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Credit vs. Exemption: A Comparative Study of Double Tax Relief in the United States and Japan

Lawrence Lokken and Yoshimi Kitamura***

The overriding issue in international taxation is the problem of double taxation. Under the tax laws of most countries, income may be taxed on the basis of either residence or source. That is, a country may tax residents of the country on worldwide income and may tax nonresidents on income from sources within the country. Thus, if a resident of one country has income from a business activity or investment in another country, the person may be taxed on the income on a residence basis by its home country and on a source basis in the other country. Most countries observe an international consensus on two points:¹ First, relief from double taxation is essential to a healthy flow of international investment and business activity,² and second, a taxpayer's country of residence should assume the burden of alleviating double taxation of the taxpayer's cross-border income. Under this consensus, a country may generally tax nonresidents on income from sources within the country, without regard to the possibility of double taxation, but a country should relieve double taxation for its residents.³

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¹ The best evidence of a consensus in international income taxation is the network of income tax treaties based on models prescribed by the Organisation for Economic Cooperation and Development (OECD) and the United Nations. See COMM. ON FISCAL AFFAIRS, ORGANISATION FOR ECON. CO-OPERATION & DEV., MODEL TAX CONVENTION ON INCOME AND ON CAPITAL (2008) [hereinafter OECD MODEL]; U.N. MODEL DOUBLE TAXATION CONVENTION BETWEEN DEVELOPED AND DEVELOPING COUNTRIES (2001).

² According to the OECD, "[c]ross-border investment would be seriously impeded if there was a danger that the returns on such investment were taxed twice." Organisation for Economic Co-Operation and Development, Tax Treaties, http://www.oecd.org/topic/0,2686,en_2649_33747_1_1_1_1_37427,00.html (last visited Oct. 4, 2010).

³ See, e.g., OECD MODEL, *supra* note 1, at art. 7 (allowing country to tax business profits of nonresident having permanent establishment in taxing country), and at art. 23 (requiring country of taxpayer's residence to provide double tax relief).

There are two common forms of double tax relief: A country may exempt its residents from tax on income from investments and activities outside the country, or it may include foreign source income in the base on which it taxes residents but allow a credit for taxes paid to other countries. A few countries tax on a strictly territorial basis, taxing residents and nonresidents on income from domestic sources and exempting both residents and nonresidents from tax on all income from foreign sources. Singapore is a prominent example of this approach,⁴ which is here called a territorial system. The United States exemplifies the opposite approach, taxing residents on worldwide income but allowing a credit against U.S. tax for income taxes paid to other countries.⁵ Many countries use a mixed approach, exempting residents from tax on some income from foreign sources and using a worldwide/credit approach for other income. For companies, the principal subject of this article, a country following a mixed approach typically exempts residents from tax on income from active business operations in other countries, but taxes residents on other types of foreign source income, with credit for foreign taxes on that income. The mixed approach is here called an exemption system.

Historically, many English speaking countries, including Australia, Canada, the United Kingdom, and the United States, have had worldwide/credit systems, while countries in continental Europe have had exemption systems. Until recently, Japan has also had a worldwide/credit system. Over the last decade or so, Australia and Canada have amended their laws to incorporate exemption features.⁶ In 2009, both Japan and the United Kingdom adopted exemption systems.⁷

Influential voices in the United States have advocated that it should also switch to an exemption system. In November 2005, an Advisory Panel on Federal Tax Reform, which President Bush had charged with developing plans for reforming the federal tax system, issued a report outlining two

⁴ According to the Inland Revenue Authority of Singapore, “[a] company, regardless of whether it is a local or a foreign company, will be taxed on its income accruing in or derived from Singapore; or income received in Singapore from outside Singapore.” Inland Revenue Authority of Singapore, Scope of Tax, <http://www.iras.gov.sg/irasHome/page04.aspx?id=1392> (last visited Oct. 4, 2010).

⁵ *E.g.*, I.R.C. § 61(a) (2006) (defining “gross income” as “all income from whatever source derived”); *id.* § 901 (allowing credit for income taxes paid to other countries).

⁶ *See, e.g.*, ADVISORY PANEL ON CANADA’S SYSTEM OF INTERNATIONAL TAXATION, ENHANCING CANADA’S INTERNATIONAL TAX ADVANTAGE (2008), available at http://www.apcsit-gcrfi.ca/07/cp-dc/pdf/finalReport_eng.pdf (last visited Oct. 4, 2010); Peter Madden et al., *Australia Tax Alert – 6 July 2009*, INTERNATIONAL TAX ALERT, DELOITTE TOUCHE & TOHMATSU, available at https://www.deloitte.com/view/en_GX/global/services/tax/international-tax/article/9170a59366b62210VgnVCM100000ba42f00aRCRD.htm (last visited Oct. 4, 2010).

⁷ *See, e.g.*, HM TREASURY, BUDGET 2009, 2009, H.C. 407, available at http://www.hm-treasury.gov.uk/d/bud09_completereport_2520.pdf; Charles Gnaedinger, *Japanese, U.K. Exemption Systems Could Inform U.S. Debate*, 57 TAX NOTES INT’L 848 (Mar. 8, 2010).

alternative plans, one of them being a plan to reform the present income tax and the other being a plan to convert the income tax into a tax on consumption.⁸ The first of these plans, which the Panel called a Simplified Income Tax Plan, included a move from the worldwide/credit system to an exemption system. Earlier in 2005, the staff of the Joint Committee on Taxation suggested a similar shift.⁹ In recommending an exemption system, the Panel and Joint Committee staff relied on two arguments: (1) the current system, by deferring taxation of foreign earnings of U.S.-owned foreign corporations, distorts business decisions on where and how to invest these earnings; and (2) the current system often allows U.S. multinational enterprises to achieve U.S. tax results more favorable than they could obtain under a territorial system.¹⁰ Advocates of an exemption system for the United States often claim that such a system is necessary in order for U.S. multinational firms to be competitive with firms based in countries with exemption systems.¹¹

This article explores how an exemption system might work in the United States by applying both U.S. law and Japanese law, as recently amended, to three hypothetical cases. Each of the cases involves a domestic corporation (Japanese or American) with one or more subsidiaries organized, managed, and doing business in other countries.¹² Some of the basic principles applicable to the cases are similar or identical under Japanese and U.S. law. Under the laws of both countries, the separate existence of each foreign subsidiary is recognized, and each subsidiary is only taxed by the country or countries in which it is organized, does business, or has income. The home country of the parent corporation (Japan or the United States) does not tax a foreign subsidiary on its income

⁸ PRESIDENT'S ADVISORY PANEL ON FED. TAX REFORM, SIMPLE, FAIR, AND PRO-GROWTH: PROPOSALS TO FIX AMERICA'S TAX SYSTEM (2005)

⁹ STAFF OF THE JOINT COMM. ON TAXATION, 108TH CONG., OPTIONS TO IMPROVE TAX COMPLIANCE AND REFORM TAX EXPENDITURES 189 (Comm. Print 2005).

¹⁰ For an analysis of these arguments, see Lawrence Lokken, *Territorial Taxation: Why Some U.S. Multinationals May Be Less Than Enthusiastic about the Idea (and Some Ideas They Really Dislike)*, 59 SMU L. REV. 751 (2006).

¹¹ Press Release, U.S. Dep't of the Treasury, Statement For the Record of the Senate Committee on Finance Hearing on International Tax Reform Held on June 26, 2008 (June 26, 2008), available at <http://www.ustreas.gov/press/releases/hpl060.htm>. Competitiveness is also cited as a primary motivation for other countries' switch from worldwide/credit systems to exemption systems. *E.g.*, Gnaedinger, *supra* note 7.

¹² Although this article only compares U.S. and Japanese law, the Japanese exemption system is broadly similar to the systems used in many other industrialized countries. See U.S. GOVERNMENT ACCOUNTABILITY OFFICE, INTERNATIONAL TAXATION: STUDY COUNTRIES THAT EXEMPT FOREIGN-SOURCE INCOME FACE COMPLIANCE RISKS AND BURDENS SIMILAR TO THOSE IN THE UNITED STATES (Sept. 2009), available at <http://www.gao.gov/new.items/d09934.pdf> (surveying exemption systems in Australia, Canada, France, Germany, and the Netherlands).

merely because the subsidiary is owned by a resident of the home country.¹³ Generally, income of a foreign subsidiary is recognized for tax purposes by the parent's home country only when it is distributed as dividends. However, both Japan and the United States have statutes, sometimes called controlled foreign corporation legislation ("CFC legislation"), designed to limit the ability of residents to avoid tax by shifting income to entities resident in low-tax jurisdictions (tax havens).¹⁴ When applicable, CFC legislation taxes a shareholder on income of a foreign corporation, whether or not the income is distributed. Each of these principles is explained further in its application to the hypothetical cases.

CASE I

X Corp., which is organized under the laws of and managed in country *X*, manufactures goods in country *X* and sells them in country *X* and elsewhere. Sales to customers in country *Y* are made through *X*'s wholly owned subsidiary, *Y Corp.*, which is organized under the laws of and managed in country *Y*. For the first year of *Y Corp.*'s existence, *X* manufactures goods in country *X* at a cost of 60,000 and sells them to *Y Corp.* for 80,000 (an arm's length price), and *Y Corp.* resells the goods to unrelated customers in country *Y* for 100,000.¹⁵ *X Corp.* ships the goods directly from its facilities in country *X* to *Y*'s customers in country *Y*, and title to the goods passes from *X* to *Y* and then to the customers on delivery at the customers' places of business. Apart from the cost of goods sold, *X Corp.* has costs of 4,000 allocable to its income from the sales to *Y Corp.*, and *Y Corp.*'s costs consist of operating costs paid to unrelated persons of 6,000. *Y Corp.* pays income taxes of 4,200 to country *Y* (30% of its net income of 14,000), and distributes dividends to *X* of 4,900. *X Corp.* has expenses of 1,000 allocable to the dividends from *Y*. Country *Y* imposes a 5% withholding tax on the dividends.

How is *X Corp.*'s income from the transactions with and investment in *Y Corp.* taxed by country *X* if country *X* is, alternatively, Japan or the United States?

A. The United States is Country *X*.

The United States taxes *X Corp.* on the income of *Y Corp.* only as the income is distributed to *X Corp.* as dividends. Under the U.S. CFC

¹³ See, e.g., I.R.C. § 882(b) (2006) (defining foreign corporation's gross income to include only income from U.S. sources and income effectively connected with conduct of trade or business in the United States).

¹⁴ These statutes are described below in the analysis of Case III. See *infra* text accompanying notes 74–96.

¹⁵ All monetary amounts are units of an imaginary currency used throughout the world. This assumption is made to avoid confusing the analyses with amounts in different currencies.

legislation, a U.S. shareholder of a controlled foreign corporation (“CFC”) is taxed directly on a ratable share of the CFC’s subpart F income, even if the CFC does not distribute the income.¹⁶ *X Corp.* is a U.S. shareholder of *Y Corp.* because it owns at least 10% of *Y Corp.*’s voting stock,¹⁷ and *Y Corp.* is a CFC because a U.S. shareholder owns more than 50% of its stock.¹⁸ Because *X Corp.* owns all of *Y Corp.*’s stock, its ratable share of *Y Corp.*’s subpart F income is 100%.¹⁹ *Y Corp.* does not, however, have subpart F income.²⁰ One category of subpart F—foreign base company (“FBC”) sales income—includes income of a CFC from sales of goods that the CFC acquired from a related person but only if the goods are sold for use, consumption, or disposition outside the country under the laws of which the CFC is organized.²¹ Although *Y Corp.*’s income is from sales of goods purchased from a related person (*X Corp.*),²² the income is not FBC sales income because *Y*’s customers are located in its country of organization (country *Y*).

X Corp. must include dividends from *Y Corp.* in its U.S. gross income,²³ but it is allowed credit for both the withholding tax collected by country *Y* from the dividends (5% of the dividends) and a portion of the income taxes that *Y Corp.* paid to country *Y*.²⁴ If a domestic corporation

¹⁶ I.R.C. § 951(a)(1)(A).

¹⁷ I.R.C. § 951(b) (defining “United States shareholder” as a U.S. person owing at least 10% of foreign corporation’s voting stock, directly, indirectly, or constructively). See I.R.C. § 7701(a)(30) (2006) (defining “United States person” to include U.S. citizens and residents, domestic partnerships and corporations, and certain estates and trusts).

¹⁸ I.R.C. § 957(a) (defining “controlled foreign corporation” as foreign corporation, more than 50% of the stock of which, by vote or by value, is owned by U.S. shareholders).

¹⁹ I.R.C. § 951(a)(2) (U.S. shareholder’s ratable share of subpart F income is portion of that income that the shareholder would receive if CFC distributed the income to its shareholders on last day of taxable year.).

²⁰ See I.R.C. §§ 952–954 (defining subpart F income). Subpart F income consists of several types of income that Congress found to be susceptible to tax haven manipulations and other income that Congress, for various reasons, decided to tax directly to U.S. shareholders of CFCs. Probably, the most common type of subpart F income is foreign personal holding company income, which consists principally of dividends, interest, rents, royalties, and gains on sales of property producing these types of income. I.R.C. § 954(c). Foreign personal holding company income is discussed more fully in connection with Case III. See *infra* text accompanying notes 80–82.

²¹ I.R.C. § 954(d)(1). See Treas. Reg. § 1.954-3(a)(3) (determining country of use, consumption, or disposition).

²² A “related person” is an individual, corporation, partnership, trust, or estate that controls the CFC, is controlled by the CFC, or is controlled by same person or persons that control the CFC. “Control” is ownership of more than 50% of the voting stock (in the case of a corporation) or more than 50% of the beneficial interests (in the case of a partnership, trust, or estate). I.R.C. § 954(d)(3). *X Corp.* is related to *Y Corp.* because it owns more than half of *Y*’s stock.

²³ I.R.C. § 61(a) (defining “gross income” as “income from whatever source derived,” specifically including, among other things, dividends).

²⁴ A withholding tax—a tax imposed at source on the gross amount of an income item

receives dividends from a foreign corporation and owns at least 10% of the foreign corporation's voting stock, the domestic corporation is deemed to pay some portion of the foreign income taxes paid by the foreign corporation. The amount deemed paid is based on the foreign corporation's "post-1986 foreign income taxes" and its "post-1986 undistributed earnings."²⁵ The former amount is the sum of all foreign income taxes paid by the foreign corporation for all taxable years since 1986, adjusted for amounts deemed paid in prior years.²⁶ Since the assumed facts occur during *Y Corp.*'s first taxable year, its post-1986 foreign income taxes for the year are its country *Y* taxes for that year (4,200). A foreign corporation's post-1986 undistributed earnings are its earnings and profits for all years after 1986, including the current year, with adjustments for dividends distributed in prior years.²⁷ For the year in question, *Y Corp.*'s post-1986 undistributed earnings are its current earnings and profits (9,800).²⁸ The deemed paid taxes are post-1986 foreign income taxes, multiplied by a fraction whose numerator is the dividends and whose denominator is post-1986 undistributed earnings. For *X Corp.*, the arithmetic is as follows:

$$(4,200)(4,900/9,800) = 2,100$$

X Corp. is required to recognize an amount equal to the deemed paid taxes as additional dividend income.²⁹ This gross income is usually called a gross-up. *X Corp.* therefore has dividend income of 7,000 (4,900 actual and 2,100 gross-up) and has foreign income taxes of 2,345 (withholding tax of 245—or 5% of 4,900—and deemed paid taxes of 2,100).

A taxpayer is allowed credit for foreign income taxes only to the extent of a statutory limitation that restricts the credit to the pre-credit U.S. tax allocable to foreign source income.³⁰ The limitation is U.S. tax, before

not attributable to a business of the recipient in the source country—is creditable only if the country imposing the tax has a general income tax qualifying for credit against U.S. tax and the withholding tax, when imposed, is a substitute for, rather than an addition to, the general income tax. I.R.C. § 903; Treas. Reg. § 1.903-1. It is assumed that country *Y*'s withholding tax satisfies these criteria.

²⁵ I.R.C. § 902(a).

²⁶ I.R.C. § 902(c)(2).

²⁷ I.R.C. § 902(c)(1).

²⁸ Earnings and profits may be computed as taxable income, with adjustments for items that affect a corporation's ability to pay dividends but are not reflected in taxable income. See 4 BORIS I. BITTKER & LAWRENCE LOKKEN, FEDERAL TAXATION OF INCOME, ESTATES & GIFTS ¶ 92.1.3 (Warren, Gorham & Lamont 2005). For the year in question, *Y Corp.*'s taxable income is 14,000 (sales of 100,000, less cost of goods sold of 80,000, and less expenses of 6,000). The only adjustment is income taxes of 4,200. Post-1986 undistributed earnings are computed with U.S. tax accounting rules.

²⁹ I.R.C. § 78 (requiring shareholder to recognize gross income equal to taxes of foreign corporation deemed paid by shareholder under § 902).

³⁰ The idea underlying the limitation is that the purpose of the foreign tax credit—to alleviate double taxation—is fully accomplished once it has reduced U.S. tax on foreign

the tax, multiplied by a fraction whose numerator is taxable income from sources outside the United States and whose limitation is entire taxable income.³¹ If a corporation's taxable income exceeds \$18½ million, it is taxed at a flat rate of 35%,³² and the credit limitation is 35% of its taxable income from foreign sources.³³ It is assumed that this shortcut accurately states the limitation for *X Corp.*

X Corp.'s dividends from *Y Corp.* (4,900) and the constructive dividend reflecting the deemed paid taxes (2,100) are gross income from sources outside the United States.³⁴ *X Corp.* has expenses of 1,000 that are allocated to this income, and the dividends thus add foreign source taxable income of 6,000 (the sum of 4,900 and 2,100, less 1,000).³⁵

A portion of *X*'s income on the sales to *Y Corp.* is also considered foreign source income. Income on sales of goods that a taxpayer produces in the United States and sells outside the United States is partly from U.S. sources and partly from foreign sources.³⁶ A sale is considered made outside the United States if title to the goods passes from the taxpayer to the buyer outside the United States.³⁷ These rules apply to *X*'s income on its sales to *Y* because *X* produces the goods in the United States and sells them in transactions in which title to the goods passes from *X* to *Y* in a foreign country. Unless the taxpayer elects otherwise, income on sales of goods produced within and sold outside the United States is split equally between U.S. and foreign sources.³⁸ *X Corp.*'s income on these sales is 16,000 (sales of 80,000, less cost of goods sold of 60,000, less expenses of 4,000 allocated to this income), of which 8,000 is assigned to sources outside the United States.

X Corp. thus has taxable income from sources outside the United States of 14,000 (6,000 from dividends and 8,000 sales). Its credit limitation is 4,900 (35% of 14,000). Its foreign income taxes are 2,345

source income to zero.

³¹ I.R.C. § 904(a). For a more complete discussion of the credit limitation, see BITTKER & LOKKEN, *supra* note 28, ¶¶ 72.6–72.8.

³² I.R.C. § 11(b). The statute provides three lower rates for the first 10 million of taxable income, but the benefits of these rates are phased out. The phase-out is completed when taxable income reaches 18½ million, and a corporation with taxable income exceeding this threshold is thus taxed at a flat 35%.

³³ The statutory formulation of the limitation can be restated as foreign source taxable income, multiplied by a fraction whose numerator is the pre-credit U.S. tax and whose numerator is entire taxable income. If the taxpayer is taxed at a flat 35%, this fraction is 35%.

³⁴ I.R.C. §§ 861(a)(2), 862(a)(2).

³⁵ See I.R.C. § 862(b) (defining “taxable income from sources outside the United States” as gross income from foreign sources, less deductions allocated and apportioned to this gross income); Treas. Reg. § 1.861-8 (providing rules on allocating and apportioning deductions).

³⁶ I.R.C. § 863(b)(2).

³⁷ Treas. Regs. §§ 1.861-7(c), 1-863-3(c)(2).

³⁸ Treas. Reg. § 1.863-3(b)(1).

(withholding tax of 245 and deemed paid taxes of 2,100). Since the foreign income taxes are less than the limitation, the taxes are fully creditable.

B. Japan is Country *X*.

Under the Japanese Corporation Tax Act, as amended in 2009,³⁹ a Japanese corporation is exempt from Japanese tax on 95% of dividends received from a foreign corporation if the Japanese corporation directly owns at least 25% of the foreign corporation's stock throughout the six-month period ending with its receipt of the dividends.⁴⁰ The exemption applies to the gross amount of the dividends, before deduction of any taxes withheld at source. The remaining 5% of the dividends is included in the corporation's Japanese tax base. No deduction or credit is allowed for foreign taxes on the dividends.⁴¹ The corporation is not required to allocate any of its other expenses to exempt dividends. The inclusion of 5% of the dividends is intended to offset expenses that might otherwise be allocated to the dividends.

In Case I, *X Corp.* is exempt from Japanese tax on 95% of the dividends received from *Y Corp.* if it owns the *Y* stock for at least six months before it receives the dividends. In determining its Japanese income tax, *X Corp.* is allowed no credit or deduction for the country *Y* tax withheld from the dividends (245) or for any portion of the country *Y* taxes paid by *Y Corp.* It must include 5% of the dividends in its Japanese tax base, but it is allowed deductions for all of the expenses allocable to the dividends. The expenses (1,000) fully offset the taxable portion of the dividends (245).

Apart from the dividend exclusion, the foreign tax credit continues to

³⁹ The amendments became effective on 1 April 2009.

⁴⁰ Japanese Corporation Tax Act §23-2(1) (2007). The 25% threshold may be lowered if the foreign corporation is a resident of a country (treaty country) with which Japan has an income tax treaty that requires Japan to allow an indirect credit to a Japanese corporation receiving dividends from a corporation resident in the treaty country. The indirect credit is only allowed if the Japanese corporation's ownership of the foreign corporation is not below a threshold stated in the treaty. If the treaty threshold is below 25%, it is substituted for 25% in the statutory exemption rule. Japanese Corporation Tax Act Enforcement Ordinance §22-3(4). For example, the U.S.-Japan income tax treaty requires Japan to allow an indirect credit to a Japanese corporation receiving dividends from a U.S. corporation if the Japanese corporation owns at least 10% of the U.S. corporation's voting stock. Convention between the Government of the United States of America and the Government of Japan for the Avoidance of Double Taxation and the Prevention of Fiscal Evasion with respect to Taxes on Income, Art. 23(1)(b). Under the newly enacted dividend exemption, a Japanese corporation is thus exempt from Japanese tax on 95% of dividends received from a U.S. corporation if the Japanese corporation owns at least 10% of the U.S. corporation's voting stock.

⁴¹ Japanese Corporation Tax Act §39-2 (excluding foreign withholding taxes on dividends from gross expense), Japanese Corporation Tax Act §69, Japanese Corporation Tax Act Enforcement Ordinance §142-3(7) (denying foreign tax credit for such taxes).

be the principal means of double tax relief in Japan.⁴² For example, if a Japanese corporation conducts business in a foreign country through a branch, rather than a separately incorporated entity, income from branch operations is included in the corporation's Japanese tax base, but the corporation is allowed credit against Japanese tax for foreign taxes on the branch income.⁴³

C. Observations.

In this simple example, *X Corp.* would pay less tax if the United States followed the lead of Japan in substituting a 95% dividends exemption for the worldwide/credit rules currently applied to dividends from foreign subsidiaries. The pre-credit U.S. tax attributable to the dividends that *X Corp.* receives from *Y Corp.* is 2,100 (35% of 6,000).⁴⁴ The tax credit is 2,345. The net tax on the dividends is thus negative 245. Under a 95% dividends exclusion, the calculations would be as follows:

Dividends received	4,900
Less 95% exclusion	(4,655)
Less deductions allocable to dividends	(1,000)
Net effect on taxable income	(755)
Net reduction of tax at 35%	(264)

On these facts, a 95% dividends exclusion would thus reduce *X Corp.*'s U.S. taxes on the dividends from negative 245 to negative 264.

The differences between the results under current law and a 95% dividends exemption depend on two factors: the relative tax rates in the United States and the source country; and the amounts of expenses allocable to the dividends. To eliminate the effects of expense allocations, assume 5% is a fair estimate of the expenses allocable to dividends. With this assumption, worldwide tax is less under a 95% exemption than under the current U.S. rules if the effective rate of foreign tax is less than the U.S. corporate tax rate of 35%. In the example, the effective rate of country *Y* tax, including both the income tax paid by *Y Corp.* and the withholding tax on the dividend, is 33.5% (30% corporate tax, plus withholding tax of 5%

⁴² Japanese Corporation Tax Act § 69.

⁴³ Japanese Corporation Tax Act § 69(1). Many countries with dividends exemptions also exempt income from foreign permanent establishments (branches), but even in these countries, a worldwide/credit system applies to all other types of income. See U.S. GOVERNMENT ACCOUNTABILITY OFFICE, INTERNATIONAL TAXATION: STUDY COUNTRIES THAT EXEMPT FOREIGN-SOURCE INCOME FACE COMPLIANCE RISKS AND BURDENS SIMILAR TO THOSE IN THE UNITED STATES (Sept. 2009).

⁴⁴ As discussed above, the dividends' contribution to *X Corp.*'s taxable income is the actual dividends of 4,900, plus the gross-up under § 78 of 2,100, less expenses allocable to the dividends of 1,000.

of 70%).⁴⁵ Because 33.5% is less than 35%, if expenses allocable to the dividends were 5% of the dividends, *X Corp.* would pay some U.S. tax on the dividends under the current system, but it would pay no U.S. tax on the dividends under a 95% dividends exemption. If the combined effective rate in country *Y* were lower than 33.5%, the difference between current law and a 95% exemption could be much greater.

Under U.S. law, a U.S. person's deductions are allocated to income from foreign sources on a factual basis.⁴⁶ The general rule is that an expense is allocated to particular income if the expense is incurred in an activity or in connection with property from which the income derives.⁴⁷ Under the new Japanese rules, no deductions are allocated to dividends qualifying for the 95% dividends exemption, but the 5% of the dividends not excluded is effectively an offset to deductions for expenses allocable to the dividends. In Case I, *X Corp.* is assumed to have expenses of 1,000 allocable to the dividends of 4,900 that it receives from *Y Corp.* Because expenses allocated to the dividends exceed 5% of the dividends, *X Corp.* would be advantaged by a 95% exemption with no expense allocation. As computed above, *X Corp.*'s U.S. tax on the dividends from *Y Corp.* under a 95% exemption would be negative 264; the negative amount results from the deduction of expenses in excess of 5% of the dividends. In contrast, if a U.S. company's deductions allocable to dividends from a foreign subsidiary are less than 5% of the dividends, a 95% dividend exemption would leave a residual U.S. tax on the dividends equal to 35% of the amount by which 5% of the dividends exceeds the expenses allocable to the dividends.

One aspect of the analysis under current U.S. law requires additional mention: Under current law, U.S. tax on *X Corp.*'s dividends from *Y Corp.* is negative 245. The purpose of the foreign tax credit is to alleviate double taxation, and this goal is fully achieved by reducing U.S. tax on doubly taxed income to zero. Since the dividends from *Y Corp.* are *X Corp.*'s only doubly taxed income, U.S. tax on the dividends should not be less than zero. The credit limitation is the mechanism that is supposed to confine the credit to its role of alleviating double taxation.

The negative U.S. tax on the dividends occurs because income not taxed by any foreign country—one half of *X Corp.*'s income on its sales to *Y Corp.*—is mixed with the dividends in the limitation arithmetic. Country

⁴⁵ For example, if a country *Y* company had pretax income of 100 and distributed all of its after-tax income to a nonresident shareholder, the corporate tax would be 30, the dividend would be 70, the withholding tax would be 3.5, and the sum of the corporate and withholding taxes would be 33.5.

⁴⁶ Treas. Reg. §1.861-8. See generally BITTKER & LOKKEN, *supra* note 28, ¶ 73.10.

⁴⁷ Treas. Reg. §1.861-8(b)(2). If the income to which an expense is partly from U.S. sources and partly from foreign sources, the expense is apportioned between U.S. and foreign income "in a manner which reflects to a reasonably close extent the factual relationship between the deduction and the grouping of gross income." Treas. Reg. § 1.861-8T(c)(1).

Y's failure to tax this income is not a peculiarity of country *Y* law. The sales income is partially from foreign sources for U.S. tax purposes only because the sales are arranged to pass title from *X* Corp. to *Y* Corp. outside the United States. The fact of title passage in a foreign country is rarely, if ever, a basis for taxation of sales income by that country. For example, if the United States has an income tax treaty with country *Y*, country *Y* cannot tax *X* Corp. on its sales income because *X* Corp. has no permanent establishment in country *Y*.⁴⁸ For purposes of the foreign tax credit, income from foreign sources should be defined to include only income that is, or at least might be, taxed by a foreign country. For example, income on sales of goods might be considered from foreign sources only if it is attributable to a permanent establishment of the taxpayer outside the United States.⁴⁹

Substitution of a 95% dividends exemption would reduce some of the inappropriate results under current U.S. law resulting from bad source rules. For U.S. persons, source rules are usually used only in computing the limitation on the foreign tax credit. Under a 95% dividends exemption, no credit is allowed for foreign income taxes on dividends qualifying for the exemption, and the tax treatment of qualifying dividends is not affected by distortions in the credit limitation structure. Bad source rules do not, however, justify adoption of a dividends exemption. Under an exemption system, the foreign tax credit applies to all income other than income qualifying for the exemption. An exemption system thus reduces but does not eliminate the effects of distortions in credit rules. A much better solution is to fix the source rules by, for example, eliminating the title passage rule.

CASE II

X Corp., which is organized under the laws of and managed in country *X*, manufactures and sells goods in country *X* and elsewhere, directly and through subsidiaries. *X* Corp. owns all of the stock of *Y* Corp., which is organized under the laws of and managed in country *Y*. *X* Corp., which

⁴⁸ *E.g.*, United States Model Income Tax Convention of November 15, 2006, art. 7, available at <http://www.ustreas.gov/offices/tax-policy/library/model006.pdf> [hereinafter "Model Convention"]. When a treaty following the Model applies, a country can tax "profits" of a resident of the other country only if the taxpayer has a permanent establishment in the taxing country. Model Convention, art. 7(1). A permanent establishment is "a fixed place of business through which the business of an enterprise is wholly or partly carried on." Model Convention, art. 5(1). A company does not have a permanent establishment in a country merely because it controls a company that is a resident of that country. Model Convention, art. 5(7). Thus, country *Y* can tax profits of *X* Corp. only if *X* Corp. has a permanent establishment in country *Y*, and *X* Corp.'s ownership of *Y* Corp. is not a permanent establishment. Since *X* Corp. has no place of business in country *Y*, it has no permanent establishment in that country.

⁴⁹ U.S. law contains a similar rule, but although it applies to a foreign person's income on sales of goods, the rule does not apply to such income of a U.S. person. I.R.C. § 865(e) (2006).

owns worldwide rights to marketing and manufacturing intangibles, licenses to *Y Corp.* exclusive rights to use the intangibles in country *Y*. *X Corp.* also makes loans to *Y Corp.* Royalties and interest under the license and loan are at arm's length rates. For its first taxable year, *Y Corp.* manufactures goods in country *Y* at a cost of 80,000 and resells them to unrelated customers for 100,000. In addition to the cost of goods sold, *Y Corp.*'s costs, all deductible under country *Y* tax law, are operating expenses of 6,000 and royalties and interest paid to *X Corp.* of 4,000 and 2,000, respectively. *Y Corp.* pays income taxes of 2,400 to country *Y* (30% of its net income of 8,000), and distributes dividends to *X Corp.* of 2,800. Country *Y* imposes a withholding tax on the dividends of 140 (5% of the dividends), but it imposes no withholding taxes on the royalties or interest. *X Corp.* has expenses of 800, 400, and 560 allocable to the royalties, interest, and dividends.

How is *X Corp.*'s income from the transactions with and investment in *Y Corp.* taxed by country *X* if country *X* is, alternatively, Japan or the United States?

A. The United States is country *X*.

As in Case I, *X Corp.*, on receiving dividends from *Y Corp.*, is deemed to have paid foreign income taxes actually paid by *Y Corp.* in an amount computed as (1) *Y*'s post-1986 foreign income taxes (2,400), multiplied by (2) the dividends that *X* receives from *Y* during the year (2,800), and divided by (3) *Y*'s post-1986 undistributed earnings (pretax income of 8,000, less income taxes of 2,400).⁵⁰ The arithmetic is as follows:

$$(2,400)(2,800/5,600) = 1,200$$

X Corp.'s foreign source taxable income from its investments in and dealings with *Y Corp.* are as follows:

Dividends from <i>Y Corp.</i>		
Actual dividends	2,800	
Gross-up for deemed paid taxes	1,200	
Less expenses	<u>(560)</u>	3,440
Royalties from <i>Y</i>		
Less expenses	<u>800</u>	3,200
Interest from <i>Y</i>		
Less expenses	<u>400</u>	<u>1,600</u>
Total		8,240

⁵⁰ I.R.C. § 902, discussed in *supra* text accompanying notes 25–27.

The dividends are from sources outside the United States because the distributing corporation is a foreign corporation.⁵¹ The royalties are from foreign sources because they are received for *Y Corp.*'s use of the intangibles outside the United States.⁵² The interest income is from foreign sources because it is received on a debt obligation of a foreign person.⁵³

The limitation on the foreign tax credit is assumed to be 35% of foreign source taxable income of 8,240, which is 2,884. A credit claimant must separately compute the limitation for taxes on passive category income and general category income, respectively.⁵⁴ Dividends, royalties, and interest income are normally passive category income,⁵⁵ but look-thru rules apply to items received from a CFC, such as *Y Corp.*⁵⁶ Dividends from a CFC are allocated between the passive and general categories in the same proportions as the distributing corporation's earnings and profits fall into these categories.⁵⁷ Since all of *Y Corp.*'s income is from the manufacture and sale of goods and therefore in the general category, *X Corp.*'s dividends from *Y Corp.* are general category income. Royalties and interest received from a CFC are in the same category as the income of the CFC to which the royalties or interest are allocated.⁵⁸ Since all of *Y Corp.*'s income is in the general category, *X Corp.*'s royalty and interest income are also general category income. Since all of *X Corp.*'s taxable income from sources outside the United States is in the general category, the overall limitation of 2,884 is also the general category limitation.

X Corp.'s foreign income taxes consist of the withholding tax on the dividends (140) and the taxes of *Y Corp.* deemed paid by *X* (1,200). Since the credit limitation (2,884) exceeds the foreign income taxes (1,340), *X* is allowed credit for all of the foreign income taxes.

⁵¹ With a few exceptions not applicable here, dividends from domestic corporations are from U.S. sources, and dividends from foreign corporations are from foreign sources. I.R.C. §§ 861(a)(2), 862(a)(2). It is assumed that the expense amounts are determined under Treas. Reg. § 1.861-8.

⁵² I.R.C. § 862(a)(4) (defining gross income from foreign sources to include "royalties for the use of or for the privilege of using" intellectual property outside the United States).

⁵³ Generally, interest income is from U.S. sources if it accrues on an obligation of a domestic corporation or a "noncorporate" resident of the United States and is otherwise from foreign sources. I.R.C. §§ 861(a)(1), 862(a)(1). *X Corp.*'s interest income is from foreign sources because the obligor, *Y Corp.*, is neither a domestic corporation nor a noncorporate resident of the United States.

⁵⁴ I.R.C. § 904(d)(1).

⁵⁵ I.R.C. §§ 904(d)(2)(B)(i), 954(c)(1).

⁵⁶ *Y Corp.* is a CFC because (1) *X Corp.* owns at least 10% of *Y*'s voting stock and is thus a U.S. shareholder and (2) this U.S. shareholder owns more than one half of *Y*'s stock. I.R.C. §§ 951(b), 957(a).

⁵⁷ I.R.C. § 954(d)(3)(B).

⁵⁸ I.R.C. § 904(d)(3)(C). See Treas. Reg. § 1904-5(c)(2) (allocating interest); Treas. Reg. § 1.904-5(c)(3) (allocating royalties). See generally 3 BITTKER & LOKKEN, *supra* note 28, ¶ 72.7.8.

B. Japan is country *X*.

As discussed more completely in the analysis of Case I, *X Corp.* is exempt from Japanese tax on 95% of the dividends that it receives from *Y Corp.* It is allowed no deduction or credit for taxes on the dividends or for any portion of the income taxes paid by *Y Corp.* It is, however, allowed to deduct all other expenses that might be considered allocable to the dividends.

X Corp. is subject to Japanese tax on the royalties and interest received from *Y Corp.*⁵⁹ It would be allowed credit against Japanese tax for foreign income taxes on the royalties and interest,⁶⁰ but country *Y* imposes no taxes on *X Corp.*'s royalty or interest income. Japan has a credit limitation that is generally similar to the U.S. limitation.⁶¹ The foreign tax credit would thus be limited to the Japanese tax (before credit) that is ratably attributable to the royalties and interest after taking expenses allocable to those items into account.⁶²

C. Observations.

Domestic taxation of *X Corp.* in Case II is similar in Japan and the United States. In the case of both Japan and the United States, *X Corp.*'s home country taxes the royalty and interest income, with credit for taxes imposed on the income by other countries, and expenses are allocated to this income in determining the limitation on the foreign tax credit. As in Case I, a 95% dividends exemption would be more advantageous for *X Corp.* than current U.S. law with respect to the dividends, but because the effective rate of country *Y* tax is almost as high as the U.S. rate, this difference is not large. As in Case I, the difference would be greater if the effective tax rate in country *Y* were lower.

The facts of Case II fail to highlight an issue with the U.S. system. As noted above, for purposes of the U.S. foreign tax credit limitation, dividends, royalties, and interest from a CFC take their character from the character of the CFC's income, and to the extent these items are traced to general limitation income of the CFC, they are combined with other general limitation income of the taxpayer.⁶³ When this occurs, especially high taxes on some items of general limitation income can be absorbed by limitation created by less highly taxed items. For example, if the taxes deemed paid on receipt of the dividends were 2,800, rather than 1,200, *X Corp.*'s foreign

⁵⁹ Japanese Corporation Tax Act § 22(2) (2007).

⁶⁰ Japanese Corporation Tax Act § 69(1).

⁶¹ Japanese Corporation Tax Act § 69(1), Japanese Corporation Tax Act Enforcement Ordinance § 142.

⁶² Japanese Corporation Tax Act Enforcement Ordinance § 142(6)(7).

⁶³ More specifically, dividends, royalties, and interest from a CFC are treated as general category income to the extent the income of the CFC is general category income. I.R.C. § 904(d)(3).

income taxes for the year would be 2,940 (sum of deemed paid taxes and withholding taxes of 140), but all of them would be creditable. *X Corp.*'s taxable income from foreign sources in this case is as follows:

Dividends from <i>Y Corp.</i>		
Actual dividends	2,800	
Gross-up for deemed paid taxes	2,800	
Less expenses	<u>(560)</u>	5,040
Royalties from <i>Y</i>		
Less expenses	<u>800</u>	3,200
Interest from <i>Y</i>		
Less expenses	<u>400</u>	<u>1,600</u>
Total		9,840

The credit limitation (assumed to be 35% of foreign source taxable income) is 3,444, which is more than the foreign income taxes of 2,940. The pre-credit U.S. tax on the dividends is, however, only 1,764 (35% of 5,040). Of the credit, only 1,764 offsets U.S. tax on the dividends, and the remaining 1,176 offsets U.S. tax on the royalties and interest, which are not taxed by any foreign country. The credit limitation rules are not, in this case, effectively restricting the foreign tax credit to its function of alleviating double taxation.

Producing the results illustrated in the preceding paragraph would normally require a corporate tax rate in country *Y* of 50%,⁶⁴ a rate that is significantly higher than the rate prevailing today in any major country.⁶⁵ However, tax planners have been remarkably successful in splitting foreign income taxes from the income subject to these taxes, allowing U.S. taxpayers to take credit for the taxes while omitting some or all of the underlying income from their U.S. tax returns.⁶⁶ These schemes cause the

⁶⁴ If country *Y*'s corporate tax rate is 50%, *Y Corp.*'s earnings and profits (post-1986 undistributed earnings) are 4,000 (pretax profits of 8,000, less income tax of 4,000), and on receiving dividends of 2,800 from *Y Corp.*, *X Corp.* is deemed to have paid foreign income taxes of *Y Corp.* equal to *Y Corp.*'s post-1986 foreign income taxes (4,000), multiplied by the dividends (2,800), and divided by *Y*'s post-1986 undistributed earnings (4,000). The arithmetic is as follows: $(4,000)(2,800/4,000) = 2,800$.

⁶⁵ See, e.g., Organisation for Economic Co-Operation and Development, OECD Tax Database, http://www.oecd.org/document/60/0,3343,en_2649_34533_1942460_1_1_1_1,00.html#cci (last visited Oct. 4, 2010) (surveying income tax rates in the 30 countries belonging to the OECD).

⁶⁶ One such device is illustrated by *Guardian Indus. Corp. v. United States*, 477 F.3d 1368 (Fed. Cir. 2007). The taxpayer, a Delaware corporation, was sole owner of a

effective rate of foreign income taxes in U.S. taxpayers' returns to be much higher than the rates at which the taxes are actually imposed. Assume income of a U.S. company's foreign subsidiary is taxed at 20% by the subsidiary's home country; all of the subsidiary's foreign income taxes appear on the U.S. parent's return as creditable taxes, but only 40% of the subsidiary's pretax income is included in the parent's return. On the parent's return, the effective rate of foreign tax is 50%, even though the foreign country's tax rate is 20%.⁶⁷

The IRS and Treasury have tried to frustrate these schemes, but they have not yet succeeded in doing so, either in the courts⁶⁸ or by regulations,⁶⁹ and until 2010, Congress provided no legislative solution.⁷⁰ Adoption of a 95% dividends exemption would put an end to most of these schemes because they primarily focus on dividends and equity positions in foreign entities and a dividends exemption would eliminate the foreign tax credit

Luxembourg entity that functioned as a holding company and owned several Luxembourg operating companies. Under Luxembourg tax laws, the holding and operating companies joined together as a consolidated group of corporations. For U.S. tax purposes, the holding company elected to be a disregarded entity, but the operating companies were corporations. The court found that under Luxembourg law, the holding company was solely liable for tax on the consolidated group's income, and it held that under the U.S. regulations (Treas. Reg. §1.901-2(f)(3)), the holding company was therefore deemed to have paid all of the group's Luxembourg taxes. Because the holding company was a disregarded entity for U.S. tax purposes, the taxpayer was deemed to have paid these taxes. Because the operating companies were corporations for U.S. tax purposes, however, the group's income was included in the taxpayer's U.S. taxable income only to the extent that it was realized directly by the holding company or distributed by the operating companies to the holding company as dividends. As a result, the taxpayer was able to take credit against its U.S. tax for all income taxes paid by the group, including taxes on income of the operating companies, but it was subject to U.S. tax on the operating companies' income only to the extent these companies distributed their earnings to the holding company as dividends. Thus, on the taxpayer's U.S. return, the ratio of Luxembourg taxes to Luxembourg income was much greater than the nominal Luxembourg tax rate.

⁶⁷ For example, if the subsidiary's income is 100 and its foreign taxes are 20, the effective rate of foreign tax, as shown in the parent's return, is 20, divided by 40 (40% of 100).

⁶⁸ See *Guardian Indus. Corp. v. United States*, 477 F.3d 1368 (Fed. Cir. 2007).

⁶⁹ Treasury proposed regulations to stop many of the schemes. REG-124152-06, 71 Fed. Reg. 44240 (Aug. 4, 2006). After nearly four years, however, it has not finalized the regulations. For a discussion of the proposed regulations, see 3 BITTKER & LOKKEN, *supra* note 28, ¶ 72.3.

⁷⁰ Congress, in August 2010, enacted a provision, applicable following any "foreign tax credit splitting event," which defers credit for a foreign income tax until the income taxed by the foreign country is included in the U.S. taxable income of the person claiming credit or a related person. I.R.C. § 909, as enacted by Pub. L. No. 111-226, §211, 124 Stat. 2389 (2010). See Staff of Joint Comm. on Tax'n, Technical Explanation of the Revenue Provisions of the Senate Amendment to the House Amendment to the Senate Amendment to HR 1586, Scheduled for Consideration by the House of Representatives on August 10, 2010 at 4 (Aug. 10, 2010), available at <http://www.jct.gov/publications.html?func=startdown&id=3702> (last visited Oct. 4, 2010).

for qualifying dividends. An equally effective, and less radical, solution is to strengthen the limitation rules in order to confine the foreign tax credit more effectively to its role of alleviating double taxation.

The distortions illustrated above arise from combining the royalties, interest, and dividends in the general limitation basket in computing the credit limitation, which occurs as a result of current law's application of look-thru rules to all three types of income. The statutes appropriately characterize dividends from a CFC by referring to the CFC's income. A corporate U.S. shareholder receiving dividends from a CFC is usually allowed credit for foreign income taxes paid by the CFC,⁷¹ as well as foreign taxes imposed on the shareholder's dividend income.⁷² Since the taxes eligible for credit are determined by looking through to the distributing corporation's foreign income taxes, it is appropriate to use a look-thru rule to characterize the dividend income associated with these taxes.

Royalties and interest are quite another matter. It is assumed in Case II that the royalties and interest that *X Corp.* receives from *Y Corp.* are not taxed by any foreign country. This assumption is not unrealistic. For example, the U.S. Model Income Tax Convention generally exempts both royalties and interest from tax in the country of source.⁷³ Under the Model Convention and probably under the domestic laws of most countries, royalties and interest paid to foreign shareholders are treated no differently from royalties and interest paid to unrelated foreign persons. For purposes of the credit limitation, foreign-source royalties and interest received from unrelated persons are included in the separate limitation for passive category income. Because royalties and interest received from CFCs are likely to be taxed at source in the same way as royalties and interest received from unrelated persons, the fundamental policy of the foreign tax credit—to alleviate double taxation—requires that all royalties and interest, whether received from unrelated persons or from related CFCs, should be treated alike for purposes of the limitation, as passive income. If royalties and interest are so categorized, U.S. tax on royalties, interest, and other passive income could only be offset by credits for foreign income taxes on passive income, not credits for foreign income taxes on active business income, such as dividends from an operating subsidiary company.

CASE III

X Corp., which is organized under the laws of and managed in country *X*, manufactures and sells goods in country *X* and elsewhere, directly and

⁷¹ I.R.C. §902 (2006), discussed in *supra* text accompanying notes 25–27.

⁷² I.R.C. §903; Treas. Reg. §1.903-1, discussed in *supra* text accompanying note 24.

⁷³ Model Convention, *supra* note 48, at arts. 11(1), 12(1). The OECD Model also exempts royalties from source taxation, but it allows a tax at source of 10% of interest. OECD MODEL,, *supra* note 1, at arts. 11(2), 12(1).

through subsidiaries. *X Corp.* owns all of the stock of *Z Corp.*, which is organized under the laws of country *Z*, and *Z Corp.* is sole owner of *Y Co.*, which is organized under the laws of and managed in country *Y*. *Z Corp.* also owns exclusive rights to marketing and manufacturing intangibles in all countries other than country *X*. *Z Corp.* licenses to *Y Co.* exclusive rights to use the intangibles in country *Y*, and *Z Corp.* also makes loans to *Y Co.* Royalties and interest under the license and loan are at arm's length rates.

For its first taxable year, *Y Co.* manufactures goods in country *Y* at a cost of 80,000 and sells them to unrelated customers in country *Y* and elsewhere for 100,000. In addition to its costs of goods sold, *Y Co.*'s costs consist of operating costs of 6,000 and royalties and interest paid to *Z Corp.* of 4,000 and 2,000. *Y Co.*, which is treated as a corporation under the tax laws of country *Y*, pays income taxes of 2,400 to country *Y* (30% of its net income of 8,000), and distributes dividends to *Z Corp.* of 2,800. Country *Y* imposes withholding taxes at a 10% rate on the royalties, interest, and dividends that *Y Co.* pays to *Z Corp.*

What are the current income tax consequences to *X Corp.* in country *X* with respect to its direct and indirect investments in *Z Corp.* and *Y Co.* if country *X* is, alternatively, Japan or the United States? What additional tax consequences arise in country *X* if *Z Corp.* distributes dividends to *X Corp.* during the year?

A. The United States is country *X*.

If *Z Corp.* distributes no dividends to *X Corp.*, U.S. tax consequences may only arise under the CFC rules. If considered corporations for U.S. tax purposes, *Z Corp.* and *Y Co.* are CFCs. *X Corp.* is a U.S. shareholder of *Z Corp.* because it owns at least 10% of *Z Corp.*'s voting stock, and *Z Corp.* is a CFC because this U.S. shareholder owns more than 50% of its stock.⁷⁴ Stock held by a foreign corporation is considered held indirectly by the corporation's shareholders.⁷⁵ *X Corp.*, as indirect owner of the *Y Co.* stock held by *Z Corp.*, is a U.S. shareholder of *Y Co.*, and *Y Co.* is a CFC because more than 50% of its stock is held indirectly by a U.S. shareholder.

As a U.S. shareholder, *X Corp.* must include in its U.S. gross income its ratable share (100%) of the subpart F income of both *Z Corp.* and *Y Co.*⁷⁶ Neither CFC, however, has subpart F income. *Y Co.*'s income is from manufacturing and selling goods. One category of subpart F income,

⁷⁴ I.R.C. §§ 951(b), 957(a), discussed in *supra* text accompanying notes 17–18.

⁷⁵ I.R.C. § 958(a)(2) (providing that stock owned by foreign corporation, partnership, trust, or estate is considered owned proportionately by its shareholders, partners, or beneficiaries).

⁷⁶ I.R.C. §§ 951(a)(1)(A), 951(a)(2), discussed in *supra* text accompanying notes 16, 19. A U.S. shareholder's proportionate share is based on stock owned indirectly as well as directly.

foreign base company (“FBC”) sales income, includes income on sales of goods, but only if the goods are purchased from or sold to a related person.⁷⁷ Y Co. may not purchase from or sell to X Corp. or Z Corp.⁷⁸ Moreover, Y Co. manufactures the goods it sells, and income of a CFC on sales of goods that it manufactures are not FBC sales income, even if the CFC purchases materials or components from or sells finished goods to related persons.⁷⁹

Z Corp.’s income consists of dividends, royalties, and interest. A CFC’s dividend, royalty, and interest income is normally included in another category of subpart F income, foreign personal holding company (“FPHC”) income.⁸⁰ However, dividends, royalties, or interest that a CFC receives from another CFC are not FPHC income if the payor and recipient CFCs are related persons and the dividends, royalties, or interest are “attributable to or properly allocable” to income of the payor CFC that is neither subpart F income nor income effectively connected with a U.S. trade or business of the payor.⁸¹ Since Y Co. has no subpart F income and no U.S. trade or business, the dividends, royalties, and interest that it pays to Z Corp. are necessarily attributable to income that is neither subpart F income nor effectively connected income.⁸² Z Corp. thus has no subpart F income.

The provision discussed in the previous paragraph was enacted in 2005 and is nominally temporary, although the circumstances suggest that Congress may extend its life indefinitely by a series of periodic reenactments.⁸³ If X Corp. wants a structure not dependent on this rule, it

⁷⁷ I.R.C. § 954(d)(1).

⁷⁸ X Corp. and Z Corp. are both related to Y Co. because each of them owns all of Y Co.’s stock, directly or indirectly. I.R.C. § 954(d)(3).

⁷⁹ Treas. Reg. § 1.954-3(a)(4). A CFC is considered a manufacturer only if it engages in manufacturing activities through its employees, rather than, for example, hiring a contract manufacturer to do all of these activities. It is assumed that Y Corp. satisfies this requirement. See generally 3 BITTKER & LOKKEN, *supra* note 28, ¶69.5.

⁸⁰ I.R.C. § 954(c)(1).

⁸¹ I.R.C. § 954(c)(6)(A). A person is related to a CFC if the person controls, is controlled by, or is commonly controlled with the CFC. I.R.C. § 954(d)(3), discussed in *supra* text accompanying note 22.

⁸² Whether items are attributable to a payor CFC’s subpart F or effectively connected income is determined by rules used under look-thru rules described above. I.R.C. § 904(d)(3), discussed in *supra* note 63.

⁸³ Under current law, this provision only applies for taxable years of U.S. shareholders beginning during the period 2006–2009. I.R.C. § 954(c)(6)(C). As first enacted, the provision only applied for 2006–2008. Tax Increase Prevention and Reconciliation Act of 2005, Pub. L. No. 109-222, §103(b), 120 Stat. 346 (2006). Congress later amended the provision to apply also for 2009. Emergency Economic Stabilization Act of 2008, Pub. L. No. 110-343, §304, 122 Stat. 3866 (2008). Legislation was introduced in Congress to reenact the provision retroactively to apply for all of 2010, but the extension has not yet been enacted. H.R. 4213, 111th Cong., 1st Sess., §113. As introduced, the bill was a periodic renewal of many temporary provisions.

can avoid subpart F income by an election under the so-called check-the-box rules. Many types of business entities may choose to be classified for U.S. tax purposes either as associations taxable as corporations or as fiscally transparent entities.⁸⁴ A fiscally transparent entity with more than one owner is considered a partnership, and an entity with one owner is “disregarded as an entity separate from its owner.” If an entity is disregarded, its assets, liabilities, and activities are treated as assets, liabilities, and activities of its owner.⁸⁵

If *Y Co.* validly elects to be a disregarded entity, *Z Corp.* is considered owner of all of *Y Co.*’s assets, and *Y Co.*’s liabilities are considered *Z Corp.*’s liabilities. *Z Corp.* is therefore deemed to be both licensor and licensee under the license agreement between *Z Corp.* and *Y Co.* and both lender and borrower on the loan between the two entities. As a result, the license and loan are disregarded for U.S. tax purposes because they are contracts that *Z Corp.* has made with itself. With no license or loan, *Z Corp.* has no royalties or interest income. Also, because *Z Corp.* is deemed to be direct owner of *Y Co.*’s assets, *Z Corp.*’s ownership interest in *Y Co.* is disregarded. The dividends, royalties, and interest that *Z Corp.* actually receives from *Y Co.* are therefore disregarded. *Y Co.*’s income from the manufacture and sale of goods is, for U.S. tax purposes, *Z Corp.*’s only income. As noted above, income of a CFC on selling goods that it has manufactured is not subpart F income.

In sum, *X Corp.* suffers no U.S. tax consequences from its investments in *Z Corp.* and *Y Co.* until it receives dividends from *Z Corp.* On receiving dividends from *Z Corp.*, *X Corp.* is allowed credit for foreign income taxes paid by *Z Corp.* and *Y Co.*, but the credits will not fully insulate the dividends from U.S. tax. For example, if *Y Co.* is considered a corporation, rather than a disregarded entity, for U.S. tax purposes, *Z Corp.*’s post-1986 foreign income taxes are as follows:

⁸⁴ Treas. Reg. § 301.7701-3(a). This choice is open to any business entity, other than one organized in a form that the regulations designate as a per se corporation. Entities organized under the corporation laws of the U.S. state are per se corporations. The regulations designate one entity type under the laws of each of 80 or so countries as per se corporations. Treas. Reg. § 301.7701-2(b). All other entities may choose their U.S. tax classifications. Treas. Reg. § 301.7701-3(a).

⁸⁵ See Treas. Reg. § 301.7701-2(a) (“if the entity is disregarded, its activities are treated in the same manner as a sole proprietorship, branch, or division of the owner”).

Foreign income taxes of <i>Y</i> Co. deemed paid by <i>Z</i> Corp. ⁸⁶		1,200
Country <i>Y</i> withholding taxes (10%)		
Royalties	400	
Interest	200	
Dividends	<u>280</u>	<u>880</u>
Total		2,080

Z Corp.'s post-1986 undistributed earnings are 7,920.⁸⁷ If *Z* Corp. distributes dividends to *X* Corp. of, say, 1,000, *X* Corp. is deemed to pay taxes actually paid by *Z* Corp. and *Y* Co. as follows:

Z Corp.'s post-1986 foreign income taxes		2,080
Multiplied by the dividend received		1,000
Divided by <i>Z</i> 's post-1986 undistributed earnings		<u>7,920</u>
		263

On receiving the dividends, *X* Corp. will have gross income of 1,263 (sum of actual dividends and the deemed paid taxes). If no deductions are allocated to the gross income, it increases *X* Corp.'s U.S. tax liability by 442 (35% of 1,263), of which only 263 is offset by the foreign tax credit.

In sum, U.S. taxation of the income of *Y* Co. and *Z* Corp. that *X* Corp. beneficially owns is deferred until the income is distributed to *X* Corp. as dividends. The income is fully taxed by the United States when it is so distributed.

B. Japan is country *X*.

Japan also has CFC rules.⁸⁸ A foreign corporation is a CFC under these rules if Japanese persons own more than 50% of its stock and either

⁸⁶ This amount is computed as follows:

Y Co.'s post-1986 foreign income taxes		2,400
Multiplied by dividend from <i>Y</i> Co.		2,800
Divided by <i>Y</i> Co.'s post-1986 undistributed earnings		<u>5,600</u>
		1,200

See I.R.C. §902(b) (treating foreign corporation as having paid foreign income taxes actually paid by lower-tier foreign corporations).

⁸⁷ This amount is the income received by *Z* Corp. (royalties of 4,000, interest of 2,000, and dividends of 2,800), less the foreign income taxes that it actually pays (the withholding taxes of 880).

⁸⁸ Act on Special Measures Concerning Taxation § 66-6 (2007). A more literal translation of the Japanese term for a CFC is "specified foreign corporation."

the effective rate at which the foreign corporation is taxed on its income is less than 20% or the corporation's head office is in a country that has no income tax.⁸⁹ For purposes of the CFC rules, including the effective rate calculation, dividends that a CFC receives from another foreign corporation are excluded from the CFC's income if the CFC owns at least 25% of the other corporation when the dividends are received and throughout the preceding six months.⁹⁰ Dividends that a CFC receives from another CFC are also excluded from the CFC's income.

In applying the CFC rules in Case III, Z Corp.'s income consists of the royalties (4,000) and interest (2,000) that it receives from Y Co. Because Z Corp. owns at least 25% of Y Co., the dividends from Y Co. are not included in Z Corp.'s income for this purpose. The only taxes on the relevant income are the withholding taxes imposed by country Y (400 on the dividends and 200 on the interest). The effective rate of tax on the income is 10% (600/6,000). Z Corp. is a CFC because (1) X Corp., a Japanese person, owns more than 50% of its stock and (2) the effective rate of worldwide tax on Z Corp.'s income is less than 20%.⁹¹

A Japanese corporation or a permanent resident of Japan owning at least 5% of a CFC is taxed by Japan on its ratable share of all income of the CFC, after adjustment for the exclusions noted above.⁹² Because Z Corp. is a CFC, X Corp., as sole owner of Z Corp., is required to include all of Z Corp.'s adjusted income (6,000) in its Japanese taxable income. X Corp. is also allowed credit against Japanese tax for the country Y withholding tax on this income.⁹³ Japan does not have rules analogous to the U.S. check-the-box rules. It is thus not possible for X Corp. to escape the CFC rules by causing Y Co. to elect to be a disregarded entity for Japanese tax purposes.

A Japanese shareholder receiving dividends from a CFC can exclude 100% of the dividends from its Japanese taxable income to the extent the dividends are attributable to income of the CFC that is or was taxed to the shareholder under the CFC rules.⁹⁴ If another country imposes a

⁸⁹ Until April 1, 2010, the rate threshold was 25%, rather than 20%. A foreign corporation that would otherwise be a CFC may be exempted from CFC status if it carries on certain business activities. Under 2010 amendments, however, Japanese shareholders of a foreign corporation that would be a CFC but for the business activities exemption are taxed on their ratable shares of some types of income of the foreign corporation, including dividends from companies in which the foreign corporation's interest is less than 10% and royalties under licenses of intangible property that the foreign corporation did not develop.

⁹⁰ Order for Enforcement of the Act on Special Measures Concerning Taxation § 39-15(1)(iv),(2)(xvii).

⁹¹ Also, Z Corp.'s head office may be in country Z, which has no income tax.

⁹² Act on Special Measures Concerning Taxation §66-7(1); Order for Enforcement of the Act on Special Measures Concerning Taxation §39-18(1).

⁹³ Act on Special Measures Concerning Taxation § 66-7(1); Order for Enforcement of the Act on Special Measures Concerning Taxation § 39-18(1).

⁹⁴ Act on Special Measures Concerning Taxation § 66-8(2).

withholding tax on these dividends, the Japanese shareholder may treat the tax as gross expense for Japanese tax purposes.⁹⁵ To the extent attributable to income of the CFC not taxed to the Japanese shareholder under the CFC rules, dividends received from a CFC qualify for the 95% dividends exemption if the recipient is a Japanese corporation that owns at least 25% of the CFC.⁹⁶ Foreign taxes on dividends qualifying for the 95% exemption are neither creditable nor deductible.

In Case III, dividends that *X Corp.* receives from its CFC, *Z Corp.*, are entirely excluded from *X Corp.*'s Japanese taxable income to the extent they are attributable to *Z Corp.*'s royalty and interest income, and the dividends qualify for the 95% exemption to the extent they are attributable to income of *Z Corp.* not taxed to *X Corp.* under the CFC rules (the dividends that *Z Corp.* receives from *Y Co.*). If country *Z* imposed a withholding tax on the dividends, *X Corp.* would be allowed a deduction for withholding tax on the 100% excludable dividends, but a withholding tax on the 95% exempt dividends would be neither creditable nor deductible.

C. Observations.

The analysis of Case III suggests that the United States should not consider adopting a dividends exemption until it injects additional robustness into the CFC rules. Congress enacted these rules in 1962 to deny to U.S. shareholders the ability to defer U.S. taxation of offshore income that escapes taxation abroad through the use of "tax haven" devices.⁹⁷ The structure of *X Corp.*'s foreign investments exhibits clear

⁹⁵ Act on Special Measures Concerning Taxation § 66-8(2).

⁹⁶ Japanese Corporation Tax Act §23-2 (2007).

⁹⁷ S. Rep. No. 87-1881, at 76 (1962), *as reprinted in* 1962 U.S.C.C.A.N. 3297, 3382. According to the staff of the Joint Committee on Taxation, writing in connection with the Tax Reform Act of 1986,

It has long been the policy of the United States to impose current tax when a significant purpose of earning income through a foreign corporation is the avoidance of tax. Such a policy serves to limit the role that tax considerations play in the structuring of U.S. persons' operations and investments. Because movable income earned through a foreign corporation could often be earned through a domestic corporation instead, Congress believed that a major motivation of U.S. persons in earning such income through foreign corporate vehicles often was the tax benefit expected to be gained thereby. Congress believed that it was generally appropriate to impose current U.S. tax on such income earned through a controlled foreign corporation, since there is likely to be limited economic reason for the U.S. person's use of a foreign corporation. Congress believed that by eliminating the U.S. tax benefits of such transactions, U.S. and foreign investment choices would be placed on a more even footing, thus encouraging more efficient (rather than more tax-favored) uses of capital.

evidence of a tax haven device. Z Corp. is incorporated under the laws of a country with no income tax, but it carries on no business operations in that country. Z Corp. owns non-U.S. rights to intellectual property that it does not use but instead licenses to a related person (Y Co.) for use in another country. Z Corp. also loans money to Y Co. The principal effect of this structure is to shift income away from a country in which the group has business operations (country Y) to a country in which the income is not taxed. This effect is the hallmark of a tax haven device.

Two features of U.S. law, explained and illustrated above, allow this shift to occur without triggering taxation under the CFC rules. First, the nominally temporary provision enacted in 2005 removes the subpart F income taint from dividends, interest, and royalties received from another CFC if the items are attributable to income of the payor CFC other than subpart F income.⁹⁸ The argument supporting this provision is that income generated by active business operations of a corporate group should not become subpart F income merely because it is shifted from one member of a group to another. In terms of the policy that Congress expressed in enacting the CFC rules, the answer to this argument is clear: If the shift is accomplished by a tax haven device, having the effect of taking the income out of the tax environment of the underlying business operations and placing the income in a low- or no-tax jurisdiction, the income is precisely the type of item that Congress meant to taint as subpart F income. Congress should allow the 2005 provision to expire.

As shown in Case III, the check-the-box rules can be used to accomplish the same results as those allowed by the 2005 provision. Eliminating unwarranted tax-savings opportunities flowing from the check-the-box regulations is not a simple task.⁹⁹ The Obama administration's 2010 budget included a proposed statutory amendment that would have required Y Co. to be treated as a corporation for U.S. tax purposes.¹⁰⁰

REFORM ACT OF 1986, 964–65 (Comm. Print 1987). *See also* T.D. 8767, 63 Fed. Reg. 14613 (1998) (“one of the purposes of subpart F is to prevent CFCs from converting active income that is not easily moveable and is earned in a jurisdiction in which a business is located for non-tax reasons, into passive, easily moveable income that is shifted to a lower tax jurisdiction primarily for tax avoidance”).

⁹⁸ I.R.C. § 954(c)(6) (2006).

⁹⁹ *See* Lawrence Lokken, *Whatever Happened To Subpart F? U.S. CFC Legislation after the Check-the-Box Regulations*, 7 FLA. TAX REV. 185 (2006) (explaining some CFC loopholes resulting from check-the-box rules and suggesting solutions).

¹⁰⁰ Under the proposal, a foreign entity owned by another foreign entity could elect to be a disregarded entity only if the two entities are organized under the laws of the same country. DEP'T OF THE TREASURY, GENERAL EXPLANATIONS OF THE ADMINISTRATION'S FISCAL YEAR 2010 REVENUE PROPOSALS 28 (2009) (under current law, “locating a foreign disregarded entity under a centralized holding company . . . may permit the migration of earnings to low-taxed jurisdictions without a current income inclusion of the amount of such earnings to a U.S. taxpayer under the subpart F provisions”). Applied to Case III, this proposal would preclude Y Co. from being a disregarded entity because it is not organized in the same

Congress has not adopted this proposal, and the administration did not include the proposal in its 2011 budget,¹⁰¹ perhaps because it concluded that the proposal would not fully address the problem. As presently applied, the check-the-box rules are not consistent with effective CFC rules.

If the U.S. Congress follows the Japanese lead in adopting a dividends exemption for the United States and does not also repair the CFC rules, U.S. companies would be able to achieve tax results that have never been available under U.S. law and that do not occur under Japanese law, even after Japan's adoption of a dividends exemption. If *X Corp.* were allowed a dividends exemption for dividends that it receives from *Z Corp.*, the 10% withholding tax that country *Y* imposed on the royalties and interest received from *Y Co.* would be the only tax imposed on this part of the group's income. With a dividends exemption and no change in the CFC rules, the amounts paid by *Y Co.* to *Z Corp.* as royalties and interest would not be subject to U.S. tax either when *Z Corp.* receives the royalties and interest or when it distributes these amounts to *X Corp.* as dividends. If country *Y* had not imposed a withholding tax on the royalties and interest, the group would have been permanently exempt from tax on this income, worldwide.

As shown above, the dividends exemption recently adopted by Japan does not have this effect. A dividends exemption should be viewed as an alternative method of double tax relief, not as means of avoiding all substantial taxation worldwide. It is not appropriate for the United States unless it is a part of an overall structure that does not allow inappropriate results.

CONCLUSION

U.S. international tax law is deeply flawed. The hypothetical cases analyzed in this article illustrate some of these flaws. Although this conclusion is shared by many analysts of international tax law, including those in government, academics, and industry, these analysts do not agree on the solution to the problem. This article explores a solution that some may see as fundamental reform: Substitution of a dividends exemption for the foreign tax credit as the means of double tax relief for dividends that U.S. companies receive from their foreign affiliates. The article suggests several conclusions.

First, a dividends exemption would ameliorate some of the problems with the current U.S. system. For example, the foreign tax credit rules fail in many contexts to limit the credit to its function of alleviating double taxation, and a dividends exemption, which effectively bypasses the foreign

country as its owner, *Z Corp.*

¹⁰¹ DEP'T OF THE TREASURY, GENERAL EXPLANATIONS OF THE ADMINISTRATION'S FISCAL YEAR 2011 REVENUE PROPOSALS (2010).

tax credit with respect to dividends covered by the exemption, would partially neutralize these inadequacies. However, countries with dividends exemptions typically tax other income on a worldwide basis, with credit for foreign income taxes. Even with a dividends exemption, repair of the credit system is essential.

Second, it is not clear that a dividends exemption is a fundamental reform. The exemption only applies to dividends received by a domestic corporation from a foreign corporation in which the domestic corporation has a substantial interest. Unless a foreign corporation is taxed at rates significantly lower than the U.S. corporate tax rate, the difference between domestic taxation under a credit system and an exemption system is not large. If a domestic corporation's return on its offshore investments includes substantial income other than dividends, such as interest income or royalties, the difference is further minimized.

Third, effective CFC rules are an essential backstop to a dividends exemption. A dividends exemption is intended to be part of a system for alleviating double taxation, not a means of allowing companies to avoid domestic taxation on repatriations of income that has not been subject to substantial taxation anywhere in the world. The U.S. CFC rules have become a leaky ship. They should be repaired. Congressional consideration of a dividends exemption would provide a convenient occasion for making these repairs.

In sum, if a dividends exemption is considered fundamental reform, incremental reforms to the existing foreign tax credit and CFC regimes are an essential precondition of this fundamental reform.