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U.S. Tax Policy and Foreign Investments— Legislative and Treaty Issues

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I. INTRODUCTION

The year 1975 and the actions of the present Congress may determine the course of U.S. international tax policy for some years to come. Policy makers have increasingly used fiscal measures as a tool to achieve economic objectives. It is not surprising, therefore, that our tax structure is perceived by some as a basic factor in determining the allocation of investment resources between the United States and foreign countries. As recently as April 17, Congressman Vanick, a member of the Ways and Means Committee, expressed his concern over the influence of the tax factors on investments:

> Through piecemeal legislative changes stretching over 30 years, the Congress has constructed a "tilt" of our tax laws toward foreign investment and away from domestic investment. As Senator Church has documented in his own investigation of this matter, the tax code currently provides quite strong incentives for an American company to invest abroad. These artificial tax incentives often override substantive economic criteria in a businessman's decision to expand his foreign operations.
>
> In other words, a company may decide to build a manufacturing plant in Europe not because the profit potential alone is more attractive in a foreign plant than it would be with a similar plant built in the United States. Rather, the businessman makes his decision to invest abroad because he knows that profits from his foreign plant will escape substantially or completely U.S. tax.
>
> The implications of this bias in our tax laws are enormous. The basic health and strength of our economy is being slowly drained [and] with the continued tax-induced outflow of investment dollars from the United States American jobs are lost. American business suffers from a shortage of capital. And we have no one to blame but ourselves.[1]

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1. 121 Congressional Record H. 2944 (April 17, 1975) (remarks of Congressman Vanick).

For the reasons I shall develop in this paper, I believe that this emphasis on the relative influence of our tax rules on investment decisions is misplaced.

It is often difficult to find objective analysis in this area, let alone persuasive data on which to base conclusions. Different theories of tax neutrality have been formulated[2] and policy arguments are built around tenaciously held beliefs in these theories.

Moreover, analysis may be influenced by reactions to the facts that multinational enterprises have the ability to shift resources and operations to obtain tax and other advantages; that costs in the form of royalties or rents have been restructured as foreign income taxes to be offset against U.S. taxes; and that some tax advisors frequently stress tax planning with reference to tax havens.

In view of the theories and emotions surrounding these questions, it is appropriate today to consider whether the emphasis on tax factors influencing investment decisions may not be exaggerated—to consider whether in fact investment in this country or abroad, the competitiveness of our exports, and the value of our currency are not more dependent upon other policies and economic factors and whether other tools are not more appropriate to solve perceived problems.

II. IS FOREIGN INVESTMENT GOOD OR BAD?

There can be little quarrel with the economic analysis that a dollar invested in the United States produces benefits for this country in the income and jobs that are generated and in taxes paid to the United States. Taxes and wages are lost when the investment is made abroad. Of less theoretical, but vital concern to Americans affected, are those specific cases in which United States plants have been closed and jobs have been eliminated while the enterprise through its affiliates continues production abroad—in some instances for export to the United States. It is also clear that since we do not generally impose tax upon the undistributed income of a foreign subsidiary which manufactures products abroad, that subsidiary may have a more favorable current after tax rate on undistributed earnings than it would have if located in the United States.

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2. For example, the tax policies have been identified as involving "capital export" neutrality (when the enterprise pays the same total rate of tax on foreign and domestic profits), "capital-import" neutrality (when firms of all nationalities operating in a country pay the same ultimate tax rate on their profits from operating in such country), and "national" neutrality (where the return on capital which is shared between the national government and the taxpayer remains the same whether the capital is located at home or abroad).

Finally, there are arguments that encouraging U.S. private investment abroad also leads us to become involved in the political affairs of other countries. If the U.S. Government encourages such investment, the argument runs, then U.S. companies will expect the U.S. Government to bail them out of political problems arising in foreign countries.

There are counter arguments to each of the foregoing concerns. One fundamental issue concerns the question of availability of capital. Much United States investment abroad is financed out of foreign borrowings and retained earnings and does not represent a perpetual outflow of capital from the United States. Indeed, for every year for the past 24 years the return on U.S. capital invested abroad has exceeded the direct investment outflow from the United States.[3]

3.

U.S. Direct Investment Abroad
[In billions of U.S. dollars]

	Direct investment outflow	Investment income receipts
1950	0.6	1.5
1951	.5	1.8
1952	.9	1.7
1953	.7	1.7
1954	.7	2.1
1955	.8	2.3
1956	2.0	2.6
1957	2.4	2.7
1958	1.2	2.6
1959	1.4	2.8
1960	1.7	2.4
1961	1.6	2.8
1962	1.7	3.0
1963	2.0	3.1
1964	2.3	3.7
1965	3.5	4.0
1966	3.1	3.7
1967	3.1	4.1
1968	3.2	4.5
1969	3.3	5.1
1970	4.4	5.3
1971	4.9	6.4
1972	3.5	6.9
1973	4.9	9.4
1974[1]	4.5	18.0

[1] Estimate.

Source: International Economic Report of the President, transmitted to the Congress, March 1975.

Thus, foreign investment has been a net contributor to the United States balance of payments position and a source of capital. While capital may be short in a given period of time (in that its cost is higher during that period than over the longer term) it is generally possible for American enterprises to have both domestic and foreign investment without foregoing profitable domestic investment. The choice is not clearly either/or.

To the extent that a substantial portion of our exports are made to foreign manufacturing affiliates, it is argued that in many instances we would not be exporting even components but for the existence of the foreign manufacturing investment that went abroad to compete. It is very difficult to make conclusive judgments on this question. In 1973, in a report to the Senate Finance Committee, the Tariff Commission (now the International Trade Commission) reviewed competing claims concerning the effect of foreign investment on domestic jobs and found that the question cannot be answered conclusively. Under assumptions that the study determined to be the most realistic of those considered, it found an overall gain of half a million U.S. jobs.[4]

While we should be strongly in favor of investment in the United States, we cannot assume that if we artificially deter American investment abroad (by punitive tax rates on foreign income, for instance) the potential American investor will necessarily invest his funds in productive capacity within the United States. He may spend his money in a manner that does not return it to domestic investment channels, for example, simply by increasing imports. Nor in a world of tariff and non-tariff barriers, high shipping costs and varying consumer preferences, should we assume that the alternative to foreign investment is likely to be exports. The choice is more often between making foreign investments and simply foregoing foreign business.

With regard to the argument that private investment abroad entails U.S. interference in the political affairs of countries, it is important to recognize that American companies operating abroad are neither better nor worse than individuals or governments. Their conduct is sometimes desirable and sometimes undesirable. Our recent involvement in Southeast Asia cannot be attributed to the influence of American private investment. Meanwhile, most developing countries themselves still seek to attract the managerial and technological knowledge of the multinational enterprises.

Among intangible factors, the international scope of United States industry makes it compete more effectively. In a competitive

4. SENATE FINANCE COMM., 93D CONG., 1ST SESS., IMPLICATIONS OF MULTINATIONAL FIRMS FOR WORLD TRADE AND INVESTMENT AND FOR U.S. TRADE AND LABOR 56, 669-72 (Comm. Print. 1973).

system, we should benefit as consumers.

The ability of U.S. and foreign multinational enterprises to bring technology and consumer products to all areas of the world on competitive terms makes a positive contribution to world welfare and stability.

To the extent the mobility of these enterprises is of concern, the issue is broader than tax planning strategy. Indeed, the multinational enterprises are probably subject to more government regulation as to their tax liability than to other important aspects of international investment, *e. g.*, their employment policies. As for manipulation of credits, income and deductions, including the use of tax havens, these are the types of abuses that arise domestically as well, and can be corrected by selective legislation and improved administration.

There are both advantages and disadvantages to foreign investment by United States based enterprises. On balance, foreign investment appears desirable. This is the stated position of the Administration and the implied position to date of the Congressional tax writing committees. The arguments about our tax system are primarily over what the proper balance should be in our tax structure with respect to foreign and domestic investment. In the post-World War II period, U.S. policy deliberately encouraged private U.S. investment abroad. We are currently in a period in which the question is raised as to whether we should make foreign investment less attractive.

Because the world contains a multiplicity of tax and accounting systems, our tax structure simply cannot be neutral both at home and abroad. If we tax all U.S. investment abroad currently at the U.S. rate, we place some U.S. investment at a competitive disadvantage relative to other investors in foreign countries, whether they be local investors or investors from third countries. If we do not impose a full U.S. tax on undistributed earnings, then some U.S. enterprises operating abroad will pay a lower current tax on their undistributed earnings than they would pay operating in the U.S.

What we should hope to produce are rules minimizing the making of investment decisions on the basis of tax factors, but designed with the realization that there are practical limitations to any rules or concepts and that there are such limitations in administering a tax system that tries to fine-tune our tax laws with a hundred or more other tax systems.

III. TAX STRUCTURE CONSIDERATIONS

A. *The Foreign Tax Credit*

The United States has unilaterally relieved international double taxation as a tax credit country since 1918. The foreign tax credit is now under strong attack by some as a giveaway of tax revenues or a gimmick for avoiding United States taxes.

Acceptance of the principle of the tax credit requires an understanding of the mechanics. The credit is available only where an income tax has been paid somewhere. It operates mechanically to give the taxpayer a credit against United States taxes on foreign source income in the amount of the foreign taxes already imposed upon that foreign source income, but not in excess of the U.S. tax on it. Therefore, if the foreign income tax on corporate profits is less than the United States tax, for example 30 percent, we will collect an additional amount of $18 per $100 profit to bring the total tax collection up to 48 percent, the U.S. corporate tax rate. However, if the foreign tax rate on foreign income is higher than the United States tax we will give a credit up to our 48 percent tax on the foreign source income. In that case we will not collect additional tax. The excess credit does not reduce United States tax on United States source income.

Repeal of the foreign tax credit (*i.e.*, conversion to a deduction) holds out the promise of vast tax revenues, perhaps as much as $8 billion. But this is a short term revenue gain since the consequences of double taxation at rates in excess of 75 percent would quickly lead to the selling off of foreign investment by U.S. owners[5] and the consequent replacement of U.S. investment by foreign controlled multinationals.

The tax credit is not a perfect instrument. There are problems concerning the application of the credit on a per-country or overall foreign basis and the effect of losses incurred abroad which shall be discussed later in contemplating possible changes in our tax structure.

B. *Deferral*

The other major consideration in foreign tax policy is so-called "tax deferral," under which, as a general rule, the income of a corporation is not treated as having been received by the shareholders until it is distributed to them. In the foreign area this means that, if a United States investor establishes a foreign corporation, the United States will generally not tax the income of the foreign corporation

5. For repeal of the foreign tax credit to be effective, it would be necessary to tax undistributed earnings of foreign subsidiaries currently, since ending the credit would otherwise discourage dividend repatriation. Outside of the mineral (including oil) and banking industries, most U.S. companies invest abroad through foreign subsidiaries.

The double taxation impact of turning the tax credit into a deduction can be illustrated by the example of $100 corporation income earned by a U.S. corporation in Canada and taxed at a 50 percent rate in Canada. A deduction for the $50 Canadian tax would leave the remaining $50 subject to tax at 48 percent in the United States. The corporation would pay an additional $24 of U.S. tax for a total of $74 tax on each $100 of corporate income. That would be an effective rate of 74 percent. If the remain-until that income is distributed as a dividend or until there is a sale or disposition of the stock of the foreign corporation. We have exceptions to this rule in the case of foreign tax haven corporations used as incorporated pocketbooks, as holding companies or as devices to accumulate trans-shipment selling and service profits.

From a revenue standpoint, the tax deferral issue is less significant than the repeal of the foreign tax credit. In the case of deferral, revenue estimates, following tax increases in the recent 1975 Tax Act, suggest that the revenue gain from current taxation of the net earnings of U.S. controlled foreign subsidiaries would be under $365 million[6]—less than 8/10 of one percent of estimated 1976 corporate U.S. income tax revenues.[7]

While ending deferral would have a relatively small effect on revenue, the fact that United States enterprises would be paying tax on a different schedule from that of competing local industry in foreign countries would strongly affect specific investments. For example, the benefits of rapid depreciation deductions available in the United Kingdom for U.S. taxpayers would be eliminated for U.S. owned enterprises, which would pay U.S. taxes currently under a different depreciation schedule. There would be dividend policy problems in distributing income to meet increased tax payments by United States shareholders in foreign joint ventures with minority foreign interests. The distributions would attract foreign withholding taxes that would reduce the U.S. revenue gain. There would also be complications in countries having exchange controls and blocked funds.

There is also a question of equity that is frequently ignored as to whether in taxing undistributed income currently, foreign losses would be netted with foreign income within the same controlled group to determine how much tax was owed by the U.S. shareholders. Indeed, rather than merely netting foreign losses against foreign gains and imputing net income to U.S. shareholders, should not overall foreign losses of foreign subsidiaries be deductible against U.S. source

ing $26 were taxed when distributed to shareholders, at say 35 percent, the result would be an effective tax rate on distributed corporate income of 83 percent.

6. Estimated 1976 revenue gains from taxing the undistributed earnings of U.S. controlled-foreign corporations may be in the neighborhood of $1.2 billion if losses of controlled corporations are not netted against the profits. If the losses are netted against the profits, the gain would be reduced to approximately $365 million (Preliminary Treasury estimates). (These figures assume that gross-up would be required for dividends from less developed country corporations.) There is also the strong possibility that corporate operations would be re-arranged so that additional foreign taxes are paid to foreign governments and the U.S. revenue gain reduced by the resulting foreign tax credits.

7. Fiscal 1976 corporation income taxes were estimated at $47.7 billion. Budget of the United States Government, fiscal year 1976, at 55.

income, just as undistributed income would be taxable? This step, however, would place the U.S. revenue base at a greater risk of adverse international economic developments.[8]

Current taxation of undistributed earnings would impose a major administrative burden on the I.R.S., since it would be required to audit the returns of thousands of controlled foreign corporations on a current basis.[9]

Finally, proposals to apply U.S. income taxes to the undistributed income of all U.S.-controlled foreign corporations would undoubtedly lead in time to greater efforts to avoid U.S. control status ("decontrol") and operate in joint venture form abroad. It would simply not be possible to tax U.S. shareholders on the undistributed earnings where there was no U.S. control. A significant number of U.S. taxpayers would still have a share of foreign earnings not subject to current U.S. tax.

Despite the practical problems involved, current taxation of undistributed earnings would make sense if a critical national interest were involved.[10] But does this issue in fact have the importance typically assigned to it? What weight should be given to the advantage

8. This would also be true if rather than imputing foreign earnings to the controlling U.S. shareholders, foreign corporations were required to file consolidated returns with their U.S. parent (for example, to obtain a foreign tax credit).

9. Some of these same administrative problems exist today. The practical problem of audit and administration is a matter of degree. Thus, U.S. controlled foreign subsidiaries are required to file annual information returns reporting income data under U.S. tax accounting standards. When dividends are paid, the earnings computation and the foreign tax credits claimed must be reported according to U.S. rules. There is, of course, some discretion as to the timing of such payments. It is not a question of sustaining a U.S. tax liability under all circumstances each year.

The Subpart F tax haven rules impose a requirement that controlled foreign corporations determine the relative percentage of Subpart F income they may have, if any. The reduction of the de minimis safe-haven to permit only 10 percent of a controlled foreign corporation's gross income to be tax haven income makes this an important calculation and will increase the importance of precision in the calculations on information returns by controlled foreign corporations. On the other hand, these imputation-of-income rules involve certain defined categories of income. The rules become a deterrent to the creation or operation of an organizational structure producing tax haven income and hence efforts will be made not to produce such income and current U.S. taxation will not occur.

10. If foreign earnings were taxed currently, domestic exporters could not contend that they are being discriminated against. From a structural standpoint also there are some advantages in consolidation of foreign and domestic earnings. There would be somewhat less pressure on our arm's-length allocation rules and the administration of non-recognition provisions of the Code on transfers and reorganizations involving U.S. shareholders and foreign corporations. On the other hand, the major problem of allocation of expenses between United States and foreign source income for tax credit purposes would remain.

of deferral? As a practical matter, foreign tax rates are in fact quite high in the aggregate, particularly where withholding taxes imposed on dividend distributions are included.[11]

Total U.S. revenue from taxing all foreign source income of U.S. corporations in 1972 was approximately $1.2 billion when U.S. controlled foreign corporations distributed more than 50 percent of their earnings. However, of the revenue collected, only an insignificant part was received from U.S. tax imposed on foreign dividend distributions, since those distributions in most instances carried a credit for foreign taxes already imposed equal to or in excess of the U.S. corporation's income tax. On total taxable earnings for that year of $14.5 billion, U.S. controlled foreign corporations paid some $6.7 billion in foreign corporate income tax, for a 46 percent foreign income tax rate. (The net U.S. tax revenue was basically on service fees, royalties, interest payments and export income.)

Current taxation of all earnings would adversely affect some investment, such as tax-free U.S. controlled foreign flag shipping, and would have some impact on specific operations, but would probably not be a major deterrent to continued foreign investment. In this sense, given the foreign tax credit, current taxation would not be the end of the world for U.S. investment abroad, as some have tended to suggest, particularly if it were done fairly. On the other hand, the considerations enumerated should make us pause before we substantially rearrange our tax rules in pursuit of a theoretical standard of domestic neutrality and a kind of legislative tidiness.

C. *Recent and Prospective Changes*

The net balance of present tax rules and likely further changes already represent a shift in favor of domestic rather than foreign investment. If there is a "tilt" in our tax system it is in favor of domestic investment. Our accelerated depreciation rules are more favorable for domestic investment. The DISC reduces tax revenues over $1 billion a year for exports if the production is located in the United States, and the investment credit, as further increased this year, reduces U.S. taxes in 1976 by some $8.7 billion for investment in capital assets used in the United States. We should compare this with the $365 million that would be obtained from changing our rules to tax the undistributed earnings of U.S. controlled affiliates currently. Deferral is "permanent" for only a portion of foreign earnings and is simply a postponement of U.S. taxation on the rest. This is an imperfect offset to major incentives for investment in the U.S.

11. We should note, conversely, that there are many instances where our effective domestic tax rates fall below 48 percent on domestic income.

Indeed, when one looks at the specific reform provisions that are being proposed, there is little neutrality in them—foreign losses of subsidiaries would not be netted against taxable gains, the investment credit and ADR (accelerated depreciation rules) do not apply to foreign investment, and consolidated returns for subsidiaries generally are not allowed.

The preceding analysis does not mean, however, that some changes are not overdue or that the foreign area should not be subject to careful review. The Congress has already acted this year to tighten substantially the tax haven rules first enacted in 1962 and to affect significantly the taxation of foreign oil operations of United States enterprises.

The Tax Reduction Act of 1975 eliminated a provision called "minimum distributions" which permitted United States companies with foreign operations to average their foreign tax rates to shelter a portion of foreign source tax haven income from current taxation. U.S. corporations were also entitled to have up to 30 percent of the gross income of a controlled foreign subsidiary in the form of tax haven income before any of the tax haven income became subject to current U.S. taxation. This amount was reduced to a de minimis 10 percent of gross income. In addition, a minor provision permitting the reinvestment of tax haven income in so called "less developed country corporations" was repealed and foreign profits of U.S. controlled foreign flag shipping corporations, which are largely untaxed throughout the world, will henceforth be treated as tax haven income unless reinvested in shipping assets by the controlled foreign corporations.

In addition, the oil income of U.S. companies must now be computed on an overall tax credit limitation with a limitation on the maximum amount of tax paid to foreign oil producing countries that is currently creditable or will be so in future years. Rules were also adopted to recapture overall foreign losses currently deducted against United States income by reducing foreign tax credits claimed in later years when the foreign operations become profitable.

D. *What Might We Anticipate?*

Foreign Tax Credit. One can anticipate that the tax credit will be continued as a fundamental element of U.S. tax policy. It is possible, however, that its application may be limited in some respects and the computation of the credit further fragmented among different types of income.[12] The possibilities include:

12. Separate computations of the tax credit must now be made with respect to interest income, DISC dividends, and income from mineral products subject to percentage depletion.

(a) Review of the present per-country and overall methods of computing the tax credit limitation. Taxpayers today have a choice of treating their foreign income and tax credits on a country by country basis or aggregating the total foreign income and credits. The former permits undiluted tax credits for income from high tax countries while losses from other countries may be deducted against U.S. source income. The overall method permits the averaging effect of foreign taxes imposed in a country with taxes higher than the U.S. with low taxed foreign income to shelter the latter from U.S. taxation. The Congress may determine that taxpayers should have only one method of computing the tax, for example, under the per-country limitation (perhaps with a recapture rule for foreign losses against United States income)[13] or an overall tax credit limitation. At one time, the tax credit was applied by computing the credit under both methods and the taxpayer was limited to the method resulting in the lower credit under the two methods;

(b) a separate limitation of the credit for capital gains income, which is taxed at a lower rate by the United States than ordinary income;

(c) a requirement that dividends from less developed country corporations be calculated in the same manner as those from developed countries. At the present time LDC dividends need not be grossed-up for U.S. tax by the amount of foreign tax that was paid on them—an advantage or not, depending on the foreign tax rate;

(d) a broadening of loss recapture rules applied this year to foreign losses on oil exploration and drilling deductions taken against United States income but followed by credits for foreign taxes on the profits in subsequent years; heretofore the United States has borne the losses as a reduction of U.S. income and foreign governments have collected all of the tax when the operations become profitable.

Deferral. It is difficult to predict whether the deferral will be modified. The substantial tightening of the Subpart F tax haven rules this year, which will raise in excess of $225 million in 1976, may satisfy the goal of increased tax equity. The fact remains, however, that in a number of countries tax holidays are given for the establishment of manufacturing facilities. (Indeed this practice is followed

13. Adoption of an effective per-country limitation would require a significant change in the United States source of income rules. As was recognized when the overall limitation was adopted in 1960, the averaging effect of foreign income and taxes can be obtained by incorporating a foreign holding company into which all foreign income flows. Under present rules, dividends paid by the holding company are considered to have their source in the country in which the foreign corporation is incorporated and all foreign income taxes paid are considered to be income taxes imposed by that country for tax credit purposes. Our source rules, including the passage of title test on the sale of goods, would create complex tracing problems if taxpayers were required to determine the country source of income for every transaction, particularly through tiers of corporations. In theory, this problem now exists for a branch operation that is on the per-country method, but most U.S. operations abroad are in subsidiaries. To reduce the potential complexity, it might be necessary to adopt a rule that attributed income to a foreign country if the income is "effectively connected" with an establishment in that country rather than depending on source rules. All of the consequences of such a modification in the tax structure could not be clearly foreseen in advance.

under the tax laws of some of our states and possessions.) Some highly visible industries have moved into these areas combining tax advantages and low labor costs. This remains the single most politically significant aspect of international corporate tax practices.[14] There are arguments that such incentives are not of major significance, that they phase themselves out over time, that the same result can be obtained by non-tax measures, and that if U.S. companies do not take advantage of them, multinational enterprises of other nations will, both to compete in the domestic U.S. market and to displace U.S. exports. All of this may be more or less correct, but it is difficult for a Congressman to explain to his constituents who have just seen a typewriter or electronics plant close down in his district while production is continued in a foreign country.

Investment Incentives. There are understandable domestic policy reasons for a country to encourage captial investment in depressed areas. Incentives to overcome the costs of doing business in such areas may take the form of tax and non-tax measures. The United States tax system generally permits U.S. companies to take advantage of such provisions by incorporation abroad. In many instances the economic progress of these areas will ultimately result in the phasing out of the development incentives. However, the existence in one country of subsidies that may attract investment away from another country is an inherently destabilizing element in relations among countries. All capital exporting countries have some interest in the effect of such incentives on their own industries and domestic jobs, and it would be desirable to have some ground rules concerning such economic aids. Indeed the Treaty of Rome calls for the development of standards for

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14. In 1973 the Treasury Department proposed that termination of deferral might be imposed (a) in those cases in which foreign countries provided tax holidays for manufacturing and (b) in the case of United States controlled investments in countries with low taxes where a substantial portion of the production of the foreign investment was exported to the United States. The Treasury suggested that exceptions could be made by treaty.

The 1973 Tariff Commission report to the Senate Finance Committee found that:

> Although foreign direct investment by the "runaway firm" which is interested principally in evading high production costs in the United States, represents but a small proportion of total U.S. direct investment overseas, it is common enough to have raised important social questions—especially for labor in the affected industries. Two essential characteristics delineate the kinds of industries in which developments of this sort are likely to occur: (1) the industries are generally labor-intensive ones in which labor costs represent a high proportion of the value of output; and (2) foreign investment to serve *foreign* markets is minimal (most or all of the output produced abroad being returned for sale in the U.S. market).

See *supra* note 4, at 115-16.

such economic aids within the member countries of the European Economic Community.[15]

Special Status Provisions. In addition to a continuing Congressional review of basic U.S. tax rules is the likelihood that certain special provisions of the Internal Revenue Code will be repealed or substantially modified. These areas include specifically:

> (a) *Western Hemisphere Trade Corporations.* Domestic corporations taxed at a lower rate than our ordinary corporate tax rate have arguably reached the end of the road as part of our tax structure. Originally heavily involved in foreign mining ventures and later including export operations, Western Hemisphere Trade Corporations have been declining in use in view of increased foreign tax rates, foreign expropriations and alternative methods of doing business. At the end of the 1974 session, the Ways and Means Committee reported a bill that would have phased them out.
>
> (b) *Sections 911 and 912.* Section 911, which provides an earned income exclusion for non-governmental employees overseas, and Section 912, which provides an exemption for certain government allowances overseas. The bill reported out by the Ways and Means Committee in 1974 contained provisions that would phase out those sections. The Treasury Department has been reviewing with the Joint Committee Staff the question of whether there are special costs incurred in foreign employment that would merit statutory deductions if the Congress repeals these exemptions.
>
> (c) *Less Developed Country Corporations.* In addition to the likelihood that dividends from LDC corporations will bear a tax credit under the same mechanics applicable to corporations operating in developed countries, the statutory concept of distinguishing between developed and less developed countries for limited tax purposes may be removed from the Code.
>
> (d) *DISC.* In the form of DISC (Domestic International Sales Corporation) provisions, the 1971 Revenue Act placed a substantial United States export incentive in the Code. A flexible exchange rate system and

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15. Article 92 of the Treaty of Rome states that any aid granted by a member of the European Economic Community in any form which "distorts or threatens to distort competition by favoring certain undertakings or the production of certain goods" is incompatible with the Common Market "insofar as it affects trade between Member States." Certain aids "may be" considered to be compatible with the Common Market. These include:

> (a) aid intended to promote the economic development of regions where the standard of living is abnormally low or where there is serious underemployment;
>
> (b) aid intended to promote the execution of an important project of common European interest to remedy serious disturbance in the economy of a Member State;
>
> (c) aid intended to facilitate the development of certain economic activities or of certain economic regions, where such aid does not adversely affect trading conditions to an extent contrary to the common interest . . . ;
>
> (d) such other categories of aid as may be specified by the Council by qualified majority decision on a proposal from the Commission.

> a substantial realignment of the U.S. dollar reduce the need for special export and balance of payments measures. A number of economists now argue that DISC is no longer appropriate. (This analysis also applies to weaken the argument that we should increase U.S. taxes on U.S. investments abroad.)[16]

There are a number of conflicting arguments and unsettled questions concerning export policies. Unlike the U.S., most foreign countries do not tax the profits of intermediary foreign selling subsidiaries.[17] To what extent should DISC and foreign export laws be considered together as a subject for multilateral negotiations? Are we assured that a truly flexible exchange rate system will continue and what assumptions should we make about its nature and effect?

To what extent does a continuously devaluing dollar result in a worsening of our ability to import in real terms and permit other countries to purchase U.S. goods at a bargain? It is argued that optimum exports under a system of flexible exchange rates can be

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16. If "floating," "flexible," or "managed" exchange rates mean that we need not reduce our corporate tax burden on exports in order to be more competitive, the same reasoning suggests that we need not increase our taxes on U.S. investment abroad, since exchange equilibrium levels will adjust for any tax incentives given to encourage investment exports.

17. Most developed countries do not tax the undistributed earnings of foreign subsidiaries. Whether a corporation is foreign or not may depend upon the place of incorporation (as in the United States) or upon the place where management and control is exercised (the United Kingdom). Since enactment of the tax haven income provisions of the Revenue Act of 1962 in the United States, only Canada and West Germany have enacted provisions influenced by that legislation. Both are somewhat less stringent. The Canadian legislation is limited to the current taxation of passive investment income and royalties accumulated in a foreign holding company controlled by Canadians. It does not apply to sales or service income. Canada in fact has very liberal rules on the tax free return of income from a controlled foreign operating company. Originally by statute, and now by treaty, if more than 25 percent of the stock of a foreign affiliate is Canadian owned then dividends distributed by the affiliate are tax free in Canada without regard to taxes imposed in the foreign country.

In the case of Germany, provisions dealing with the current taxation of passive income and of the income of foreign sales subsidiaries were introduced by the German Government. Upon final enactment, the selling company income rules were made applicable only in the case of sales of German exports (and not, for example, on sales by a controlled foreign manufacturing subsidiary into another country through a tax haven) and the rule was made applicable only where there was no economic substance in the foreign selling subsidiary.

It is not unusual in some foreign tax systems (*e.g.*, France) to exempt foreign source income both in the form of dividends from foreign affiliates and also branch profits (where there is a full cycle of economic activities in a foreign branch). While suggestions are made from time to time that the United States should adopt an exemption system, it is highly unlikely that there would be acceptance in the Congress of the principle that United States taxpayers could remain wholly tax free on their income merely by operating abroad, even though an exclusion of both foreign income and deductions might not represent a significant revenue loss.

obtained only if U.S. firms respond to changing rates. It is doubtful that we export at such an optimum rate. It is estimated that 92 percent of U.S. manufacturing firms have no regular export business. The United States exports about 14 percent of the total goods produced domestically as compared with 32 percent for France, 33.6 percent for Japan, 37.8 percent for Germany, 51.3 percent for the United Kingdom, and 73.8 percent for Canada. Finally, as a matter of tax structure, if deferral is retained for foreign manufacturing, should export profits be taxed in all cases at the U.S. rate, or is this again, like the termination of deferral, largely a question of conceptual tidiness?

IV. THE TAX/TRADE CONTEXT

The action taken to date and the most likely further changes do not represent a massive assault on foreign investment or real impediments for conducting international business such as would occur from repeal of the foreign tax credit. This being said, there remains genuine concern about the relative advantages of foreign and domestic investment. What can we propose to meet those concerns?

I began by referring to the emphasis placed in recent years on our tax structure as a factor in investment decisions. This approach is found in a number of proposals, the best known being the Burke/Hartke bill introduced in 1971. Although it dealt with trade matters, it emphasized taxes as having an equal or greater impact than trade rules on foreign investment. These views are echoed in statements today.

This emphasis on the tax structure is not a reasonable perspective as evidenced by events. Changes in international monetary policy, eliminating the trading burden of an over-valued U.S. dollar, have had a vastly greater effect on U.S. exports than could be obtained through changes in our tax laws. Two successive dollar devaluations made it possible for U.S. exports to share in a world-wide explosion of trade. U.S. exports, which had been increasing for several years at about an 8 percent rate, increased 13 percent in 1972, 44 percent in 1973, and by 38 percent in 1974. Meanwhile U.S. enterprises no longer have the prospect of buying up foreign subsidiaries with over-valued U.S. dollars.

United States strategy in maintaining domestic investment and in exporting should rely primarily upon the development and improvement of international trading rules, and not upon unilateral changes in our income tax laws. We have our own dumping and countervailing duty laws, strengthened by the Trade Act of 1974, and we are participants in the General Agreement on Tariffs and Trade and the multilateral trade negotiations that are now underway.

With respect to imports, it is our trade laws and not our tax laws that can provide an even-handed approach to products manufactured outside the United States whether by U.S. controlled foreign corporations or by foreign controlled foreign corporations. Our countervailing duty laws may be invoked to counter foreign tax incentives applied to exports to the United States regardless of where manufactured or by whom. The Trade Act of 1974 specifically directed the President to seek reform of the GATT or to negotiate other agreements to promote a fair economic system, including "any revisions necessary to define acceptable forms of subsidies to industries producing products for export and to attract foreign investment." The right of access to our markets should be developed as a bargaining element in securing fair rules.

V. FOREIGN INVESTMENT IN THE UNITED STATES

The United States should continue to maintain an open investment policy. For the same reasons that we desire domestic investment by U.S. industry, we should maximize the ability of foreign investors to place their investments in the United States. Shakespearian advice notwithstanding, we are both a lender and a borrower and we should promote the development of and participate in international capital markets.

The tax element here is important, but again should be placed in perspective. Whether we are talking about U.S. investors or foreign investors, a stable climate for investment, including productive labor, reasonable costs of capital, and moderate inflation rates is ultimately more conducive than other factors to investment decisions favoring the United States.

VI. TREATY POLICY

Implications for tax treaty policy flow from the foregoing analysis.

1. Artificial tax incentives for U.S. investments abroad are inappropriate by treaty. For a number of years, less developed countries have sought to obtain tax concessions from the United States in the form of "tax sparing," so that even if the foreign country does not impose its income tax on local investment, the United States would give a credit for the hypothetical foreign taxes that were "spared." The Senate rejected such treaty provisions. Our present tax system does permit U.S. companies to reinvest funds used in the business abroad until they are repatriated. This prevents outright frustration of limited tax incentives offered by developing countries while insuring ultimate U.S. taxation of distributed profits. If the Congress moves to the general taxation of undistributed foreign earnings of

U.S. controlled foreign corporations, consideration should be given to authorizing negotiated treaty exceptions for developing countries. Otherwise, given the tax benefits now available only for U.S. investment, we could create a tax disadvantage to investing and developing countries.

2. Our tax treaties must insist upon proper allocation of income and expenses between U.S. companies and their foreign branches or affiliates so that each country receives its fair share of revenues and permits reasonable deductions.

3. We believe strongly in the treaty principle of nondiscrimination for foreign investors and for our investors abroad. This is of particular importance in reviewing the changes in the laws of a number of developed countries to integrate their corporate and shareholder taxes. As a matter of long range policy we do not believe that these provisions should be adopted to discriminate against foreign investors.

4. In the past our tax treaties have tended to be negotiated apart from other economic consultations and arrangements. Recently, however, there has been a trend toward establishing joint economic working groups with other countries, and our tax treaties should be seen as merely one more tool in the context of overall cooperation in an interdependent world. The tax treaties provide advantages for the United States as well as for our trading partners in determining a fair allocation of income and deductions and in providing a mechanism to exchange information and to resolve the tax problems of enterprises conducting business in both countries. Our treaties should be negotiated in the light of our desire to expand commerce with other countries and to assure fair treatment on both sides.

VII. CONCLUSION

In the 1930's, during the economic depression in this country, efforts were made to impose greater tax burdens on the foreign investments of U.S. companies.[18] Then, as now, advantages through differ-

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18. See *e.g.*, SUBCOMMITTEE OF THE COMMITTEE ON WAYS AND MEANS, 73D CONG., 2D SESS., PRELIMINARY REPORT RELATIVE TO METHODS OF PREVENTING THE AVOIDANCE AND EVASION OF THE INTERNAL REVENUE LAWS TOGETHER WITH SUGGESTIONS FOR THE SIMPLIFICATION AND IMPROVEMENT THEREOF 9-10 (Comm. Print. 1933).

> Your subcommittee recommends complete elimination of the provision of the present law (sec. 131, Revenue Act of 1932) allowing foreign income taxes to be credited against federal income tax. The present provision discriminates in favor of American citizens and domestic corporations doing business abroad as compared with those doing business in this country.

The recommendation was opposed by then Acting Treasury Secretary Morgenthau. STATEMENT OF THE ACTING SECRETARY OF THE TREASURY REGARDING THE PRELIMINARY REPORT OF A SUBCOMMITTEE ON WAYS AND MEANS, at 11-12 (1933).

ences in U.S. and foreign tax structures were cited as an encouragement to foreign investment. These issues were heatedly debated in 1961 and 1962, resulting in the compromise foreign tax haven provisions of the Revenue Act of 1962, recently tightened by the 1975 tax legislation. The implications of this history seem to me relatively clear. Going beyond our unilateral review of the U.S. tax structure, we must encourage a greater focus by the Organization for Economic Cooperation and Development (OECD) and more broadly based organizations such as the General Agreement on Tariffs and Trade (GATT) on the harmonization of general principles applicable to the granting of tax incentives to attract investment and to encourage exports. The alternative to international standards of conduct is to witness continued efforts, varying with transitory economic cycles, by all countries, including the United States, to alter their income tax laws to encourage exports, to induce domestic investment by foreigners, or to restrain foreign investment by their nationals.