'L TAX J. 589, 597 (2000) [hereinafter Rousslang, *Deferral*].

13. *See* Peroni, *supra* note 5.

14. *See id.*

15. *See id.*

16. *See id.* Taken to its logical extreme, this competitiveness argument would suggest that if a foreign company that competes with U.S. taxpayers in U.S. markets is able to obtain tax preferences from its country of residence that exempt it from tax on foreign source earnings and it pays no tax in the United States by reason of a tax treaty (*i.e.*, its U.S. business is not conducted through a permanent establishment because the products are shipped into the United States from abroad), the United States should exempt the U.S. taxpayer from U.S. tax on the

system based on capital import neutrality, a rationally acting domestic taxpayer will choose to locate an investment in a source foreign country offering a low tax rate even if that investment bears an economic return lower than an equivalent amount of investment in the home country that is fully taxable, provided that the difference in economic rate of return is less than the difference in home country and source country tax rates.[17] Moreover, if the deferral period is long enough, deferral is nearly as beneficial as exemption and will have nearly the same distortive effects as fully exempting the foreign source income from the residence country's tax base.[18] It is important to note that deferral is a problem even if the taxpayer is engaged in real business activity in the low-tax foreign country, because the existence of the deferral privilege encourages the taxpayer to shift investments to the low-tax country even if those investments provide a lower pre-tax economic return than investments in the residence country or some other foreign country with higher tax rates.[19]

Because capital import neutrality/competitiveness proponents are arguing for preferential tax rules for foreign source business income (in the form of either an exemption of such income from the federal income tax base or, its possible economic equivalent, deferral of U.S. tax on the income if it is earned through a foreign corporation), they should bear a heavy burden of justifying this special treatment.[20] To satisfy that burden they need to do something more than merely repeat unsupported claims that Subpart F and other features of the U.S. international tax system adversely affect the ability of U.S. multinationals to compete in the global marketplace.[21]

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sale of its products in the United States that compete with the foreign competitor. This would be an absurd argument that presumably would be rejected by a sensible Congress. What then if so special about foreign source income that justifies acceptance of the argument if the U.S. taxpayer is seeking exemption from U.S. tax on its foreign source income for the same reason?

17. *See id.*

18. *See id.*

19. *See* Peroni, *supra* note 5. However, under certain circumstances, deferral of a residence-based tax on foreign source profits can enhance economic efficiency. *See, e.g.*, James R. Hines, Jr., *The Case Against Deferral: A Deferential Reconsideration*, 52 NAT'L TAX J. 385 (1999). *See generally* Rosanne Altshuler, *Recent Developments in the Debate on Deferral*, 87 TAX NOTES 255 (2000).

20. *See* Peroni, *supra* note 5.

21. *See id.* The National Foreign Trade Council's "study" of the international

To date, the proponents of capital import neutrality/competitiveness have not satisfied this burden and they are not likely to be able to do so in the future.[22]

The current U.S. international tax rules dealing with deferral (particularly subpart F) represent a compromise between these concerns that in the end, of course, satisfies almost no one. These provisions raise a relatively small amount of revenue and whatever revenue they raise is only at substantial administrative costs by the government and compliance costs by taxpayers because of the substantial complexity they add to the Internal Revenue Code. The rules target certain types of foreign source income (primarily passive income and so-called foreign base company transactions) but leave in place deferral of U.S. tax for most types of foreign business income earned through foreign corporations, thus preserving the distortive effects of deferral on location choice for business and investment activities.[23] The dividing lines in subpart F between

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tax rules, THE NFTC FOREIGN INCOME PROJECT: INTERNATIONAL TAX POLICY FOR THE 21ST CENTURY—PART ONE: A RECONSIDERATION OF SUBPART F (1999), is an example of a report that promises much more than it delivers in terms of support for the competitiveness concerns of U.S. multinationals. This well-written report, prepared by some of the best and brightest international tax specialists in the United States, offers mostly anecdotes (labeled "industry case studies") about supposed competitiveness problems in certain industries by U.S. multinationals caused by the Subpart F provisions. It certainly does not provide the strong empirical support necessary to support its conclusion that "Changes in the international economic environment, as well as refinements in the theory of international taxation, support a shift in the balance of U.S. international tax policy towards competitiveness and away from capital export neutrality." *Id.* at xxi. For critiques of the NFTC study, see Reuven S. Avi-Yonah, *Competition and Competitiveness: Review of the NFTC Subpart F Report*, 83 TAX NOTES 582 (1999); Fleming, Peroni & Shay, *supra* note 3. For a spirited defense of the NFTC report by one of its authors, see Peter R. Merrill, *A Response to Professor Avi-Yonah on Subpart F*, 83 TAX NOTES 1802 (1999).

22. *See, e.g.*, Peroni, *supra* note 5; Fleming, Peroni & Shay, *supra* note 3, at 469-70, 838. *See also* U.S. TREAS. DEP'T, DEFERRAL STUDY, *supra* note 4, at 57-61.

23. In addition to the failure of the Subpart F compromise to deal adequately with the policy problems arising from the deferral privilege, there are various structural imperfections in the constructive dividend mechanism used by Subpart F to curtail deferral. *See, e.g.*, Peroni, *supra* note 5; Fleming, Peroni & Shay, *supra* note 3, at 507-10, 847-48, 986-94. First, the Subpart F inclusions are treated as ordinary income, without regard to the character of the underlying income that the foreign corporation earns. *See id.* Second, instead of the U.S. shareholder obtaining a direct foreign tax credit for the shareholder's share of foreign taxes paid by the foreign corporation, as would be the case under a pass-through regime, the pass-through of foreign tax credits to the foreign corporation's U.S. corporate shareholders are determined under the complex rules of Sections 960 and 902 and

"good" and "bad" deferral may or may not have made sense in 1962, when the provisions were originally drafted. They make little sense in a U.S. and world economy with much increased international trade and "new economy" industries conducting transactions that do not fit easily into the subpart F framework. These rules distort choice of entity decisions by favoring use of a branch for loss-producing activities and of a foreign corporation for income-producing activities in low-tax foreign countries. They distort repatriation decisions by foreign corporations with respect to low-taxed foreign earnings qualifying for deferral because the foreign corporation is encouraged to retain the earnings abroad, rather than distribute them to a U.S. shareholder and trigger U.S. income taxation on the repatriation. Further, when Congress or the Treasury Department actually comes up with a change to the anti-deferral rules that cuts back on deferral (such as the excess passive assets rules in section 956A, the overlap between the subpart F and passive foreign investment company regimes, or the hybrid branch regulations issued by the Treasury Department), the U.S. multinationals and their advocates successfully lobby to repeal or eviscerate the anti-deferral change.

In essence, the anti-deferral rules of current law, working together with a foreign tax credit limitation regime that allows liberal cross-crediting of high- and low-taxed foreign source income (notwithstanding the basket limitations in section 904(d)), create a poorly designed, elective exemption system for the well-advised taxpayer and numerous traps for the unwary taxpayer. These provisions violate equity, efficiency, and complexity criteria and, working together with the cross-crediting allowed under the foreign tax credit limitations, effectively may impose less U.S. income tax on foreign source income than would a properly designed, non-elective exemption system (*i.e.*, in some cases, they create a negative tax on foreign source income).[24] Thus, I see nothing so compelling about the

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generally only U.S. corporate shareholders owning at least 10 percent of the voting stock of the foreign corporation are entitled to claim such credits. *See id.* Third, losses of the controlled foreign corporation do not pass through to its shareholders under Subpart F. *See id.*

24. Harry Grubert and John Mutti estimate that the current rules create a negative average effective U.S. tax rate on active foreign earnings underlying dividends of non-financial controlled foreign corporations. *See* Harry Grubert & John Mutti, *Dividend Exemption Versus the Current System for Taxing Foreign Business*

subpart F compromise that we should continue trying to fix it with tinkering instead of repealing it and trying something else.[25]

My strong preference would be to attempt to reform the international tax system to bring it closer to the capital export neutrality norm, but with correction of the defects in the current foreign tax credit rules that effectively create a negative effective U.S. tax rate on certain types of foreign source income. I would end deferral completely and would include in gross income currently all foreign source income earned by U.S. persons, whether directly or through a foreign corporation.[26] I would repeal the foreign earned income exclusion and preferential tax regimes such as the FSC provisions in whatever form they appear. I would repeal the export source rule for inventory property. I would replace the basket limitations on the foreign tax credit in current law with a per-country limitation containing only two basket limitations: passive income and all other foreign source income. Finally, I would abandon the "technical taxpayer" rule for determining who is entitled to foreign tax credits for gross basis withholding taxes on passive-type income.

However, if we could not accomplish reform along the lines discussed above, then, as a second-best alternative, I would be willing to consider a carefully designed exemption system as a way of radically reforming the current international tax system. I think that Professor Rosenbloom's proposal for a targeted exemption system gives us a good starting point for designing an appropriate exemption system.[27]

First, I think that the theory underlying the exemption system is important because that theory will help determine the contours of the system and will help guide courts and tax

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Income (cited and discussed in Rousslang, *Deferral*, *supra* note 12, at 596). Donald Rousslang points out that the export source rule for inventory property sold abroad, combined with the cross-crediting opportunities under the foreign tax credit limitations, creates a negative U.S. tax on the foreign source income from such property. *See* Donald J. Rousslang, *The Sales Source Rules for U.S. Exports: How Much Do They Cost?*, 8 TAX NOTES INT'L 527 (1994). *See also* U.S. TREAS. DEP'T, DEFERRAL STUDY, *supra* note 4, at 46.

25. *But see* U.S. TREAS. DEP'T, DEFERRAL STUDY, *supra* note 4, at 98.

26. *See supra* articles cited in note 3.

27. For another good attempt at designing an exemption system, see Grubert & Mutti, *supra* note 24.

administrators in interpreting and applying the exemption provisions. Accordingly, I believe that it is important that Professor Rosenbloom's exemption proposal is not based on international competitiveness concerns, since, as discussed above, I believe that the proponents of those concerns have not come close to proving the link between those concerns and the need to provide special tax rules for foreign source income. Instead, Professor Rosenbloom's proposal is, in essence, a second-best approach to dealing with capital export neutrality concerns in the light of the difficulties in trying to end deferral completely and the complex rules needed to protect the residence country's tax base in a foreign tax credit system that must be applied to income earned not only directly and but through foreign corporations and that cannot effectively prevent all cross-crediting.

Second, it is important that Professor Rosenbloom's exemption system incorporates the principle, that for purposes of the international tax rules, a foreign corporation is to be treated as transparent with respect to its shareholders, at least if it is controlled by U.S. persons. Disregard of the foreign corporate form in this context is long overdue, particularly in the light of the ease with which a taxpayer can elect whether to have a foreign entity treated as a corporation for federal income tax purposes. However, I would go further and disregard the corporate form even in the non-controlled foreign corporation situation, at least if the U.S. person owns ten percent of the voting power of the entity. The ten-percent threshold is used in several places in the Code to distinguish between situations in which the U.S. person is treated as holding a mere portfolio interest in a foreign corporation and those in which the corporate interest is treated as a direct investment by the U.S. person abroad. In other words, the indirect credit provisions in Section 902, and the look-through rules for non-controlled section 902 corporations in section 904(d)(4), in essence, both treat the foreign corporation as transparent with respect to its ten-percent-or-more U.S. shareholders, even though U.S. shareholders as a group do not control the foreign corporation.[28] Sections 902 and 904(d)(4) also presume that a ten-

28. In any event, a U.S. shareholder's less-than-50 percent, but more-than-10 percent, stock interest in a foreign corporation will often give the U.S. shareholder considerable influence over the financial affairs of the foreign corporation, regard-

percent-or-more U.S. shareholder will be in a position to obtain the necessary information concerning the foreign corporation's earnings and foreign taxes in order to determine in what basket dividends from the corporation should fall and to compute the deemed paid credit. Moreover, in the case of below-ten-percent U.S. shareholders of foreign corporations, some approach for recapturing the benefits of deferral is necessary in order to prevent tax avoidance. In this regard, a modified version of the passive foreign investment company rules probably is necessary, allowing the under-ten-percent-shareholder to obtain deferral, while requiring a later payback of the benefits of deferral through an interest charge.

Third, it is important that Professor Rosenbloom's proposed exemption system is not elective and would remove much electivity from the international tax rules. Losses attributable to income earned in the exempt countries would be disallowed; whether earned directly or through a controlled foreign corporation. Moreover, the abuses arising under the foreign tax credit rules of current law would be eliminated because Professor Rosenbloom's proposal would include a repeal of the foreign tax credit provisions even with respect to foreign taxes paid or accrued on foreign source income not falling within the proposed exemption regime. As discussed above, the current elective deferral system, combined with a foreign tax credit system that allows a great deal of cross-crediting, essentially is an elective exemption system, but one that is only available with considerable planning.

Fourth, it is important that Professor Rosenbloom would limit his exemption approach to active business income earned only in countries with fully developed income tax rules. Thus, his exemption system would not contain an incentive for U.S.

less of the country of residence of the corporation's other shareholders. *See* Peroni, *supra* note 5. Thus, using the definition of controlled foreign corporation in Section 957 as the dividing line for whether or not the foreign corporate form will be disregarded does not seem appropriate. It will perpetuate a choice-of-entity bias in the existing international tax rules regarding how a U.S. person's significant, but non-controlling, interest in a joint venture with foreign persons—the non-corporate form—will be used in the early years to take advantage of the pass-through of losses to offset the taxpayer's other income (including U.S. source income) and the corporate form will be used in later years when the venture is producing profits, particularly if those profits are earned in a low-tax foreign country. *But see* I.R.C. § 367(a)(3)(C).

taxpayers to locate their business or investment activities in low-tax or no-tax foreign jurisdictions.

Finally, the proposed exemption approach, particularly if enacted in its purest form, could achieve significant simplification of the international tax rules, leading to lower compliance costs for U.S. taxpayers and lower administrative costs for the U.S. government. The anti-deferral regimes and foreign tax credit provisions would be eliminated. This exemption system would reduce somewhat the pressure on the source-of-income, allocation-and-apportion-of-deduction, and transfer pricing rules; except with respect to taxpayers having activities in listed foreign countries. In which event, the pressures on the source-of-income, deduction-allocation, and transfer pricing rules would remain, if not be intensified, although in the context of a determination of the business profits attributable to a permanent establishment in the listed foreign country.

I do have some problems with Professor Rosenbloom's proposal. First, I am concerned that by eliminating the foreign tax credit provisions and allowing only a deduction for foreign taxes paid on active business income earned in countries not on the list of exempt countries, equity and efficiency principles are substantially compromised. Stated differently, a deduction for foreign taxes in such a situation does not mitigate adequately international double taxation and, thus, would serve to discourage otherwise economically efficient transactions from taking place. Having said that, if his proposal were modified to allow a foreign tax credit for foreign taxes paid on such non-exempt income, a substantial amount of the simplification gains from this exemption proposal would be lost.

Second, I believe that Professor Rosenbloom recognizes, but underestimates, the intense pressure that would be placed on the United States or other residence country to expand its list of listed foreign countries beyond those that serve the intended purpose of the proposal. One can safely predict that representatives of U.S. multinationals will place strong lobbying pressure on Congress to include on the list low-tax or no-tax foreign jurisdictions on the ground that exemption from U.S. tax on the business profits in those countries is necessary in order for U.S. multinationals to be able to compete with their competitors from foreign countries with more liberal exemption systems. Thus, vigilance in protecting the list of designated exempt foreign countries would be crucial to pre-

serving the integrity of this exemption proposal. Given the financial strength of the lobbying groups in favor of capital import neutrality, maintaining such vigilance will not be easy.

Third, by using a targeted country approach to determining where the exemption system would apply, this proposal likely would lead to greater use of the international tax provisions by Congress and the Executive Branch to punish countries whose political, trade, or other non-tax system-related behavior is not to our liking. This tendency is already exhibited in the current international tax rules, in provisions such as sections 901(j) and 908. But, by drawing a sharp line between those foreign jurisdictions in which the exemption system would apply and all other countries, the temptation to use the exemption country list to reward or punish non-tax system-related behavior by foreign countries would be intense. This is not an appropriate use of the tax system without subjecting the tax penalty provision to a rigorous cost-benefit analysis. It complicates the Code and has the wrong government agency (the IRS) in charge of administering the penalty program. Stated differently, the Internal Revenue Code is generally not the appropriate vehicle for conducting a foreign relations program by the U.S. Government and Professor Rosenbloom's exemption proposal might well lead to a greater use of the international tax rules in this way.

Finally, as is true of all radical changes in the tax law, Professor Rosenbloom's proposal would require complicated transition rules. In addition, many details (including some important definitional rules) and collateral consequences of the proposal remain to be thought out and worked out. However, none of these should be viewed as insurmountable obstacles to enactment of the proposal, if we decided that this type of exemption system is the right pathway to reform of the U.S. international tax rules.

In conclusion, for many years, we have tried to seek a balance between capital export neutrality and capital import neutrality concerns in the design of the U.S. international tax rules. That approach predictably has produced an incoherent system of elective deferral combined with a complex set of foreign tax credit provisions, which still permit too much cross-crediting of high and low foreign taxes on foreign business income. Part and parcel of this incoherent system are the subpart F provisions, which fail to substantially cut back on

deferral (except in the case of passive income and certain types of base company transactions), and yet add tremendous complexity to the Internal Revenue Code.[29] Further, tinkering with the current anti-deferral regimes by adding more rules to subpart F, that target particular transactions based on the type of income involved or that attempt to update the subpart F rules in the light of the modern technology-based economy to accommodate the concerns of capital export neutrality proponents or adding additional exceptions to the definition of subpart F income to accommodate the concerns of capital import neutrality proponents is not the answer. Instead, radical overhaul of the U.S. international tax rules is in order.

Ultimately, I believe that the competitiveness of the U.S. tax system will be improved by broadening the tax base by bringing into it all income that is realized by a U.S. person, including foreign source income earned through a foreign corporation, thereby removing distortions in the tax system that favor or disfavor particular types of income based on its geographical source.[30] As a result of this base broadening, marginal tax rates should be cut for all income across the board.[31] Stated differently, instead of enacting a capital-import-neutrality-based exemption system that cuts the tax rate on foreign source business income to zero, we should broaden the tax base to include all foreign source income earned by U.S. persons and cut the tax rates on all income, without regard to source.[32] To accomplish this, we should end deferral completely on income earned by U.S. persons through a foreign corporation, whether by treating the foreign corporation as a pass-through entity with respect to U.S. persons who own stock in it (my preferred approach) or through some other mechanism.[33] It also means that the foreign tax credit provisions need to be changed by replacing the current basket limitations in section 904(d) with a per-country limitation, with two categories: passive income and all other foreign source income, and making certain other changes to the foreign tax credit rules. On the other hand, if we determine that it is too difficult to enforce

29. *See* Peroni, *supra* note 5.
30. *See id.*
31. *See id.*
32. *See id.*
33. *See id.*

residence-based taxation through a system that ends deferral completely and uses a per-country foreign tax credit system, then we should consider moving to a carefully designed exemption system.

In other words, my first choice would be to revise substantially the U.S. international tax rules based on a capital export neutrality approach.[34] But, if we lack the political will to achieve that type of reform, my second choice would not be maintaining the status quo of the current incoherent U.S. international tax system that is tantamount to a poorly designed, elective exemption system.[35] Instead, I would rather see the United States consider adopting an exemption system that is not elective and that is not based on the largely unproven claims of capital import neutrality/competitiveness theorists. In other words, we should at least take a serious look at attempting to design a coherent exemption system that does not serve as an incentive for U.S. taxpayers to divert investments to low-tax foreign countries and that attempts to balance concerns about fairness, economic efficiency, and complexity.[36] Professor Rosenbloom's paper has given us a proposal that provides a good starting point for at least one version of such a system.

34. *See id.*
35. *See* Peroni, *supra* note 5.
36. *See id.*