Viewpoints

Why Not Des Moines?

A Fresh Entry in the Subpart F Debate

by H. David Rosenbloom

H. David Rosenbloom is a member of Caplin & Drysdale, Chtd, in Washington and director of the International Tax Program at the New York University School of Law.

After the 15 July hearings on "U.S. Tax Policy and Its Effect on the International Competitiveness of U.S.-Owned Foreign Operations," U.S. Senate Finance Committee Chairman Charles E. Grassley, R-Iowa, posed the following written questions to witnesses:

> Company X manufactures widgets in the United States for sale in the United States and abroad. It forms a subsidiary, Y, in a zero-tax jurisdiction such as Bermuda to serve as a trading company. Y hires 200 persons in Hamilton. Widgets are sold by X to Y for 100, and Y resells the widgets, without changing them, for 125 to unrelated parties in the United States and the rest of the world. The transfer price from X to Y is defensible. The 25 earned by Y is attributable to economic functions that Y performs in Bermuda. Should the United States tax that 25? Why or why not?

Those are good questions. And this is an excellent way to relaunch a debate on what should be done to, or about, the main U.S. antideferral statute, subpart F of the Internal Revenue Code. The statute clearly shows age. What revisions should be considered in the name of international competitiveness?

The debate needs to be relaunched because, although there has been a great deal of recent discussion about subpart F, much of it has soared above and beyond the ostensible subject. It has approached subpart F from perspectives that are historical and perhaps oxymoronic (what was Congress *really* thinking in 1962?), economic (is capital export neutrality reconcilable with — or preferable to — capital import neutrality?), and philosophical (how can we best advance the cause of global welfare? U.S. welfare?). What happened to practical? That is where the debate should focus, and that is why Chairman Grassley's questions are so good. They portray what is at stake.

The questions imply, fairly, that the subpart F debate is really about tax havens. The statute does not impose a serious impediment to investment in, or income derived from, the high-tax countries that are the locus of most U.S. foreign investment, such as Germany, Japan, and the United Kingdom. An effective rate of 31.51 percent or higher puts income beyond the statute's reach. Subpart F may intrude in those countries at the margin, and perhaps occasionally more deeply, but the overall limitation on the foreign

tax credit goes a long way — some might say too far — to alleviate the pain of residual U.S. tax on income from an active business in Munich.

Some countries are not high-tax countries, but are not tax havens either. My own preference would be to take a benign view of these situations as long as a real tax system is in place. But I must acknowledge, sadly, that my view is not the law, and subpart F can surely have an effect here as well. Nevertheless, the real prize in subpart F "reform" lies in the low- or no-tax countries, the tax havens of the world. U.S. companies would be pleased to be able to establish the sort of structure described in Chairman Grassley's questions — with a slice of the combined income from manufacture and marketing "hived off" to a jurisdiction where taxes are low or nonexistent.

Checking the box to render all foreign affiliates part of one large corporation for U.S. tax purposes does not obviate the branch rule, and although contract manufacturing may sometimes undermine the rule, it also may not.

Of course, the subpart F debate is not really about subpart F as a whole, sections 951 through 964 of the Internal Revenue Code. Those sections represent the most far-reaching of six or seven U.S. regimes (depending on how one counts the passive foreign investment company/qualified electing fund rules) aimed either directly or glancingly at deferral — the nonimposition of current U.S. tax on the foreign income of controlled foreign corporations. No one (I think — I hope) maintains that passive investment income should qualify for deferral, for reasons that are obvious: That income can be earned by anyone and, in the absence of an antideferral statute, can and would be stuffed into a foreign corporation by anyone and everyone. There is room for argument about what income is passive, but in the area where the argument has been most heated — financial services income — powerful lobbies have succeeded (appropriately, in my view) in distinguishing most of their activities as nonpassive and outside the scope of the subpart F regime. It is also true that the statute regards moving funds around within a foreign group as passive, but the check-the-box rules, and particularly their disregarded entity corollary, have made it easy for taxpayers to do as they wish in this regard without interference.

Nor — and I confess to venturing now into areas that derive more from experience than analysis — is the subpart F discussion focused on base company oil-related income, base company shipping income, or even base company services income. No doubt those categories produce their share of aggrieved taxpayers, but the categories are industry-specific (in the case of oil-related and shipping income), applicable to relatively few taxpayers even within the designated industry (oil-related income), or, if broadly applicable, infrequently enforced by the Internal Revenue Service (services).

Finally, for reasons that are unclear, the discussion in recent years has not extended to the aspect of subpart F that seems to operate most effectively — the provision that earnings of a controlled foreign corporation, when invested in the United States, are taxable to U.S. shareholders as if the earnings had been distributed to them.

If much of subpart F has not been the subject of intense and widespread discussion, and a large share of foreign income and investment lies outside the statute's purview, what has the core discussion been about? Sales. The subpart F regime pertaining to foreign base company sales income — income earned by a controlled foreign corporation either buying from or selling to a related person, with both manufacture and consumption outside the country of the CFC's incorporation — retains vibrancy. In the case of products manufactured abroad, this is largely attributable to the "branch rule." Checking the box to render all foreign affiliates part of one large corporation for U.S. tax purposes does not obviate the branch rule, and although contract manufacturing may sometimes undermine the rule, it also may not. The courts — stalwart guardians of international tax principles — will have to tell us. In any event, for products manufactured in the United States with no further manufacture abroad, contract manufacturing will be of no help.

Thus, it seems that the rubber, insofar as subpart F is concerned, hits the road principally in the area of base company sales income. That is why Chairman Grassley's questions resonate. They present a fair view of how prototypical base company sales are made. They are modeled on the facts in *Dupont* (*E.I. Dupont de Nemours & Co. v. United States*, 608 F2nd 445 (Ct.Cl. 1979)), a transfer pricing case involving years before the effective date of subpart F. It cannot seriously be contended that the questions, though simplified, are unrealistic, or that in the absence of subpart F companies would not operate in the way reflected in the questions, or that the questions fail to arrive at the nub of the issues. Under subpart F, the 25 earned by Y is now taxable to X. Without the base company sales rules, this income would be taxable only when repatriated to X in the United States. And that, of course, may be never, for all practical purposes.

It is perhaps wise at this point to spend a couple of sentences on transfer pricing. Most knowledgeable observers believe that this is a malleable subject and that in the absence of the foreign base company sales rules, the 25 earned by Y could easily grow to 50 or more. Presumably that would occur by contriving to situate intangible values and other footloose elements of the manufacturing and marketing cycle in Y. Some, alleging faith in the transfer pricing regime — and, more importantly, in the ability of tax administrators to enforce that regime — say the 25 is overstated and that the real number is closer to 5.

The controversy does not matter much, however. Whatever the transfer pricing rules and however talented those charged with enforcing them, there is a slice of income that will properly reside in the base company. Elimination of the foreign base company rules may not be important if that slice is small enough, but it is hard to believe the transfer pricing regime could ever confine the slice that narrowly.

If that conclusion is right — and the rest of this essay proceeds on the assumption that it is — Chairman Grassley's questions are realistic and fair. Should the United States tax the income that comes to repose in Bermuda? We tax it now. Should we continue to do so? Why or why not? *Any discussion of subpart F or the need for reform that fails to address these questions is not participating in the debate.* The questions are clear. They are realistic. They are central to subpart F. They deserve answers.

Not that the answers are easy. In the first place, the functions that generate income in Bermuda are real. In Chairman Grassley's questions, there are really employees in Hamilton — not likely to be Americans, because Americans generally are not enthusiastic about living and working outside the United States — but nevertheless real employees. There is a slice of income in Bermuda because something significant is occurring in Bermuda.

Secondly, those who argue against subpart F in the name of competitiveness have a point (a better point by far than the one made by those arguing complexity, whose aim would be better trained on the foreign tax credit). Many, possibly all, of our major trading partners would not tax the 25 of income if X was a resident of their countries. In that respect the United States may well treat its multinationals less favorably than competitor nations treat theirs. (Whether it makes sense to compare particular aspects of tax systems while disregarding the overall context in which those aspects fit is a fair question but, because it is hard to answer, one that is generally ignored.) So a company resident in, say, the United Kingdom might be able to establish a base company of the sort described in Chairman Grassley's questions and use that company to reduce worldwide taxation on products sold into Switzerland or Japan. Or, for that matter, the United States.

Although the competitiveness concern is rarely spelled out, presumably it runs something like this: A firm that benefits from tax exemption of a distinct slice of its manufacturing and marketing income is in a position to reduce ultimate prices and garner a greater share of the market. Alternatively, that firm can provide a greater return to investors and enjoy an advantaged position in seeking capital. A firm in a position to achieve either of these goals is likely to fare better than competitors. And that conclusion holds not only when firms are competing in foreign markets, but also when the competition takes place in the United States.

Allowing exemption to domestic companies engaged in base company activities would appear to represent not only a logical but a necessary extension.

Advocates for terminating deferral thus have a long hill to climb. They must defend taxation of the 25 in Chairman Grassley's questions in the face of evidence that other countries would not impose tax in parallel circumstances and the argument — if not perhaps incontrovertible proof — that Y will be able to justify the 25 under a transfer pricing analysis only if it is performing real economic functions. Those advocates attempt to climb that hill on the basis of policy goals that range from protecting the U.S. tax base to backstopping the transfer pricing regime, to preventing the loss of U.S. jobs, to avoiding the creation of incentives that favor foreign investment over investment at home.

This rapid and truncated recitation of the policy arguments against deferral is not intended to denigrate those arguments. They are powerful and deserve thorough consideration. The discussion of subpart F has consisted for the most part of weighing those arguments against the competitiveness concern — the notion that tolerance of base companies implies undesirable exemption for income that would otherwise be subject to current U.S. taxation against the threat to U.S. competitiveness of taxing income of the base company under an antideferral regime.

The policy arguments might be blunted to some extent if it could be shown that the exempted income would not otherwise be earned in the United

States. It may be that, with subpart F in place, the income is now assigned to the country of sale, not the country of manufacture. On the other hand, it seems reasonable to believe that elimination of the foreign base company rules would attract at least some activity either from the United States or otherwise subject to current U.S. taxation into the low-tax jurisdiction. Is that consequence not implicit in the argument that subpart F interferes with competitiveness — that competitors are able to achieve exemption for income that, when earned by U.S. controlled companies is subject to U.S. taxation?

In any event, assuming that competitiveness requires that a slice of income — however defined, however measured — be exempted from U.S. taxation, the next inquiry is why that exemption should be available only when economic functions are carried on outside the United States. Proponents of a change to subpart F argue only for that. They would rescind the foreign base company rules and allow the Duponts of the world to recur to the use of those companies, with a slice of income coming to rest in a low-tax jurisdiction, just as in Chairman Grassley's questions.

Why, however, should U.S. companies be required to situate economic functions abroad to achieve a desirable result? It is hardly obvious that there is a national interest in providing an otherwise justifiable tax benefit only when U.S. persons operate through foreign investment and a foreign corporation. If exemption is warranted, why stop with abolition of the foreign base company rules? U.S. companies are allegedly encountering serious competitiveness problems that arguably deserve a solution — but why is it the right solution to exempt income from operations in Hamilton? Why only Hamilton? Or Singapore? Or Nassau? Or Zug? Why not Des Moines?

Assuming an exemption for base company income is justified by a competitiveness concern, there would be less distortion in our tax system if the slice of income accruing to the base company could be earned without U.S. taxation regardless of whether the base company is foreign or domestic. That would answer the charge that U.S. tax policy is driving jobs out of the country, and it is hard to see how proponents of competitiveness could object it. Indeed, because the competitiveness argument applies to sales into the United States and sales from the United States for consumption abroad, allowing exemption to domestic companies engaged in base company activities would appear to represent not only a logical but a necessary extension.

So here is the concept: exemption not only for foreign but for domestic base companies, corporations incorporated in the United States that buy a product from or sell it to related parties. To parallel the reach of subpart F, the exemption should extend to situations involving manufacture or ultimate sale (but possibly not both) in the United States, since subpart F does not reach income from manufacture or sale in the country of incorporation. The middleman function would thus qualify for U.S. nontaxation, wherever it is located. It is true that the contours of that function might be expected to vary by industry and, indeed, with the creativity of each affected company, but none of this is dramatically different from the situation of foreign base companies. If foreign companies qualify for the exemption, why should similar domestic companies not also qualify? This would further national goals (nondistortion, U.S. employment) while doing no violence to the goal of subpart F reformers to bring the statute into the 21st century.

And so I ask again: Why not Des Moines? ✦