The Tax Lawyer

VOL. 59
NO. 3
SPRING 2006

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Published by
Section of Taxation, American Bar Association
in Collaboration with the
Georgetown University Law Center

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66 YEARS OF PUBLIC SERVICE

REPORT OF THE TASK FORCE ON INTERNATIONAL TAX REFORM*

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CHAPTER 4: ALTERNATIVES FOR REFORM OF THE INTERNATIONAL TAX RULES: EXEMPTING FOREIGN INCOME AND CURTAILING DEFERRAL

I. DEFICIENCIES OF CURRENT INTERNATIONAL TAX RULES

The discussion and analysis in the preceding Chapter 3 leads to the conclusion that the existing U.S. rules for taxing foreign income do not achieve objectives of fairness, efficiency and administrability. They also do not raise material U.S. revenue. As the Staff of the Joint Committee on Taxation has observed:

> The present-law system thus creates a sort of paradox of defects: on the one hand, the system allows tax results so favorable to taxpayers in many instances as to call into question whether it adequately serves the purposes of promoting capital export neutrality or raising revenue; on the other hand, even as it allows these results, the system arguably imposes on taxpayers a greater degree of complexity and distortion of economic decision making than that faced by taxpayers based in countries with exemption systems, arguably impairing capital import neutrality in some cases.[141]

Some suggest that the solution to this "paradox of defects" is basic reform in key elements of the rules. The Joint Committee Staff and President's Advisory Panel each have proposed consideration of a dividend exemption system in lieu of a foreign tax credit for taxing active foreign income.[142] Both proposals would retain subpart F, but do not propose changes to address its deficiencies.

The Joint Committee Staff highlights several "reasons for change" in support of exemption. These reasons include:

> (1) The timing of U.S. taxation upon repatriation of CFC earnings creates incentives for CFCs to re-deploy low-foreign-taxed earnings abroad;
>
> (2) Payment of U.S. tax on foreign-source business income is substantially elective because repatriation of the earnings is elective;
>
> a. deferral can be unlimited in time, and
>
> b. cross-crediting of high- and low-taxed earnings such as royalties may eliminate the residual U.S. tax; and
>
> (3) The result of the U.S. rules may be that taxpayers have to contend with greater complexity, and engage in greater tax-distorted planning than competitors from exemption countries, yet still be taxed at rate greater than local and third-country taxpayers.[143]

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[141] JOINT COMMITTEE STAFF, OPTIONS, *supra* note 17 at 189. The President's Advisory Panel Report similarly criticizes current law; however, it emphasizes the burden of complexity and that other countries employ exemption. That Report also makes an efficiency argument for exemption that is not developed. PRESIDENT'S ADVISORY PANEL REPORT, *supra* note 4, at 132.

[142] *Id.* Others have described exemption proposals as well. *See* Michael J. Graetz & Paul W. Oosterhuis, *Structuring an Exemption System for Foreign Income of U.S. Corporations.* 2001 NAT. TAX J. 771 [hereinafter Graetz & Oosterhuis, *Structuring an Exemption System*]; Rosenbloom, *Taxing CFCs*, *supra* note 22.

[143] JOINT COMMITTEE STAFF, OPTIONS, *supra* note 17, at 188-89.

Current taxation of income earned through a controlled foreign corporation with modified source rules would fully address the Joint Committee Staff's first two reasons for change. While current taxation of a controlled foreign corporation's foreign income would treat foreign income no better than U.S. income, it would not allow taxpayers to be taxed at the same rate as local and third country taxpayers unless the foreign effective rate is equal to or greater than the U.S. effective rate. Neither the Joint Committee Staff nor the President's Advisory Panel explain why lower-taxed foreign business income should be preferred to domestic income by favoring foreign business income with exemption.

This chapter describes and evaluates as reform alternatives (1) exemption of foreign business income, and (2) current taxation of U.S. shareholders' foreign business income.

II. EXEMPTION OF FOREIGN BUSINESS INCOME FROM U.S. TAXATION

A. *Joint Committee Staff Dividend Exemption Proposal*

The Joint Committee Staff proposal has the following elements.

Exemption of Controlled Foreign Corporation (CFC) Dividends to Ten Percent Corporate Shareholder. Dividends by a CFC of earnings not taxed under subpart F to a ten percent or more (by vote) corporate U.S. shareholder would be exempt from U.S. tax. CFCs would continue to be subject to current law subpart F, modified only to exclude inter-company dividends of exempt earnings.[144] As under current law, a foreign tax credit would be allowed with respect to foreign corporate taxes on the subpart F income.[145] The Joint Committee Staff states that passive and highly-mobile income of the foreign corporation would be taxed currently to the U.S. parent corporation under subpart F, and all other earnings would be exempt and could be repatriated free of any tax impediment.[146]

Non-dividend payments from the CFC to the U.S. parent corporation, such as interest, royalties, rents, service fees, and income from inter-company transactions, would be fully taxable to the U.S. corporation.[147] Foreign source income not eligible for exemption, including export income under the export sales rule, could be offset by a credit for foreign taxes on other income; the separate limitation categories of section 904 would be eliminated.[148]

Gain on the sale of CFC stock would be exempt to the extent of undistributed exempt earnings.[149] Gain in excess of this amount would be fully taxed and no deduction would be allowed for losses on the sale of CFC stock.[150]

[144] JOINT COMMITTEE STAFF, OPTIONS, *supra* note 17, at 190.
[145] *See* I.R.C. § 960.
[146] JOINT COMMITTEE STAFF, OPTIONS, *supra* note 17, at 189.
[147] *Id.* at 191.
[148] *Id.* at 192.
[149] *Id.* at 191.
[150] *Id.*

Foreign Branch Income. Income earned by a domestic corporation through a foreign trade or business would be treated in the same manner as though the income were earned by a CFC.[151] Transactions between the U.S. corporation and the branch would be subject to the full range of rules dealing with inter-company transactions. Except as provided in regulations, trades or businesses conducted in the same country would be treated as a single branch. The subpart F rules would apply to the branch's operations as though it were a separate corporation. Losses of the branch would not flow on to the U.S. corporation's tax return.[152] The Treasury would be authorized to issue rules necessary to place branches and CFCs on an equal footing.

Allocation of expenses to exempt income. Deductions for interest and certain other expenses would be disallowed to the extent allocable to exempt (non-subpart F) CFC earnings as the earnings are earned (not when they are distributed). Thus, for calculation purposes, the U.S. parent would apply the calculation rules as though the CFC's income were fully distributed on an annual basis.[153]

The U.S. parent's interest expense would be allocated between U.S. and foreign income on a worldwide fungible basis taking into account the debt of the CFC. The interest allocated to foreign income would be apportioned between exempt CFC earnings and other foreign income on a pro rata basis according to the assets generating each category of income.[154]

The U.S. parent's R&D expense would be first allocated between U.S. and foreign income under rules similar to current law. The amount allocated to foreign income would be directly allocated to foreign royalty, cost-sharing and royalty-like sale payments to the extent thereof, and then to CFC earnings to the extent thereof. The R&D expense allocated to CFC earnings would be apportioned on a pro rata basis between exempt and nonexempt CFC earnings. Any excess R&D would be allocated to other foreign source income.[155]

General and administrative expense would be allocated to exempt CFC earnings based on the ratio of exempt CFC earnings to the total earnings of the group. Stewardship expenses could be directly allocated to exempt CFC earnings in cases not specified in the Joint Committee Staff description.[156]

Noncontrolled Section 902 Corporations and Noncorporate Shareholders. A U.S. corporate shareholder in a noncontrolled Section 902 corporation would be taxed on dividends from the corporation in the same manner as a portfolio

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[151] *Id.*

[152] JOINT COMMITTEE STAFF, OPTIONS, *supra* note 17, at 191. Presumably, the branch would have to maintain an equity account, similar to that utilized under section 987 to track branch currency gain or loss, and currency gain or loss would not be recognized at the time a branch is terminated or becomes wholly worthless.

[153] JOINT COMMITTEE STAFF, OPTIONS, *supra* note 17, at 190.

[154] *Id.*

[155] *Id.*

[156] *Id.*

dividend.[157] The dividend would be fully taxable and no foreign tax credit would be allowed for corporate level-taxes. A 10% corporate shareholder could elect to treat the foreign corporation as a CFC and to be subject to subpart F with respect to its earnings and thereby become eligible for the indirect credit for foreign corporate-level taxes.[158] As under current law, a non-corporate shareholder, such as a private equity fund, would be fully taxable on any dividend from a foreign corporation. Moreover, a non-corporate U.S. shareholder that owns more than 10% by voting power in a CFC would continue to be subject to subpart F with respect to that foreign corporation.

President's Advisory Panel Exemption Proposal. The President's Advisory Panel Report recommends two alternative tax reform plans, the Simplified Income Tax Plan and the Growth and Investment Plan. We do not discuss the Growth and Investment Plan.[159]

Under the Simplified Income Tax Plan, a domestic corporation generally could dividend its domestic earnings to a domestic shareholder and the shareholder would be exempt from tax on the dividend.[160] In other words, the double tax on corporate income would be eliminated though a dividend exemption method. The dividend exemption from a domestic corporation would not be allowed for exempt foreign earnings.[161]

The integration of domestic corporate and shareholder taxation raises issues beyond the scope of this Report. We discuss the President's Advisory Panel's foreign income exemption proposal nonetheless, because of its similarity to the Joint Committee Staff proposal and the possibility that this element of the plan is carried forward as a separate proposal, contrary to the exhortation of the Panel not to adopt individual elements of that Report without taking the reforms as a broader whole.

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[157] *Id.* at 191. A "non-controlled section 902 corporation" is a corporation that is more than 10% owned (by voting power) by a domestic corporation that is entitled to a so-called indirect credit for foreign corporate income taxes imposed on the foreign corporation, but is not more than 50%-owned by 10% United States shareholders and therefore is not a CFC. *Id.*

[158] *Id.* at 192.

[159] The Growth and Investment Plan adopts a hybrid consumption/income tax by taxing business using a form of subtraction method value-added tax (*i.e.*, by exempting dividends and interest and expensing capital investment), taxing individuals on consumption using progressive rates and interest and dividends at low flat rates. The effect of the plan is to exempt foreign business income. More precisely, dividends from a foreign corporation would be exempt. Income earned through a branch would be taxed under a subtraction method consumption tax, which would mean that risk-free returns would be subject to tax, but above normal returns and returns for risk-taking are exempt. This point is discussed extensively in the recent economic literature on consumption taxation. *See generally*, Avi-Yonah, *Risk, Rents, and Regressivity*, *supra* note 3. The implication of this point is that conducting even zero-taxed foreign operations through a foreign corporation assures that the above normal and risky returns are never taxed. This suggests that the Growth and Investment Plan also would retain biases for shifting activity into appropriately low-taxed foreign corporations. This issue is not explored further in this Report, but should be the subject of additional analysis if the Growth and Investment Plan is pursued.

[160] PRESIDENT'S ADVISORY PANEL, REPORT *supra* note 4, at 124-25.

[161] *Id.*

The principal differences between the President's Advisory Panel exemption proposal and the Joint Committee Staff proposal are that:

(1) gains on the sale of foreign corporate stock appear to be exempt under the President's Advisory Panel proposal;[162]

(2) research and development expense would be allocated entirely to taxable income and not to exempt foreign income;[163] and

(3) the President's Advisory Panel Report would allow exemption for all pre-effective date earnings.[164]

B. *Evaluation of Dividend Exemption Proposal*

1. *Income Subject to Exemption*

Condition for Exemption. Under the Joint Committee Staff and President's Advisory Panel proposals, it is not necessary for there to be any minimum level of foreign tax (or even a subject to tax requirement), as a condition for exemption. In other words, the proposals would extend exemption to foreign earnings of a CFC so long as they are not taxed under subpart F even if the foreign country in question imposed no tax on the income.[165] A critical question is whether export sales that pass title outside the United States would be eligible for exemption. If eligible for exemption, this would be contrary to usual international practice. If not eligible for exemption, the U.S. tax on these sales could be offset by foreign tax credits.

The second consequence of not having any "subject to tax" requirement would be that income in zero tax havens will be eligible for exemption without being includible in income under subpart F. Under subpart F, income from manufacturing products, income from performing services in the CFC's country of incorporation, active financing and active insurance income is not included in subpart F income without regard to the level of foreign tax.[166] In addition, there are a variety of techniques that may be used under current law to avoid the reach of the subpart F rules.

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[162] *Id.* at 240.

[163] *Id.* at 241.

[164] *Id.* at 240.

[165] The 1993 Treasury dividend exemption proposal and most dividend exemption systems used by other countries would require that exempt income at least be subject to tax. U.S. TREAS. DEPT., INTERNATIONAL TAX REFORM, *supra* note 5. Some countries deny exemption to companies organized in certain black list countries or achieve the same result through controlled foreign company rules. The domestic law exemption for foreign business income in The Netherlands, as one example, applies to foreign income that is earned directly as business income from a foreign permanent establishment, income from real property, and income from employment abroad, and, under a participation exemption for dividends from substantial holdings in a foreign corporation, if the income or foreign corporation is "subject to tax" under an income tax in a foreign jurisdiction. *See* HUGH J. AULT & BRIAN J. ARNOLD, COMPARATIVE INTERNATIONAL TAXATION 372-75 (2d ed. 2004) [hereinafter Ault & Arnold, COMPARATIVE INTERNATIONAL TAXATION].

[166] Thus, for example, if an insurance company earns active foreign insurance income in a country that does not impose income tax, such as Bermuda, these earnings would be exempt from U.S. taxation.

Under the current deferral regime, the benefit of deferral is limited if the U.S. parent corporation needs to use the CFC's earnings in the United States because the earnings will be taxed upon repatriation as a dividend. Consequently, deferral is of most benefit to U.S. multinational corporations that have other non-U.S. businesses in which to invest the deferred earnings. Under these exemption proposals, however, any kind of non-subpart F income that can be earned at a lower tax rate outside the United States could benefit from exemption *and* the cash could be repatriated to the United States. So, for example, a local manufacturer that has only one line of products and only sells products to U.S. customers, could benefit from manufacturing the product in Ireland (whether through a CFC or an Irish branch), selling the product back to the United States, paying the Irish corporate tax on the manufacturing earnings at a 12.5% tax rate and repatriating any unused cash to the U.S. parent as exempt earnings. An exemption regime like that in the Joint Committee Staff or President's Advisory Panel proposal would materially expand the U.S. businesses that could realize tax benefits from earning low-taxed foreign business income.[167]

The Joint Committee Staff and President's Advisory Panel proposals would put pressure on a range of collateral rules. First, consideration would have to be given to whether property should be permitted to be transferred tax-free for use in a trade or business outside the United States that after the transfer would generate exempt income and gains. Transfer pricing would have higher stakes for the taxpayer and the Government and enforcement of the rules would have to be strengthened and, possibly, the rules reviewed.[168] There would be pressure to tighten the subpart F rules, including the manufacturing exception from subpart F, at least insofar as they applied to sales back to the United States. The interaction of the proposal with the foreign tax credit rules is discussed below.

Under the Joint Committee Staff and President's Advisory Panel proposals, deductible payments from CFCs, such as interest and royalties, would not be exempt. While this approach is consistent with the international norm, it will have the effect of encouraging fewer returns in the form of royalties from countries with lower effective tax rates than in the United States. The Joint Committee Staff proposal and the President's Advisory Panel proposal would eliminate the separate passive limitation in favor of a single overall foreign tax credit limitation for foreign income that is not exempt. Accordingly, excess foreign tax credits on subpart F income or on income from non-controlled Section 902

[167]The 1993 Treasury Department Interim Report on International Tax Reform published at the close of the first President Bush's administration included a proposal for a modified exemption system that either would apply an effective rate test, so that only foreign income that bears a certain level of foreign tax would be exempt, or alternatively, and arguably more simply, only would exempt income from certain designated countries. The 1993 Treasury Interim Report acknowledged that the scope of current taxation would be broader than under subpart F and would include foreign manufacturing income that was not taxed or taxed at a low rate. U.S. TREAS. DEPT., INTERNATIONAL TAX REFORM, *supra* note 5.

[168]The President's Advisory Panel acknowledges that "it would continue to be necessary to devote resources to transfer pricing enforcement." PRESIDENT'S ADVISORY PANEL, REPORT, *supra* note 4, at 242. This is an understatement.

corporations could be used to offset U.S. tax on "active" royalties. This would result in taxpayer planning to make high-foreign-taxed income subpart F income in order to be able to cross-credit foreign taxes against other non-exempt foreign income.

Effect of exempt earnings on QDI and UBIT. The Joint Committee Staff proposal does not discuss whether the U.S. parent's exempt earnings should qualify for qualified dividend income treatment and taxed as net capital gain in the hands of an individual shareholder. If no adjustment is contemplated to the definition of qualified dividend income, exempt earnings that are not subject to any foreign tax would be taxed at a 15% rate when distributed to an individual shareholder.[169] Similarly, assuming that no adjustment were made to the definition of unrelated business taxable income, a tax-exempt shareholder, such as a pension fund or an endowment, would pay no corporate level tax on exempt earnings that are not subject to any foreign tax.[170]

Under the President's Advisory Panel's Simplified Income Tax Plan, dividends paid by a domestic corporation to its shareholders would be exempt if paid out of domestic earnings, whether or not the earnings bear full corporate-level tax, but dividends would be fully taxable if from exempt foreign income.[171] In other words, under the President's Advisory Panel proposal, the domestic corporate dividend exemption would not be denied because of corporate-level tax preferences other than the exemption for foreign dividends and foreign non-mobile income.

2. *Stock Gains and Losses*

The Joint Committee Staff Proposal only would exempt gains on the sale of CFC stock to the extent of undistributed exempt earnings. The Joint Committee Staff acknowledges that excess of gain over the exempt earnings amount may be attributable to assets generating exempt income, but believes that the valuation difficulties do not justify exempting this gain.[172] This approach generally would have the effect of taxing foreign generated goodwill recognized in the stock price, which arguably would be inconsistent with exempting active foreign busi-

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[169]The same issue exists today with respect to foreign dividend distributions from non-subpart F income to a U.S. individual (or a partnership in which the individual is a partner). If a distribution is paid by a foreign corporation that is not a passive foreign investment company and is eligible for the benefits of a comprehensive income tax treaty, and is taxable as a dividend (*i.e.*, it is not previously taxed income), it will be qualified dividend income to an individual shareholder without regard to whether the earnings distributed were ever subjected for foreign tax. For planning possibilities under this regime, see Timothy J. Devetski and Christopher S. Kippes, *Taxation of an Individual Investor in a Private Investment Fund Exiting An International Project*, 103 Tax Notes (TA) 1001, 1010-12 (May 24, 2004) (if a foreign holding elects to treat a foreign operating subsidiary as a disregarded entity, sells stock, and avoids subpart F under Dover Corp. v. Commissioner, 122 T.C. 324 (2004), a section 1248 dividend on liquidation may be qualified dividend income to an individual shareholder).

[170]This report does not discuss the issue of whether the unrelated business income tax should apply to foreign business income.

[171]President's Advisory Panel, Report, *supra* note 4, at 124-25.

[172]Joint Committee Staff, Options, *supra* note 17, at 191.

ness income without regard to whether a foreign tax is imposed on the income. While this approach recognizes that most foreign countries do not tax stock sale gains of a non-resident, a credit arguably should be allowed for the foreign tax if the foreign country taxes the gain. The President's Advisory Panel exemption proposal would exempt all gains on the sale of CFC stock.

The Joint Committee Staff proposal would not allow a deduction for a loss on the sale of CFC stock. While this rule seems appropriate for basis attributable to invested capital earning exempt income, to the extent basis is adjusted upward for subpart F inclusions and has not been reduced by distributions, the basis arguably should result in an allowable loss.

3. *Allocation of Deductions*

The allocation of deductions to foreign income has long been a contentious issue. Under the present law system of deferral, the allocation of deductions to foreign income adversely affects a taxpayer only if the expenses allocated to foreign income reduce the taxpayer's foreign tax credit limitation to the point that foreign taxes are not allowed as a credit. In other words, the issue has practical significance for taxpayers with excess foreign tax credits. To the extent feasible, taxpayers use the timing flexibility offered by deferral to manage the repatriation of foreign taxes so as to avoid being in an excess credit position. This may not be possible if the taxpayer has domestic operating losses, large amounts of interest expense allocated to foreign income or structurally high foreign taxes. With the new 10-year foreign tax credit carryover period, the expense allocation issue should diminish in significance.

In contrast, under an exemption system, every dollar of expense allocated to exempt earnings is a lost deduction. Thus, the issue will affect *every* taxpayer with exempt foreign income. It may be predicted that there will be increased controversies between taxpayers and the Service over the allocation of expenses. Like transfer pricing, the allocation of expenses is highly factual and there is room for a reasonable range of outcomes. The Service will need to hone its skills and devote substantial additional resources to be able to audit this issue effectively.

The Joint Committee Staff and President's Advisory Panel proposals set out a number of expense allocation rules. Both proposals would use the interest expense allocation rules adopted in the American Jobs Creation Act. Those rules add an elective worldwide group expense allocation method. If taking foreign interest expense into account is believed to result in a more accurate allocation of interest expense, it is difficult to identify a valid policy reason for the worldwide method to be elective. The worldwide method should be mandatory.

The Joint Committee Staff proposal for allocation of R&D expense would apply present law rules to allocate the expense between U.S. and foreign income.[173] The amount allocated to foreign income would be directly allocated

[173]Issues raised by the current R&D expense allocation rules and possible changes are discussed in Chapter 6.

first to royalty and similar income.[174] The President's Advisory Panel proposal would go further and allocate R&D only to taxable income.[175] There is little justification for a rule that does not take account of the benefit of R&D expense for intangible income embedded in returns from sales of goods. Returns to intangibles often are earned through an increased sale price on goods using the intangible as an alternative or supplement to returns earned in the form of a royalty. These allocation rules would under allocate R&D expense to exempt income.

There are many general and administration expenses that may be allocated to income on a factual basis. The Joint Committee Staff proposal's requirement that they be allocated on a pro rata basis only may be justified as a rule of administrative convenience. A taxpayer should be permitted to use any reasonable allocation method, consistently applied. The Service should be allowed to mandate a pro rata allocation on a finding that the taxpayer's method is unreasonable.

Stewardship expenses, the costs associated with a shareholder's supervision of its investment in a subsidiary, generally are *not* directly charged to subsidiaries. The failure to charge all shareholder expenses against all of the income of the group, including foreign subsidiaries, is conceptually wrong and inconsistent with the results mandated by treaty for a branch operation. This approach does, however, reflect an international consensus.[176] This consensus is based in part on the inability of the source country to monitor the validity and amount of the deductible charges. Regardless of whether the expenses are charged out to subsidiaries, under an exemption system shareholder expenses should be allocated to exempt earnings on a pro rata basis in relation to all earnings.

Losses of a branch appropriately would not be allowed as a deduction. These losses will have to be tracked and excluded from net operating loss carryovers.

4. *Foreign Tax Credit Limitation*

The Joint Committee Staff proposal and the President's Advisory Panel would adopt a single, overall foreign tax credit limitation, which would permit broad cross-crediting.[177] If export sales of inventory are not exempted and changes are not made to the inventory source rules, substantial cross-crediting would be possible against U.S. tax on this income. The Joint Staff Committee and President's Advisory Panel apparently believe that most foreign income currently taxed under their respective proposals will be low-taxed.[178] It would not

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[174] JOINT COMMITTEE STAFF, OPTIONS, *supra* note 17, at 190.

[175] PRESIDENT'S ADVISORY PANEL, REPORT, *supra* note 4, at 241.

[176] ORGANIZATION FOR ECONOMIC CO-OPERATION AND DEVELOPMENT, COMM. ON FISCAL AFFAIRS, COMMENTARY TO OECD MODEL TAX CONVENTION ON INCOME AND CAPITAL, Art. 7, para 3, ¶ 21 (2005) [hereinafter "OECD Model Commentary"].

[177] Graetz and Oosterhuis also would support a single overall limitation. Graetz & Oosterhuis, *Structuring an Exemption System*, *supra* note 142, at 777.

[178] *See* JOINT COMMITTEE STAFF, OPTIONS, *supra* note 17, at 192.

be difficult, however, to cause otherwise high taxed exempt income to be taxable under subpart F in order to achieve the benefits of averaging against royalties and other low-taxed income. If this were permitted, one of the principal advantages of an exemption system over a credit system that permits cross-crediting would be lost.

Retaining the foreign tax credit for taxable income will cause the reformed system to be even more complex than existing law. It is difficult to see how the objectives of administrability and efficiency would be enhanced by adding yet another tax regime to the taxation of foreign income. Mr. Rosenbloom's exemption proposal, discussed below, which only would allow exemption or full taxation with a deduction for foreign taxes, would be simpler in this regard.

5. *Shareholders in Noncontrolled Section 902 Corporations*

Under the Joint Committee Staff Proposal, a U.S. corporate shareholder in a noncontrolled Section 902 corporation either would be taxed on dividends from a noncontrolled Section 902 corporation when a dividend is received, or would elect to treat the foreign corporation as a CFC so as to be subject to subpart F and exempt on non-subpart F income, allowed a Section 960 tax credit with respect to subpart F income. The Joint Committee Staff proposal does not specify that the election must be made for all CFCs. If it is not so limited, a separate election for each corporation likely will result in foreign tax credit planning as discussed above.

C. *The Rosenbloom Proposal to Exempt Active Business Income Earned Through Permanent Establishments In Designated Countries*

1. *Proposal*

Income Eligible for Exemption. David Rosenbloom proposes a simpler exemption system that would allow exemption of foreign business income, whether earned directly or through a foreign corporation controlled by a U.S. taxpayer, attributable to a substantial business presence in designated foreign countries with "formal and serious tax systems."[179] The Rosenbloom proposal would rest exemption of income on a determination that the income is "attributable" under treaty concepts to a permanent establishment in a "good" country. To achieve its simplification objective, the Rosenbloom proposal would tax all other income currently with only a deduction for foreign taxes. It appears that Mr. Rosenbloom would not exempt gain from the sale of foreign controlled corporation stock. Mr. Rosenbloom would impose tax at the time of transfer on assets transferred to permanent establishments the income from which would be exempt.[180]

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[179]Rosenbloom, *From the Bottom Up*, *supra* note 22, at 1544.
[180]*Id.* at 1552-53.

Allocation of Expenses to Exempt Income. Mr. Rosenbloom would disallow deductions allocable to exempt income under expense allocation rules similar to those applied under current law for purposes of the foreign tax credit limitation.[181] Mr. Rosenbloom does not discuss the treatment of losses.

Non-Controlling Shareholders in a Foreign Controlled Corporation. A minority shareholder either (1) would be allowed to exempt income attributable to a permanent establishment if it had sufficient information to determine the amount, or (2) would not be taxed until it receives income and would not be eligible for an "indirect" tax credit for corporate level taxes.[182]

2. *Rationale*

Mr. Rosenbloom grounds his proposal in part on the view that use of the corporate form by a controlling shareholder is purely elective and therefore should not be accorded tax significance.[183] Accordingly, Mr. Rosenbloom's exemption proposal would subject a controlling shareholder to current U.S. tax on all income earned through a foreign controlled corporation, subject to exemption for income for business profits earned in designated countries and a deduction for direct foreign taxes on other income.[184]

3. *Evaluation*

Mr. Rosenbloom's proposal would eliminate the foreign tax credit and its limitation and rely on exemption for income from substantial business activities in countries with "formal and serious" income tax systems to mitigate double taxation. This form of exemption likely would be less onerous to apply than the Treasury's 1993 proposal of an effective tax rate test, but would not provide open-ended exemption for all business income as under the Joint Committee Staff proposal. Indeed, Mr. Rosenbloom acknowledges that it would be necessary to monitor countries' application of their tax laws to avoid allowing exemption where a country has converted to "low-tax status."[185] Rosenbloom also would not allow exemption where there likely would not be a source country tax, such as a source country exemption for foreign income not attributable to a permanent establishment.[186] All non-exempt income of a foreign controlled corporation would be taxed currently and only a deduction allowed for foreign taxes.

Minority shareholders would be treated separately on the grounds that the use of a foreign corporation was not their election. A minority shareholder either (1) would be allowed to exempt income attributable to a permanent establishment if

[181] *Id.* at 1551.
[182] *Id.* at 1550-51.
[183] *Id.* at 1535-37.
[184] It is not clear that Mr. Rosenbloom would limit exemption to a corporate shareholder.
[185] Rosenbloom, *From the Bottom Up*, *supra* note 22, at 1544.
[186] *Id.* at 1548. Rosenbloom notes: "Systemic holes in a tax system are like the drain in a bathtub; the fact they are limited in diameter is of little importance."

it had sufficient information to determine the amount, or (2) would not be taxed until it receives income and would not be eligible for an "indirect" tax credit for corporate level taxes.[187]

The Rosenbloom exemption proposal would result in substantial simplification at the cost of a "rough justice" approach to efficiency and equity concerns.[188]

D. *Transition to an Exemption System*

Moving to an exemption system for active foreign business income would result in a windfall for United States shareholders in controlled foreign corporations to the extent the value of existing shareholdings increased. Licensors of non-U.S. intangible property and exporters who previously could utilize foreign tax credits to offset foreign royalty and export sales income likely would pay greater tax on this income.

Neither the Joint Committee Staff proposal nor Mr. Rosenbloom discuss how to treat pre-effective date untaxed CFC earnings. While the stakes of transition may be reduced as a consequence of homeland dividend relief under Section 965, in the absence of a transition rule, pre-effective date earnings would continue to be taxed upon repatriation.

One approach would be to extend relief to pre-effective date earnings on the grounds that earnings not repatriated under homeland dividend relief are unlikely to be repatriated in the absence of exemption. Consequently, it could be argued, there would be limited revenue loss and efficiency gains from removing the tax on repatriation. Indeed, this is the approach adopted by the President's Advisory Panel Report.[189]

An alternative argument is that it would be an inappropriate additional windfall to provide relief for pre-effective date earnings. If taxation of pre-effective date earnings were retained, one question would be whether such earnings should be treated as repatriated first, last, or on a pro rata basis. If pre-effective date untaxed earnings were stacked first in the case of a distribution, there would be a disincentive to repatriate earnings unless the cost were modest and the taxpayer desired to re-deploy exempt earnings without a repatriation tax. This could defeat one of the principal benefits of exemption, which is to permit redeployment of earnings without a repatriation tax. If pre-effective date earnings were "stacked" last, however, the effect of extended deferral could come to approximate exemption. A pro rata approach would be consistent with "pooling" under

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[187] *Id.* at 1550-51.

[188] *See* Robert J. Peroni, *Commentary: The Proper Approach for Taxing the Income of Foreign Controlled Corporations*, 26 BROOKLYN J. INT'L L. 1579, 1580 (2001).

[189] Were it not for the substantial risk that it would not be adopted, the timing of the President's Advisory Panel proposal was awkward, as it came before the end of a period in which many companies are considering paying very substantial homeland dividends subject to a 5.25% effective tax rate. Such companies must evaluate the possibility of having complete exemption of such earnings if the proposal were adopted.

current law Section 902, but would be complex. An alternative solution would be to cause pre-effective date earnings to be included in income over a reasonable period. One approach would be to follow the model for adjustments resulting from accounting method changes and spread the inclusion over a four year period.

E. *Evaluation of Exemption Proposals Under Policy Criteria*

The Joint Committee Staff and President's Advisory Panel exemption proposals are deficient on several grounds. The failure to include any requirement that the exempt income be subject to a foreign tax will invite substantial tax avoidance planning and place great pressure on transfer pricing rules. This would undermine any efficiency gains from the proposal. Only if there is a reasonable subject to tax condition would the proposal not result in a substantial erosion of the U.S. tax base.[190]

Material simplicity gains from an exemption system only will be achieved if the foreign tax credit regime is restricted to a narrow range of cases or eliminated. In addition to reducing complexity, it would be important to prevent the foreign tax credit regime that is retained from allowing high foreign taxes to offset U.S. tax on income from U.S. economic activity, as occurs under current law, as well as to minimize cross-crediting. Ideally, the scope for the need for a foreign tax credit would be sufficiently restricted that a per item credit limitation might be feasible.[191] If this approach were not followed, it would be important to limit the extent to which income not subject to foreign tax is treated as foreign and thereby easily absorb excess foreign taxes against U.S. tax on that income.

As proposed, the Joint Committee Staff and President's Advisory Panel proposals are difficult to justify under any fairness analysis and it is unclear that any efficiency gains would result from these proposals. The Rosenbloom proposal would achieve some simplicity gains from use of a country-by-country determination of eligibility for exemption, but the criteria for identifying such countries remain open-ended and vague. Without further definition it is not possible to fully evaluate the proposal. The proposal does, however, address the need to eliminate the foreign tax credit to achieve simplification objectives. Moreover, unlike the Joint Committee Staff and President's Advisory Panel proposals, it addresses the deficiencies of current subpart F by ending deferral for shareholders on income that is non-exempt.

Substantial work remains to fashion an exemption proposal that would clearly improve the situation over either current law or current law as it might be reformed under other proposals in this Report.

[190] Also, a subject to tax requirement would clearly exclude export sales from exemption.
[191] *See, e.g.*, I.R.C. § 865(h)(1).

III. PROPOSALS TO EXPAND TAXATION OF FOREIGN INCOME

A. *Alternatives for Expanding Taxation of Foreign Income*

There are two principal elements of reforms that would expand taxation of foreign income in relation to current law consistent with the objectives outlined in Chapter 2. One is to limit the scope of deferral of U.S tax on low-taxed foreign income. The second is to repair the principal flaws of the existing foreign tax credit regime that permit high foreign taxes to offset U.S. tax on other income. These flaws include the miss-measurement of foreign net income, by utilizing defective source and deduction allocation rules, and over-crediting of foreign taxes as a consequence of overly generous cross-crediting. Reforming the foreign tax credit rules does not in our view constitute "fundamental" tax reform. Accordingly, possible improvements to the rules relating to crediting foreign taxes, including possible modifications to the source and expense allocation rules, are discussed in Chapter 6 of this Report. This Part will consider current taxation of income earned through a controlled foreign corporation.

Under prior law, deferral has been restricted and then expanded again.[192] In addition, numerous proposals have been made to end or substantially curtail deferral of U.S. taxation of controlled foreign corporation earnings.[193]

There are two basic approaches to taxing the income of a controlled foreign corporation currently in the hands of a U.S. shareholder. One approach proposed would be to adopt pass-through treatment for earnings of a controlled foreign corporation.[194] This would have the benefit of maintaining character and source of income and subjecting the income to the applicable tax rate of the shareholder. It would permit current pass-through of losses. A pass-through approach would, however, require application of the subchapter K partnership rules in an environment for which they were not designed. While conduit taxation has much

[192]From 1987 through 1996, interest income of banking, financing, and insurance companies was not excepted from foreign personal holding company income. In 1996, deferral was reinstated for income eligible for under the active financing and active insurance exceptions of sections 954(h) and 954(i). From 1993 to 1996, deferral was limited under section 956A, repealed in 1996, to the extent that a controlled foreign corporation or group held more than 25% passive assets. In addition, from 1962 to 1968, a minimum distribution rule under former section 963, repealed by section 602(a) of the Tax Reduction Act of 1975, Pub. L. No. 94-12, 89 Stat. 26 (1975), operated as an alternative to taxation under the other subpart F rules. It generally caused the combined effective foreign and U.S. rate to be comparable to the then applicable U.S. statutory rate. *See* Stuart E. Leblang, *Deferred Gratification: A More Rational Approach for Taxing Multinationals*, 26 TAX NOTES (TA) 1413 (Dec. 14, 1998) [hereinafter Leblang, *Deferred Gratification*].

[193]In 1962 President Kennedy proposed ending deferral. Message from the President of the United States Relative to Our Federal Income Tax System, April 20, 1961, reprinted as H.R. Doc. No. 87-140, at 6-7 (1961). In 1992, Representatives Rostentowski and Gradison included a proposal to end deferral in their Federal Income Tax Rationalization and Simplification Act of 1992, introduced as H.R. 5270, 102d Cong. (2d Sess. 1992). Commentators also have proposed alternatives for ending deferral. *See* Robert J. Peroni, J. Clifton Fleming, Jr. & Stephen E. Shay, *Getting Serious About Curtailing Deferral of U.S. Tax on Foreign Source Income*, 52 SMU L. REV. 455 (1999) [hereinafter Peroni, Fleming & Shay, *Curtailing Deferral*].

[194]*See* Peroni, Fleming & Shay, *Curtailing Deferral*, *supra*, note 193, at 508-15.

to recommend it as the optimal method to tax foreign income, additional work would be required to address the complexities of applying conduit tax rules to CFCs. CFC capital structures rarely will prescribe "economic" allocations of income under U.S. principles.

This Report considers a second alternative that would expand current taxation under a subpart F-type model.

B. *"Ending Deferral:" Current Taxation of Controlled Foreign Corporation Earnings*

Level of U.S. Ownership. A threshold question for any proposal to end deferral of U.S. tax on income of a controlled foreign corporation is for which U.S. shareholder should deferral be ended? One approach is to cause U.S. persons who today are subject to subpart F, United States Shareholders (10% or greater shareholders by vote) in a controlled foreign corporation (more than 50% owned, by vote or value, directly or indirectly, under constructive ownership rules, by United States Shareholders), to be currently taxed on their share of the controlled foreign corporation's income. The difficult cases are (1) where a foreign corporation has a majority or plurality of U.S. shareholders, but they are not ten percent shareholders, and (2) where the U.S. person owns more than ten percent, but not a controlling interest in a foreign corporation.

It seems appropriate in general to limit current taxation to a ten percent U.S. shareholder; however, the United States Shareholder test, like the current law test for controlled foreign corporation status, should be based on vote or value.[195] We also would consider reducing the threshold for when current taxation would apply to where there is 25% or greater U.S. ownership in the aggregate and U.S. shareholders exceed non-U.S. shareholders from any other single country. In most cases, a 25% U.S. shareholder group would be adequate to cause U.S. tax issues to be taken into account by a company.[196]

Less than 10% U.S. shareholders and 10% U.S. shareholders in foreign corporations that did not have a 25% U.S. shareholder group would be taxed under current law rules on distributions when received. The passive foreign investment company (PFIC) rules would continue to apply, however, the PFIC asset test should be eliminated and the passive income threshold reduced to 50% from 75%. The PFIC taxing rules—a deferred tax with an interest charge, qualified electing fund pass through taxation, or mark-to-market taxation—would apply to a U.S. shareholder in a PFIC.

Simplifying the Shareholder-Level Tax. It has long been a principle of U.S. tax law that Subchapter C shall apply to determine the timing and amount of a

[195]We also would explore whether U.S. shareholders in a controlled foreign corporation who do not own ten percent by vote or value should nonetheless be taxed under the subpart F rules instead of the PFIC rules.

[196]These proposals also may be considered in connection with a proposal to reform subpart F described in Chapter 7.

U.S. shareholder's income from stock in a foreign corporation. This is true even though Subchapter C is designed to implement a classical taxation structure involving tax at both the corporate and shareholder level. The earnings and profits measure of a shareholder-level tax base eliminates most corporate-level tax preference items. Yet, a foreign corporation with no effectively connected earnings bears no U.S. corporate-level tax. The question is raised whether it would be feasible to greatly simplify the measurement of shareholder income under a full taxation regime (recognizing that this could create some arbitrage possibilities).

Under a current taxation regime, a U.S. shareholder would include his or her share of the current year's earnings of the foreign corporation. Under current law, earnings are measured by earnings and profits under U.S. tax principles. One question is whether it would be possible to simplify the calculation of earnings and profits by minimizing the adjustments required from financial statement income. One alternative would be to permit U.S. shareholders in a foreign corporation to use a modified earnings and profits that relies on foreign financial income, determined under Internationally Accepted Accounting Standards (IAAS) or an equally accepted standard, as the starting point for measuring corporate income subject to current shareholder level taxation. If using a foreign financial statement measure of taxable inclusion would vary too much from U.S. tax principles, it would be desirable to identify the minimally necessary adjustments necessary to bring foreign financial statements to an acceptable U.S. base and such a simplified earnings and profits as a measure for determining shareholder income.

Effectively connected income earnings would have to be determined under regular U.S. tax accounting principles. These earnings would be subject to U.S. corporate-level tax and branch tax and would not be subject to the current shareholder-level taxation. When distributed to a domestic corporate shareholder, however, these earnings should be allowed a regular dividends received deduction.

A U.S. shareholder would treat actual distributions as first out of earnings previously-taxed to the shareholder and next from the shareholder's share of effectively connected earnings. Distributed amounts in excess of these measures would be applied to recover the shareholder's basis. Distribution in excess of these amounts with respect to a share would be treated as capital gain with respect to the share. This approach to distributions would eliminate the need to track earnings and profits. Previously-taxed earnings would be measured at the shareholder level and would not transfer to a new shareholder. Simplified reorganization rules should be applied that would permit rollover of tax basis in shares in a transaction.

Indirect Foreign Tax Credit. The indirect foreign tax credit would continue to be allowed to a ten percent corporate shareholder but would be based on the ratio of foreign tax for the year to current year earnings. Since earnings would be deemed distributed currently there would be no need to track pools of historical

earnings and foreign tax credits. In many ways, current taxation of foreign corporate income would be much simpler than under the current deferral regime.

Allowance of Losses. One objection to the controlled foreign corporation model for current taxation is that losses would not flow through to shareholders. In the 1992 Rostenkowski-Gradison bill this was addressed by allowing a controlled foreign corporation an election to be treated as a domestic corporation provided that it included historic earnings and profits in income of its shareholders as would be the case in the event of an inbound liquidation of a foreign corporation.[197] The domestic corporate election was criticized for allowing a one-time deferral from U.S. tax on intercompany transactions with the foreign members of the group electing U.S. corporate status.[198] It is not clear that the one-year deferral is an unacceptable price for such an election.

A U.S. shareholder subject to current taxation under the above rules generally would have the alternative to carry on business through a domestic corporation or a foreign entity classified as a pass through for U.S. tax purposes. Moreover, the shareholder could "hedge" its choice of form and preserve self-help loss recognition through use of intercompany debt as described in Chapter 3. While this choice of form difference in treatment of losses is distortive, it does not seem necessary to allow a domestic corporate election to a controlled foreign corporation as an additional loss pass through alternative.

C. *Evaluation of Current Taxation Alternative*

1. *Efficiency Debate*

Current U.S. taxation of low-taxed foreign income would decrease the after tax returns of non-U.S. investments below what they would be to an investor resident in the local country or in a third country that exempts foreign active business income, as well as in relation to the current law deferral system. Current taxation would not encourage taxation in low-tax countries as occurs under current law and also would be true under an exemption system.

Under a traditional form of an exemption system, foreign taxes on investment in a high tax country could not be used to offset other U.S. tax. Whether this were true under a current tax regime would depend on the foreign tax credit limitation rule employed. This subject is discussed in Chapter 6, but a current taxation proposal should be coupled with reforms to the foreign tax credit that restrict cross-crediting of excess foreign tax credits.

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[197]The inclusion of a prior earnings condition was criticized as creating too large a cost to make the election attractive. *See* Paul W. Oosterhuis & Roseann M. Cutrone, *The Cost of Deferral's Repeal: If Done Properly, It Loses Millions*, 58 TAX NOTES (TA) 765 (Feb. 16, 1993).

[198]It would be possible to treat the electing group of foreign corporations as a separate consolidated group, but this would defeat the ability to use losses against income of the domestic group.

The U.S. banking industry was subject to current U.S. taxation on interest income under subpart F from 1987 through 1996. Although the active banking and financing exception to subpart F was added in 1997, the industry did not fare poorly during the period before 1997.[199]

A reform that increases current taxation of foreign business income ideally would form a part of larger tax reform that expands the business tax base and lowers tax rates on business income. The consequences of moving to current taxation of foreign income on particular taxpayers would be mitigated to the extent that the change is a part of an overall base broadening reform used to reduce U.S. tax rates generally on business income. While it cannot be predicted what will occur under current taxation of foreign income, the experience of the banking industry suggests that most U.S. business could continue to be competitive and even thrive.

2. *Equity and Administrability*

The current taxation alternative described above, would reduce the opportunities for U.S. taxpayers to benefit from lower tax rates in foreign countries, whether under a local tax holiday or as a consequence of tax planning designed to lower the foreign effective tax rate. A reduction in the elective nature of the U.S. tax on foreign income and the rate differential between domestic and international income will enhance the administrability of the income tax by reducing the scope for taxpayer arbitrage between effective tax rates. It would act as a "back stop" to frustrate use of transfer pricing to shift income to lower tax jurisdictions. The more equal taxation of foreign income would enhance the perception that the income tax is fair and as well as the reality of that perception. Current taxation would come closer to satisfying the ability-to-pay criterion.

Whether current U.S. taxation of foreign income would increase or decrease revenues depends in part on how the foreign tax credit and foreign tax credit limitation rules operate. This subject is taken up in Chapter 6.

[199]A study by Rosanne Altshuler and R. Glenn Hubbard found that the application of subpart F to financial services firms after 1986 did decrease the sensitivity of financial firms asset location to host country tax rates. The study was unable to find the significant data necessary to reach a conclusion as to whether the increase in residence taxation under subpart F on operations in low-tax countries reduced market share of U.S. firms in those countries. Rosanne Altshuler & R. Glenn Hubbard, *The Effect of The Tax Reform Act of 1986 on the Location of Assets in Financial Services Firms* 25 (Nat'l Bureau of Econ. Research, Working Paper, No. 7903, 2000).

CHAPTER 6: THE FOREIGN TAX CREDIT AND ITS LIMITATION

I. INTRODUCTION

A. *Background*

The foreign tax credit was introduced in 1918 to relieve double taxation on U.S. taxpayers who are subject to tax on a worldwide basis.[264] The legislative history indicates that Congress was concerned about the "very severe burden" placed upon U.S. citizens by the high rates of tax imposed by certain countries because those taxes only could be deducted.[265]

The first foreign tax credit provision limited the amount of foreign taxes that could be claimed as a foreign tax credit to those taxes imposed by a foreign country on income from sources within that foreign country. This type of source limitation did not prevent foreign tax credits from offsetting U.S. tax on U.S. source income, however, where the foreign tax rate was higher than the U.S. tax rate.[266] As a result of concern over elimination of U.S. tax by higher rate foreign taxes, in 1921, Congress imposed a limitation on the amount of foreign taxes that could be applied as credits against U.S. tax.[267] Under this limitation, the amount of foreign taxes that could be claimed as a credit against U.S. tax was limited to the amount of the U.S. tax that otherwise would be imposed on the foreign source income as determined under U.S. law. This limitation preserved U.S. primary taxing jurisdiction over U.S.-source income.

Under the overall limitation first adopted, the creditable amount was determined by multiplying the U.S. tax due on total worldwide taxable income by the ratio of the foreign net taxable income over worldwide net taxable income both as determined under U.S. principles. By applying this fraction, the formula takes into account the pre-credit effective rate of U.S. tax and allocates that tentative U.S. tax between U.S. and foreign source income.

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[264]Revenue Act of 1918, ch. 18, §§ 222 (individuals) and 238 (corporations), 40 Stat. 1057, 1073, 1080.

[265]H.R. Rep. No. 65-767, at 11 (1918). The allowance of foreign taxes only as a deduction against gross income resulted in U.S. taxation of taxable income remaining after the deduction for foreign taxes.

For example, assuming the same taxable base for the United States and Country A, if Country A imposed tax at a 50% rate on $100 of income, or $50, the United States permitted a deduction of $50 against the $100 of gross income, leaving a tax base of $50 on which U.S. tax was imposed. If the U.S. rate was also 50%, the tax on $50 of net income would be $25. Thus, $50 of net income was subject to tax twice—once by Country A and once by the United States. The total amount of tax paid on the $100 of gross income would be $75 or 75% of the gross income.

[266]For example, if the rate in Country A is 70%, the Country A tax on $1000 Country A source income would be $700. If the U.S. tax rate was 50%, and a U.S. company earned $1000 of U.S.-source income in addition to the $1000 in Country A, the U.S. tax on $2000 would be $1000, $500 on the U.S.-source income and $500 on the Country A source income. Under an unlimited foreign tax credit system, the U.S. company would be allowed a $700 foreign tax credit against its $1000 U.S. tax liability, resulting in a net U.S. tax payment of $300. Thus, the $700 foreign tax credit would reduce the U.S. tax on the U.S.-source income by $200.

[267]Revenue Act of 1921, ch. 136, § 238, 42 Stat. 227, 258.

Under such an overall limitation, foreign taxes could offset U.S. tax on other foreign source income. The overall limitation allowed unrestricted cross-crediting of foreign taxes on foreign income. Successive legislative changes modified the rules to restrict cross-crediting and the use of foreign losses,[268] including by creating certain separate limitation categories (baskets). In 1986, the number of separate limitation categories was increased to nine and the rules were tightened to further restrict cross-crediting. For years after 2006, the separate limitation categories are reduced to two (passive and general). Recapture of overall domestic losses as foreign income was added to the existing overall foreign loss recapture regime.[269]

The application of U.S. tax law to determine the tax base for purposes of the limitation fraction is significant. The use of the U.S. tax base for measuring the credit limitation is necessary to assure that the credit for foreign tax is applied to reduce U.S. tax on an apples-to-apples basis. Use of a foreign tax base would be incoherent.[270]

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[268]In 1932, the per country limitation was added to the Code as alternative to the overall limitation in certain circumstances. Revenue Act of 1932. The per country limitation applies the limitation fraction separately to each foreign country rather than applying the limitation to an aggregate of all foreign income and foreign taxes. Under this regime, the foreign tax credit allowed was the lesser of the amount determined under the overall limitation or the total aggregate amounts determined under the per country limitation. As part of the 1954 Code, the overall limitation was repealed leaving only the per country limitation. In 1958, a carryover provision was added for excess taxes that could not be credited under the per country limitation, thereby permitting an averaging effect under the per country limitation that had been possible only under the overall limitation. The provision was enacted to prevent the loss of credits (and therefore double taxation) under the per country limitation system that resulted from timing differences in income inclusions between the United States and foreign countries. P.L. 85-866, § 42. In 1960, an election was introduced that permitted a taxpayer to choose whether to apply the overall limitation or the per country limitation. In 1962, the first income basket, *i.e.*, a separate limitation for a specific type of income, was introduced for "nonbusiness interest income." The Tax Reduction Act of 1975 made important changes to the foreign tax credit as it applied to foreign oil-related foreign source income that were precursors to the more broadly applicable foreign tax credit limitation changes made in 1976. Those changes included the repeal of the per country limitation for oil companies and the enactment of a separate overall limitation for foreign oil-related income. (Oil companies were singled out because most other taxpayers used the overall limitation and did not incur the high level of foreign losses incurred by oil companies.) Another change for oil companies was that overall foreign losses were to be recaptured as U.S.-source income to the extent that foreign operations became profitable in later years. In 1976, the per country limitation was repealed for all taxpayers and the recapture of overall foreign losses as U.S.-source income was applied to all taxpayers.

[269]American Jobs Creation Act of 2004, Pub. L. No. 108-357, §§ 403(b), 404, 118 Stat. 1418, 1492-97.

[270]Some would argue that use of the U.S. tax base also may be considered to implement the fairness principle. By adopting the U.S. tax base—and not the foreign tax base—for the limitation fraction, a taxpayer will at a minimum pay tax at the effective U.S. tax rate on repatriated income. Thus, where the foreign effective rate measured against the U.S. tax base is equal to or less than the U.S. rate, a U.S. taxpayer that earns income outside the United States will pay the same combined effective rate as a U.S. taxpayer that earns only U.S.-source income on the same amount of income. Under this view, the calculation of the foreign tax credit by applying U.S. tax principles promotes equity among U.S. taxpayers. Of course this view presupposes that allowing a credit for foreign taxes instead of a deduction is itself fair, an issue that is discussed in Chapter 2.

1. *Sale of Personal Property and the Inventory Sales Title Passage Rule*

General Rule. In general, gain from the sale of personal property (other than inventory) is sourced to the residence of the seller.[290] A U.S. taxpayer generally will have U.S.-source income from the sale of personal property (other than inventory) unless the gain is attributed to a foreign office and a foreign tax of at least ten percent is imposed on the gain. This generally applicable rule is administratively convenient and limits foreign source treatment to where there is actual taxation of the gain. This approach also is consistent with internationally accepted rules for taxation of gains by a source country in that many if not most U.S. trading partners only tax sales attributable to a permanent establishment in the source country.[291]

If every country adopted similar principles for source taxation of gain from the sale of personal property, there would be little potential for double taxation, even if such source rule were in some sense incorrect from a conceptual viewpoint. However, countries may tax income on a different basis. In the absence of a treaty or unilateral U.S. conformity, the U.S. taxpayer will be subject to potential double taxation if U.S. source rules are applied without regard to whether income is taxed by the source country. One way to alleviate this result is to address such source taxation by treaty (or by interaction of a treaty and the Code).[292]

Inventory Sales. Income from sales of inventory is subject to a special source rule. Gain from the sale of inventory has its source at the place of sale, as determined under the passage-of-title rule.[293] Income from cross-border sales of inventory manufactured or produced by the taxpayer generally is apportioned equally to U.S. and foreign sources if such inventory is produced in the U.S. and sold abroad or vice versa.[294] This place-of-sale sourcing principle based on title passage is susceptible to taxpayer planning and bears no necessary relation to whether a foreign country will tax the gain.[295] Consequently, taxpayers routinely use foreign title passage on export sales to boost their foreign tax credit limitation.

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[290] I.R.C. § 865(a).

[291] Many income tax treaties source gain from the sale of personal property to the residence of the seller. *See* OECD MODEL TAX CONVENTION ON INCOME AND CAPITAL, art. 13(4) (Org. for Econ. Co-Operation and Dev., Comm. on Fiscal Affairs 2003).

[292] Under section 864(h), if certain gains from the sale of stock or intangibles are allowed to be taxed under a treaty by the treaty partner, then the income may be treated as foreign source income in a separate limitation category.

[293] I.R.C. §§ 861(a)(6), 862(a)(2).

[294] I.R.C. § 863(b)(2); Reg. § 1.863-3(b)(1).

[295] The passage-of-title rule is vulnerable to manipulation because passage of title does not necessarily reflect economic or commercial reality of sales transactions. Under the modern commercial law, passage of title does not dictate the transfer of rights and burdens in connection with sales. Under the Uniform Commercial Code (UCC), title passes by the express agreement of the parties or, in the absence of agreement, when the seller completes his performance of delivery. UCC § 2-401(1), (2). See also JOSEPH ISENBERGH, INTERNATIONAL TAXATION: US TAXATION OF FOREIGN PERSONS AND FOREIGN INCOME 16:8 (3d ed. 2002) for a more detailed discussion.

2. *Royalties*

Royalties are sourced according to the place were the intangible or the right to exploit the intangible is used. For example, a royalty for use of a U.S. patent generally is U.S. source, because a U.S. patent does not afford legal protection outside of the United States. If a royalty is for exploitation of non-U.S. rights, it generally will be foreign-source income. If a royalty is for use of a bundle of patent rights, including U.S. and non-U.S. rights, it may be necessary to apportion the royalty income among the various geographies.

The disparities between the source rules for sales of personal property and the royalty source rule may give rise to planning possibilities. If gain on a sale to a distributor of property that is subject to a license of a non-U.S. intangible property right includes a return to the intangible, the source of the gain nonetheless will be determined under the personal property sales source rules. If the gain would be domestic source, a taxpayer with excess foreign tax credits may prefer to increase its foreign source income by separately charging the distributor a royalty for use of the intangible with respect to sales to the distributor's customers. Although there is an economic difference between charging a price for the sale of a product to a distributor as opposed to a royalty that only is paid if the product is sold by the distributor, the tax benefit may justify the difference. Where the distributor is a wholly-owned subsidiary, there is no economic risk in deferring the royalty income until the product is sold by the distributor.

D. *Allocation and Apportionment of Expenses*

1. *Background*

As discussed above, the allocation of expense is an integral part of determining the foreign tax credit limitation. If expenses are underallocated to foreign income, the foreign tax credit limitation will increase, and more foreign taxes will be allowed to offset U.S. tax. If, instead, expenses are overallocated to foreign income, the limitation will be decreased and fewer foreign taxes will be allowed to offset U.S. tax.[296] Two of the most significant expenses are for interest and R&D. While there have been longstanding controversies over the specifics of the interest and R&D expense allocation rules, there has been acceptance that U.S. tax concepts should govern the allocation of expense, without regard to whether the expense is allowed under foreign law. This is for the reasons set out above for using the U.S. tax base as the foundation for the foreign tax credit limitation fraction.

In the following sections we review the rules for interest and R&D expense.

[296]For example, if royalties for intangibles developed with R&D expenditures are treated as foreign income, R&D expenses should be properly allocated to the royalties. In an exemption system, foreign royalties generally are not exempt, so the R&D deduction allocable to the royalties should be allowed as an expense.

2. *Interest Expense and the Water's Edge Issue*

Section 864(e), governing interest expense allocation in this context, was enacted as part of the Tax Reform Act of 1986. This subsection, and the related regulations, put in place the group-wide allocation regime commonly referred to as "water's edge fungibility," because it allocates and apportions the interest expense of affiliated domestic corporations, but does not take into account interest expense of foreign subsidiaries.

Specifically, for purposes of the interest expense allocation and apportionment rules, all members of a U.S. affiliated group generally are treated in the aggregate as a single U.S. corporation.[297] Each member of an affiliated group is required to allocate and apportion its own interest expense based on a fraction computed by reference to the assets (measured by fair market value or by tax basis) of the entire group.[298] This fraction represents the value of the total affiliated group's assets in each separate limitation category over the total value of the affiliated group's assets.[299] Significantly, the assets and obligations of foreign affiliates are not included in the group for this purpose; rather, the shares of foreign affiliates are treated as assets of the U.S. group.

The basic approach taken under the section 864(e) rules rests, first, on the premise that money is fungible and hence whether particular borrowings are made to generate U.S. source income versus foreign source income (tracing) would not produce a more accurate determination of foreign source income and, in fact, would permit manipulation by taxpayers. To this extent, the approach is essentially identical to the approach under the pre-section 864(e) rules.[300] The second premise, and the change brought by section 864(e), is that separate calculations for each corporation in an affiliated group also do not reflect economic reality and thus do not provide the best measure of foreign source income, and in addition may serve to permit unwarranted taxpayer manipulation based on mere distinctions between legal entities.

However, as stated above, section 864(e) extends the money-is-fungible approach only to the water's edge. It excludes the interest expense and assets of affiliated foreign corporations from the scope of group-wide allocation. Instead, the stock of a foreign affiliate is generally treated as a foreign asset for purposes of calculating the foreign assets of the U.S. members of the group.[301] Increases

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[297]Banks and similar institutions, referred to in the regulations as "financial corporations," are treated as a separate affiliated group for purposes of these rules. I.R.C. § 864(e)(5)(B), (C); Temp. Reg. § 1.861-11T(d)(4). The banking portion of bank holding companies, and nonbank financial subsidiaries owned by bank holding companies, are also treated as financial corporations. I.R.C. § 864(e)(5)(D); Temp. Reg. § 1.861-11T(d)(4)(iii). Life insurance companies are treated as a separate affiliated group unless an election is made to the contrary. I.R.C. § 864(e)(7)(E); Temp. Reg. § 1.861-11T(d)(3). The Secretary has broad powers to create further exceptions. I.R.C. § 864(e)(7)(F).

[298]Reg. § 1.861-11T(c).

[299]Narrow exceptions to apportionment are provided in certain cases, in particular, with respect to qualified nonrecourse indebtedness, as to which a tracing approach is adopted. Reg. § 1.861-10T.

[300]*See* former Reg. § 1.861-8(e)(2) (1977).

[301]Reg. § 1.861-12T(c).

for earnings and profits are required for CFC shares if the tax basis valuation method is used.[302] This allocation rule in effect considers the debt of the U.S. group members to support, in part, the assets and operations of each foreign affiliate regardless of any independent leverage of the foreign affiliate. The effect is that interest expense of a foreign affiliate having only foreign operations is allocated entirely against foreign-source income whereas interest expense of the U.S. group is allocated in part against U.S.-source income and in part against foreign-source income.

In 2004, Congress adopted an elective worldwide group rule effective for years after 2008 that will allow a taxpayer a one-time election to take into account the interest expense and assets of 80%-owned foreign affiliates in determining the proportion of the interest expense of U.S. affiliated group members that should be allocated to foreign-source income.[303] If an election is made, section 864(f) takes account of the interest expense of foreign affiliates and reduces accordingly the amount of the interest expense of the U.S. group allocable to the stock of the foreign affiliates. Under this worldwide fungibility approach, the interest expense of the domestic members of a worldwide affiliated group is allocated and apportioned to foreign-source income only to the extent that (1) the total interest expense of the worldwide affiliated group, multiplied by the ratio which the foreign assets of the worldwide affiliated group bear to the total assets of the worldwide affiliated group, exceeds (2) the interest expense of the foreign members of the worldwide affiliated group that they would have allocated and apportioned to foreign-source income had they formed their own separate affiliated group.[304]

3. *Research and Experimentation Research*

Until the issuance of final regulations in 1995,[305] the allocation and apportionment of research and experimental (R&E) expenditures was the subject of substantial controversy. The issue is of importance to U.S. multinational companies because of its impact on the amount of U.S. foreign tax credits available to such companies.

The first step under the 1995 Regulations is to allocate R&E expenditures "to all items of gross income as a class (including income from sales, royalties, and dividends) related to such product category (or categories)."[306] If a taxpayer conducts R&E with respect to more than one of the categories, the taxpayer is

[302]I.R.C. § 864(e)(4); Reg. § 1.861-12T(c)(2).

[303]American Jobs Creation Act of 2004, Pub. L. No. 108-357, 118 Stat. 1418 (2004) § 401(a) (to be codified at Code section 864(f), (g)).

[304]Note that there is a one-way aspect to this formula—excess interest expense associated with foreign assets would not be deemed instead to be associated with U.S. assets, even for purposes of the foreign tax credit limitation.

[305]Allocation and Apportionment of Research and Experimental Expenditures, 60 Fed. Reg. 66,502 (Dec. 22, 1995) [*hereinafter* 1995 Regulations].

[306]*Id.* at 66,503.

permitted to aggregate the categories for purposes of allocating and apportioning R&E expenditures. Where R&E is not clearly identifiable with any one product category, it is considered conducted with respect to all of the taxpayer's product categories. The 1995 Regulations allow the allocation of R&E expenditures to three-digit classifications of the Standard Industrial Classification Manual (SIC) product categories of gross income (or, with consent of the Commissioner, to another classification).[307]

Next, for each relevant product category, all or part of the R&E expenditures in such category are potentially allocated between U.S. and foreign sources under special rules. First, where research is undertaken solely to meet legal requirements imposed by a political entity concerning improvement or marketing of specific products or processes, and the results cannot be reasonably expected to generate amounts of gross income (beyond *de minimis* amounts) outside a single geographic source, the deduction is allocable only to the grouping or groupings of gross income within that geographic source as a class (the legal requirement rule).[308]

Second, if R&E activities accounting for more than 50% of the amount of the deductions in the product category are performed at a single geographic source, the 1995 Regulations provide that a fixed percent of the relevant deductions is allocated to the statutory (or residual) groupings of gross income corresponding to that source.[309] Thus, the 1995 Regulations include a 50% exclusive place-of-performance apportionment under the sales method[310] (described below) and a 25% exclusive place-of-performance apportionment under the optional gross income methods (described below) (in both cases, applied after the application of the legal requirement rule).[311]

That portion of the R&E deduction that is not apportioned either under the legal requirement rule or the place-of-performance apportionment rule is apportioned using either the sales method or the gross income methods.[312] Under the sales method, an amount equal to the remaining portion of such deduction is

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[307]Reg. § 1.861-17(a)(2). A two-digit code denotes "major group" (*e.g.*, agricultural services), a three-digit code denotes "industry group" (*e.g.*, crop services), with increasing-digit codes denoting increasingly detailed classifications.

[308]Reg. § 1.861-17(a)(4).

[309]Reg. § 1.861-17(b)(1).

[310]The corresponding figure under prior regulations was 30%.

[311]A rule permitting exclusive apportionment at a higher percent based on facts and circumstances involving very limited or long delayed application abroad may apply to the exclusive apportionment under the sales method and the optional gross income methods. Reg. § 1.861-17(b)(2).

[312]Reg. § 1.861-17(c), (d). The 1995 Regulations provide that if the amount of sales of a licensed product is unknown (for example, when a licensed product is imbedded in or bundled with another product), a reasonable estimate based on the principles of section 482 should be made and, in the case of intangible property, "if the amount of sales of products utilizing the intangible property is unknown, a reasonable estimate of sales shall be made annually." Reg. § 1.861-17(c)(2). (Under the prior regime, the sales amount taken into account was ten times the amount received or accrued for the intangible property during the taxable year.) Permission from the Service is not required to change a method of apportionment that the taxpayer has used for at least five years. Reg. § 1.861-17(e).

apportioned between the statutory grouping (or among the statutory groupings) within the class of gross income and the residual grouping within such class in the same proportions as the amounts of sales from the product category (or categories) that resulted in such gross income within the statutory grouping and the residual grouping, respectively, bear to the total amount of sales from the product category (or categories).[313] For purposes of such apportionment, special rules exist for taking into account sales of uncontrolled and controlled parties, including foreign corporations.[314]

Under the gross income methods, subject to the conditions below, the taxpayer may apportion its R&E expenditures ratably between the statutory grouping (or among the statutory groupings) of gross income and the residual grouping of gross income in the same proportions as the amount of gross income in the statutory grouping and the amount of gross income in the residual grouping, respectively, bear to the total amount of gross income.[315] Preconditions of such apportionment, however, are that (1) the amount of R&E expense ratably apportioned to the statutory grouping (or groupings, in the aggregate) must not be less than 50% of the amount that would have been so apportioned if the taxpayer had used the sales method, and (2) the amount of R&E expense ratably apportioned to the residual grouping must not be less than 50% of the amount that would have been so apportioned if the taxpayer had used the sales method (floor).[316] If either of the conditions is not met, 50% of R&E expenditures that would have been apportioned to the statutory grouping or residual grouping, as applicable, under the sales method, are apportioned to such statutory grouping or residual grouping.[317]

The 1995 Regulations represent the culmination of a continuing series of compromises to accommodate the objections of multinationals to the allocation of R&D expense to foreign income, notwithstanding that income from the intangibles developed generates foreign source income that increases the foreign tax credit limitation.[318] These concessions include (1) use of a gross income alloca-

[313]Reg. § 1.861-17(c)(1).

[314]Reg. § 1.861-17(c)(2), -17(c)(3).

[315]Reg. § 1.861-17(d)(1).

[316]Reg. § 1.861-17(d)(2).

[317]Reg. § 1.861-17(d)(3).

[318]The 1995 Regulations are the most recent in a long series of approaches adopted in this area. The first attempt to create a framework governing R&E expenditure allocations was made in 1977 with the introduction of Treasury regulations under section 861 ("1977 Regulations"). T.D. 7456, 1977-1 C.B. 200. The 1977 Regulations provided two allocation and apportionment methods for research expenses—the sales method and the optional gross income method. Under the sales method, a 30% exclusive apportionment was accorded to the place of performance of the R&D activities. No exclusive apportionment was provided under the gross income method.

The Economic Recovery Tax Act of 1981 suspended the application of the 1977 Regulations for a two-year period and provided that during such period R&E expenses for research activities conducted in the U.S. were to be apportioned entirely to U.S.-source income. Pub. L. No. 97-34, § 223, 95 Stat. 172,249. The Tax Reform Act of 1984 extended this moratorium for two additional years. Pub. L. No. 98-369, § 126, 98 Stat. 494, 648. The Consolidated Omnibus Budget Reconciliation Act of 1985 extended the moratorium for one additional taxable year. Pub. L. No. 99-272, § 13211, 100 Stat. 82,324.

tion method that does not look through to the gross income of foreign subsidiaries, and (2) use of a three-digit SIC product categories to group gross income (versus the broader two-digit classification required by the 1977 Regulations), which allows taxpayers to allocate R&E expenditures to narrower classes of gross income. While in theory this may accomplish a more accurate matching of such costs between U.S.- and foreign-source income, in practice it permits R&D expense to be more easily allocated away from high-taxed foreign income categories.

The rule also provides that a taxpayer may aggregate, disaggregate, or change a previously selected category if the taxpayer establishes to the satisfaction of the Commissioner that, due to changes in the relevant facts, a change in product category is appropriate, and "provides a simple and workable format for balancing the need for consistency with the desire for flexibility."[319] The increase in the percentage of R&E expenditures that may be exclusively apportioned to U.S.-source income under the sales method of apportionment from 30% under the 1977 Regulations to 50% also was favorable to U.S.-based multinational companies. A further change benefiting such taxpayers was to permit a 25% exclusive apportionment for the gross income method (as compared with none under the 1977 Regulations).[320]

The attribution of R&D expense to income is inherently uncertain, and the more so as the research in question approaches basic research. That is the funda-

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The Consolidated Omnibus Budget Reconciliation Act of 1989 ("1989 Act") established a new provision, section 864(f), which superseded Treasury's R&E regulations. Pub. L. No. 101-239. With respect to R&E expenditures not specifically allocated under the legal requirement rule, the 1989 Act provided that 64% of such expenses for research conducted in the United States was allocated to U.S.-source income, and 64% of expenses for foreign-based R&E was allocated to foreign-source income. The 64% allocation formula originally could not be used beyond the first 6 months of the taxpayer's first taxable year beginning after August 1, 1991 (but this period was extended for an additional 18 months in Revenue Procedure 1992-56, 1992-2 C.B. 409). A taxpayer could allocate and apportion the remainder of R&E expenses on the basis of either sales or gross income. However, if the income-based method of apportionment was chosen, the amount apportioned to foreign-source income could be no less than 30% of the amount that would be apportioned to foreign-source income had the sales method been used.

The Omnibus Budget Reconciliation Act of 1993 ("1993 Act") amended section 864(f) by changing the minimum allocation percentage for R&E expenditures from 64% to 50%. Pub. L. No. 103-66, § 13,234, 107 Stat. 312,504. The 1993 Act provides the formula for the first taxable year (beginning before August 1, 1994) that commences immediately following the taxpayer's last taxable year to which Revenue Procedure 1992-56 applies, or would have applied had the taxpayer been in existence and elected the benefits of that Revenue Procedure. On May 24, 1995, the Department of Treasury issued proposed regulations under section 861 relating to the allocation and apportionment of R&E expenditures that were intended to replace the 1977 Regulations. Prop. Reg. § 1.861-8, 60 Fed. Reg. 27,453 (May 24, 1995) ("1995 Proposed Regulations"). With modifications, the 1995 Proposed Regulations were adopted as final regulations in December 1995.

[319]1995 Regulations, 60 Fed. Reg. 66,502 (Dec. 22, 1995).

[320]Some of the changes were justified in a study performed by the Treasury Department, which was published simultaneously with the 1995 Proposed Regulations. U.S. TREAS. DEPT., THE RELATIONSHIP BETWEEN U.S. RESEARCH AND DEVELOPMENT AND FOREIGN INCOME (1995), reprinted in 95 TAX NOTES INT'L (TA) 101-17 (May 25, 1995) (concluding that "reducing the allocation of domestic R&D to foreign income by about 25 percent compared to the 1977 regulations can be expected to increase the fairness of the regulations and still remain within the range of allocations that cannot be rejected in view of the uncertainty of the evidence").

mental reason to favor a broad-based sales allocation method and tie compromises back to that methodology. While the 1995 Regulations addressed many industry criticisms, after the preceding compromises described above, the question may be raised whether the regulations materially underallocate R&D expense to foreign income. Nonetheless, they represent a hard-to-reach compromise of a contentious issue. The stakes would be much greater under an exemption system, however,. because any allocation of R&D expense to exempt income would cause the deduction to be disallowed. Under the current foreign tax credit, the allocation of a deduction to foreign income only has an adverse effect for a taxpayer that cannot credit a foreign tax as a result. Taxpayers with excess limitation are not affected.

II. OBJECTIVES OF THE FOREIGN TAX CREDIT

The foreign tax credit as it has been implemented by the United States is a highly sophisticated and complex mechanism. Over the decades many technical issues have been identified and resolved, and the current rules work well in an extraordinary range of fact patterns. The foreign tax credit is more than a series of technical rules, however. As a central part of the U.S. system for taxing foreign income, the scope of the credit allowed to a U.S. taxpayer reflects fundamental policy choices regarding the degree to which foreign investment will be treated neutrally with U.S. investment or encouraged or discouraged in relation to U.S. investment. The foreign tax credit has not always been analyzed from this broader perspective. Indeed, by focusing on narrow technical issues, such as the intricacies of R&D expense allocation of foreign tax credit limitation categories, taxpayers have sometimes persuaded Congress and the Treasury to adopt changes without regard to broader policy consequences of the changes.

Although the foreign tax credit provisions are detailed and complicated, several fundamental principles underlie them. The need for a foreign tax credit arises from the fact that the United States taxes income on a worldwide basis.[321] The objective of the foreign tax credit is to mitigate double taxation of foreign income. It is not intended that the credit for foreign taxes reduces U.S. tax on U.S.-source income as determined under U.S. principles.[322] Finally, cross-crediting of excess foreign taxes on high foreign-taxed foreign income against U.S. tax on other low foreign-taxed foreign income concedes the residual U.S. tax on such low-taxed income to the high taxing foreign country. It is difficult to see how this is in the interests of the United States.

[321] I.R.C. § 61 (providing that "gross income means all income from whatever source derived . . .").

[322] In the 1921 Senate Finance Committee Hearings, Dr. T.S. Adams identified the abuse possibility resulting from the lack of a foreign tax credit limitation: big corporations paid virtually no U.S. income tax because the English tax rates were three times higher than the U.S. rate at the time. Upon Senator Simmons' statement that Dr. Adams "made that case out so strongly" that it was unnecessary to discuss it further, Dr. Adams replied, "[T]here is nobody ready to object to it. It has been a big hole in the law." *Internal Revenue: Hearings on H.R. 8245 Before the S. Comm. on Finance*, 67th Cong. 73-74 (1921).

With the allowance of a foreign tax credit to its resident taxpayers, the United States unilaterally defers the exercise of its taxing jurisdiction to that of the source country, at least to the extent of the source-country tax. Under the Joint Committee Staff and President's Advisory Panel proposals to exempt certain foreign income, discussed in Chapter 4, the United States would go further in deferring to the source country and decline to tax foreign income even if the income were not taxed by a source country.

The differences between the credit and exemption approaches in relation to low-taxed foreign income are stark and easily understood. Less well understood is the fact that a foreign tax credit system that allows excessive crediting of foreign taxes is actually more generous to investment in high-tax countries than an exemption system. This is because under an exemption system the excess tax credits from high tax countries cannot be used as credits against U.S. tax on other income. Under present U.S. rules, foreign taxes are allowed as a credit against what should be U.S. income because of source rules that inappropriately treat income as foreign, expense allocation rules that over-allocate expense against U.S. income, and an overall limitation that permits extensive cross-crediting of foreign taxes. In many cases, excess foreign taxes may effectively be used to offset U.S. tax on income from U.S. economic activity that is misclassified as foreign under deficient source and expense allocation rules.

III. PROPOSALS FOR MODIFYING THE FOREIGN TAX CREDIT

1. *Source and Allocation Rules for the Foreign Tax Credit Limitation*

A fundamental issue under the foreign tax credit limitation is that it relies on general source rules that do not always take account of the purpose of the foreign tax credit: to mitigate or avoid double taxation. If income is treated as foreign income but is not taxed, or even subject to tax, under customary international tax principles by any source country, the foreign tax credit is inappropriately expanded. The result is that taxpayers, and the high tax foreign country, are relieved by the U.S. Treasury from the economic impact of these high foreign taxes. Similarly, but far less common in practice, if, under customary international tax principles, a foreign country taxes income that the United States treats as U.S. source, a taxpayer will be subject to unrelieved double taxation. The source rules applied in determining the foreign tax credit limitation should take account of both cases.

2. *Proposal: Source U.S. Residents' Gain from the Sale of Inventory the Same As Gain from the Sale of Other Personal Property*

The place of sale inventory source rule generally treats as foreign source gain from sales of inventory property if title passes to the buyer outside the United States. Yet, most foreign countries tax such gains only if they are attributable to a taxpayer's permanent establishment in the source country. For a U.S. taxpayer in excess credit position, foreign taxes can offset U.S. tax on gain from a foreign source sale even where a foreign country would not tax the gain in the absence

of a permanent establishment. The use of the excess credit effectively exempts the foreign source sale from tax and operates as a form of subsidy for sales of goods outside the United States that is not available for the same sales in the United States. Under an exemption system, there generally would be no opportunity for excess foreign tax credits to offset sales income not attributable to a foreign branch.

Proposal. Gain on the sale of inventory by a U.S. resident, as defined in current law by section 865(g), would have its source at the residence of the taxpayer unless the gain is attributable to a foreign office or fixed place of business of the taxpayer and the gain is taxed at an effective rate of ten percent or more. This is currently the rule for sales of personal property other than inventory.[323] The same rule would apply to the sales portion of gain currently sourced under the rule for sales of property manufactured by the taxpayer.

Rationale. The purpose of the change in source rule is to prevent the U.S. tax base from being offset by foreign tax credits. Allowing high foreign taxes on other income to be used as credits against U.S. tax on income from export sales shifts the costs of the foreign governments imposing high taxes onto U.S. taxpayers. Under an exemption system, there would be no opportunity for the excess foreign tax credits to offset this income. The current law rule cannot be justified as an export incentive because it only benefits taxpayers that have excess foreign tax credits and does not benefit purely domestic manufacturers and distributors.

Evaluation. A similar proposal was made in President Reagan's tax reform proposals in 1985. The proposal was not adopted in part because of the attractions of the simplicity of the title passage rule and fears regarding the complexities of applying a rule based on attribution of sales to a foreign office. The current law rule for sales of personal property has been in the law since 1986, however, and has proven relatively easy to apply. We have found no reported controversies regarding the application of the rule.

3. *Proposal: Source U.S. Residents' Income from Licensing Intangibles Consistently With the Source of Income From Sales of Personal Property and Allocation of R&D Expense*

An owner of an intangible may realize a return on the investment in the intangible either by licensing the intangible for a royalty or, if the owner uses the intangible in a product or service, by embedding the return in the sales price of the product or service using the intangible. Under current law, the source of income from an intangible is determined by the place where it is used and therefore derives its legal protection. A U.S. person that licenses its intangible for a foreign-use royalty realizes foreign-source income, but if the same intan-

[323] I.R.C. § 865(a), (e)(1).

gible is used in a product manufactured in the United States and sold abroad by that person the income will have a divided source depending on where title passes. Thus, in the absence of a withholding tax, there can be a foreign tax credit advantage to separately licensing intangibles as in the case of inventory sales on which no foreign tax is imposed. The U.S. tax on the royalty income, however, can be offset by excess foreign taxes on other income. Under most exemption systems, there would be no opportunity for the excess foreign tax credits from exempt income to offset this income.[324]

Proposal. Royalty income of a U.S. resident, as defined in current law by section 865(g), would have its source at the residence of the taxpayer unless the income is attributable to a foreign office or fixed place of business of the taxpayer and the net income is taxed at an effective rate of ten percent or more. If royalty income is not attributable to a foreign office or fixed place of business, but is subject to a foreign withholding tax on the gross amount of the royalty, the royalty income will be treated as foreign-source in an amount equal to the foreign tax divided by the highest rate of tax applicable to the taxpayer.

Evaluation. Under the proposal, the source of royalty income applicable to a U.S. resident for purposes of the foreign tax credit would correspond to the taxation of inventory sales under the preceding proposal. Where a royalty is not subject to a foreign tax, it would not inflate the foreign tax credit limitation. If a royalty were subject to a gross withholding tax, it would be treated as foreign-source income to an extent that would permit the taxpayer to credit the foreign tax if it were the taxpayer's only item of income.

The proposal should be no more difficult, and may be easier, to implement than the current law source rule, which depends on the place the intangible is used. It sometimes is difficult to determine the place of use of an intangible.

If the preceding change were not adopted, consideration should be given to modifying the R&D expense allocation rules to assure that foreign income is bearing its full share of the burden of supporting R&D. Consideration should be given to eliminating the optional gross income method of apportionment or determining gross income on a look-through basis with respect to controlled foreign corporations. Consideration also should be given to (1) reducing the exclusive apportionment to 30% if more than 25% of the revenues from the product area are from outside the jurisdiction where the R&D is performed, because the premise of the exclusive apportionment exception would not appear to be applicable in the particular case, and (2) applying the exclusive apportionment rule only if more than 50% of the worldwide affiliated group's R&D expenditure is performed in a single country.

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[324]As discussed in Part II.B.4 of Chapter 4, however, both the Joint Committee Staff's exemption proposal and the President's Advisory Panel's proposal would present the opportunity for taxpayers to cause high taxes income to be taxable as subpart F income and to credit those high taxes against U.S. tax on other foreign income.

4. *Proposal: Adopt Per Country Foreign Tax Credit Limitation*

The purpose of the foreign tax credit is to relieve international double taxation. With respect to an item of income, double taxation is relieved once the foreign tax on that item is creditable against U.S. tax on that item of income. No tax policy purpose is served by allowing the foreign tax on one item of foreign income to offset the U.S. tax on another item of foreign income. Indeed, allowing cross-crediting only creates an incentive to make the investment to earn the second item of lower-taxed foreign income. Moreover, the beneficiaries of that cross-crediting are the two foreign countries—the high-tax foreign country does not suffer the detriment of its high foreign taxes and the low-tax foreign country receives the benefit of the investment. The U.S. taxpayer finances these benefits.

The overall foreign tax credit limitation that is scheduled to be effective for years after 2008 allows virtually unlimited cross-crediting, except with passive income, and therefore places substantial pressure on source and other foreign tax credit rules. The preceding proposals to strengthen the source rules will reduce some of the ability to inappropriately expand the foreign tax credit limitation, but substantial cross-crediting possibilities would remain.

Proposal. The foreign tax credit limitation would be determined with respect to U.S. tax on income earned in or by a qualified business unit in a country. (It is possible that countries with similar tax bases or effective tax rates could be grouped together.) The separate limitation for passive income would be retained. As under current law, income from a controlled foreign corporation would be analyzed on a look through basis. A loss in one country would offset income from other countries, including the United States, pro rata according to income from other countries. Subsequent income in the loss country would be recaptured as income from the country the loss offset.

Evaluation. Use of a per country limitation is logical because in most countries the tax rate and tax base is the same throughout the country (this is less true for a country, such as Switzerland, with substantial differences in cantonal taxes). Consequently, the scope for cross-crediting is reduced. Restricting cross-crediting seeks to treat investment in a high tax country no better than it would be under an exemption system, while preserving the benefit of worldwide taxation with a foreign tax credit for investment in lower-taxed countries.

Any proposal to restrict cross-crediting involves trade-offs, principally relating to complexity. A per country limitation balances these trade-offs, because most smaller taxpayers will be taxable in a limited number of countries. Large multinational taxpayers, which have the greatest incentive to achieve cross-crediting, will be in many countries but also will be best able to bear the burden of the additional complexity.

5. *Proposal: Modify Technical Taxpayer Rule*

The technical taxpayer rule has been used in connection with deferral and either the check-the-box entity classification rules or hybrid instrument planning to achieve the separation of foreign taxes and, from a U.S. perspective, the

income that the taxes are imposed on. This enhances the utility of the foreign taxes, which can be used to cross-credit against other low-taxed foreign income, as well as the value of deferring U.S. tax on the separated untaxed earnings. If other changes in this Report were made, such as tightening source rules, limiting cross-crediting and restricting deferral, the potential for taking advantage of technical taxpayer planning would be eliminated (in the case of ending deferral) or materially reduced (in the case where other changes are made). Even if such changes were made, an adjustment to the technical taxpayer rule would be in order.

The New York State Bar Association Tax Section has suggested a change to the regulations that would permit apportionment of the foreign taxes among related persons (including for this purpose disregarded entities) in cases where the taxes and income were separated. The standard they propose is to be "consistent with the principles underlying the foreign tax credit rules." We understand this to mean that the Service would be empowered by regulation to associate foreign taxes with the income to which they relate.[325]

Proposal. The Service would be authorized to make allocations of foreign taxes among commonly controlled persons to the person that has the income to which the taxes relate under U.S. tax principles to achieve an appropriate matching of income and taxes and so further the objective of the foreign tax credit to avoid double taxation of income. The Service also would be authorized to make such correlative allocations as would be necessary to account for deemed transfers of cash.

Evaluation. The proposal is intended to prevent the separation of income and taxes among commonly controlled persons that would result in inappropriate allowance of credits for foreign taxes that are not associated with the income, as determined for U.S. tax purposes, that is taxed by the foreign jurisdiction. While this may be viewed as a derogation from the simplicity of the technical taxpayer rule, these cases arise most often as a result of taxpayer planning and should be addressed.

[325]NYSBA Tax Section, *Report on Allocation of Foreign Taxes*, *supra* note 214, at 5. As this Report was going to press, the Internal Revenue Service proposed regulations that would modify the technical taxpayer rule effective for foreign taxes paid in tax years beginning after January 1, 2007. *See* Notice of Proposed Rulemaking, 71 Fed. Reg. 44240 (Aug. 4, 2006), 2006 TNT 150-6. Generally, the proposed regulations are consistent with the proposal below, but they would allocate the foreign tax to a reverse hybrid according to each owner's income computed under foreign law.