Abstract - About half the OECD countries provide a tax credit for foreign taxes on foreign source business income earned by multinational corporations; the other half exempt from domestic taxation active business income earned abroad. We undertake a preliminary inquiry here into the potential structure of such an exemption system for the U.S. Most of the issues raised by an exemption system parallel those debated under the current credit system. This is not surprising; both systems share the same general goal: avoiding international double taxation without stimulating U.S. taxpayers to shift operations, assets or earnings abroad. Shifting to an exemption system might simplify U.S. international income tax law, but only if simplification is made a priority. Some of the potential simplifications of the rules governing international taxation of business suggested here could be adopted whether or not exemption is enacted.

The OECD nations have split virtually evenly over the best structure for taxing foreign source business income earned by multinational corporations. About half the OECD countries provide a tax credit for foreign taxes; the other half exempt from domestic taxation active business income earned abroad (OECD, 1991). Discussions of international tax policy often treat this choice as grounded in different philosophies or normative judgments about international taxation. Foreign tax credit systems are frequently said to implement “worldwide” taxation or a “universality” principle, while exemption systems are described as “‘territorial’” taxation (U.S. Treasury, 2000). Likewise, tax credit systems supposedly implement “capital export neutrality” while exemption systems further “capital import neutrality” (U.S. Treasury, 2000; Joint Committee on Taxation, 1991). However, tax credit and exemption systems are far closer in practice than these dichoto-

1 Capital export neutrality (CEN) is neutral about a resident’s choice between domestic and foreign investments providing the same pretax rates of return and generally requires that a resident of any nation pays the same marginal rate of income taxation regardless of the nation in which she invests. Capital import neutrality (CIN) requires that all investments in a given country pay the same marginal rate of income taxation regardless of the residence of the investor. CIN thus subjects all business activity within a specific country to the same overall level of taxation, whether the activity is conducted by a resident or a foreigner. It is well known that it is impossible to achieve CEN and CIN simultaneously in the absence of either a worldwide government or identical income tax bases and rates in all nations.
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The OECD nations have all conceded that the country of source—the nation where income is earned—enjoys the primary right to tax active business income, with the residence country—the nation where the business is incorporated or managed—retaining at most a residual right to tax such income.

Since the enactment of the foreign tax credit in 1918, the United States has never seriously considered replacing it with an exemption system (Graetz and O’Hear, 1997; Graetz, 2001). In 2000, however, the U.S. Congress, in an apparently unsuccessful effort to thwart World Trade Organization disapproval of U.S. tax benefits for “foreign sales corporations,” characterized as normal U.S. exemption of foreign business income (Westin and Vasek, 2001; U.S. Congress, 2000). Issues under foreign trade agreements may push the United States to consider replacing the foreign tax credit with exemption. Recent analyses by economists suggest that moving to an exemption system for direct investment (with appropriate anti–abuse rules) could increase U.S. revenues without precipitating any substantial reallocation of capital by U.S. firms (Grubert and Mutti, 1999; Altshuler and Grubert, 2001). Moreover, the existing U.S. foreign tax credit rules are extraordinarily complex, requiring U.S. companies doing business abroad to spend large and disproportionate amounts to comply. One study estimates that nearly 40 percent of the income tax compliance costs of U.S. multinationals is attributable to the taxation of foreign source income, even though foreign operations account for only about 20 percent of these companies’ economic activity (Blumenthal and Slemrod, 1995). Some analysts are now calling for the U.S. to take a serious look at exemption of foreign source business income, often on the grounds that an exemption system might be simpler than the existing credit system (Graetz, 2001; Chorvat, 2001). To date, however, little work has been done in identifying the issues that must be resolved for exemption to be implemented and discussing the potential structure of an exemption system for the U.S. Such analysis is essential to assess the likelihood of accomplishing simplification goals. We undertake a preliminary foray into those questions here.

Implementing either a foreign tax credit or an exemption system for foreign source business income demands resolution of similar questions. Most of the issues raised by an exemption system parallel those that have been debated over the years under the current credit system. This is not surprising; both systems share the same general goal: avoiding international double taxation without stimulating U.S. taxpayers to shift operations, assets or earnings abroad. Domestic and foreign source income must be measured in both systems. Both systems must answer the question of what income qualifies for exemption or credit. Whether income earned abroad by a foreign corporation should be included currently in U.S. income or included only when repatriated as a dividend has long been debated under our foreign tax credit system (Altshuler, 2000). If not all foreign source income is exempt, this question remains important in an exemption system. And it is necessary to decide the appropriate treatment of foreign corporations with different levels of U.S. ownership. Likewise, transfer pricing issues are significant and difficult to resolve under either a credit or exemption system.

Detailed analysis and evaluation of each of these issues is not possible here. We start, therefore, by assuming that the political and economic determinations that have shaped current law will continue to exert great influence over the design of an exemption system. We also assume that if the U.S. were to adopt an exemption system, it would generally resemble exemption systems of other OECD nations that have used exemption rather
than foreign tax credits. But, even with these constraints, investigating the potential structure of an exemption system spurs reconsideration of issues long taken for granted under our foreign tax credit regime. Our analysis illustrates that shifting to an exemption system might well afford an opportunity to simplify U.S. international income tax law, but only if simplification is made a priority in enacting such a change. Our discussion here also points to potential simplification of the rules governing international taxation of business, whether or not exemption is enacted. As a political matter, however, such simplification may be more likely when Congress is making a substantial change in the regime for taxing international business income. We begin with a brief overview of current law and then take up the major issues that must be resolved in an exemption system.

BRIEF OVERVIEW OF CURRENT LAW

Corporations incorporated in the United States are considered U.S. residents. Income earned abroad by branches of U.S. corporations is taxed currently by the U.S. with a credit allowed for any foreign income taxes imposed on the branch’s income. Foreign subsidiaries of U.S. corporations are not considered U.S. taxpayers and thus generally are not taxed by the U.S. on income earned outside the U.S. Normally the earnings of foreign corporations are subject to U.S. taxation only when distributed to their U.S. owners as dividends, treatment commonly characterized as “deferral.” The U.S. parent is entitled to foreign tax credits (the “indirect” or “deemed-paid” foreign tax credits) for taxes paid by the subsidiary on the foreign source income distributed as a dividend. U.S. parents routinely control the timing of distributions of dividends from their foreign subsidiaries in order to control the timing of U.S. taxation of foreign source income in a manner to maximize the use of foreign tax credits. For corporations owned or controlled by U.S. corporations or other U.S. persons—known as controlled foreign corporations (CFCs)—a variety of limitations apply to limit deferral to active business income. The most important of these “anti-deferral” regimes are found in Subpart F of the Code and in the rules governing passive foreign investment companies (PFICs). The former applies only to CFCs but the latter rules require current taxation (or its equivalent) of foreign source passive income for U.S. owners of interests in foreign corporations not subject to Subpart F but which earn mostly passive income.

Foreign tax credits are limited to the amount of U.S. tax that would have been paid on the foreign income. To limit the ability of U.S. corporations to use foreign tax credits on one type of income to offset taxes on a different category of income, the foreign tax credit limitation is now calculated separately for nine different categories or “baskets” of income. The ninth basket—the “residual” or “general limitation” basket—contains almost all active business income, income from manufacturing, marketing, sales of inventory and services other than financial ser-

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2 Generally the foreign tax credit limitation is calculated by multiplying the U.S. tax on worldwide taxable income (before the foreign tax credit) by the ratio of foreign source taxable income to worldwide taxable income.

3 The categories include a separate basket for passive income, high withholding tax interest, financial services income, shipping income, dividends from each non-controlled §902 corporation, taxable income attributable to foreign trade income, dividends from a DISC or former DISC, distributions from a FSC, and “residual” or all other income. Internal Revenue Code, §904(d). Since income from each non-controlled §902 corporation goes into a separate basket, U.S. corporations may have many more than nine separate baskets limiting their foreign tax credits.
services, regardless of the rate of tax imposed on such income by the relevant foreign government, and items of passive income subject to foreign tax rates equal to or higher than the U.S. tax rate. The need to allocate income to each of these baskets and calculate separate foreign tax credit limitations for each is a major source of the complexity of current law.

INCOME ELIGIBLE FOR EXEMPTION

Alternatives

The first issue in designing an exemption is deciding what foreign source income is exempt. Potentially such an exemption could apply broadly to all foreign source income or narrowly, for example, only to active business income that is subject to tax by a nation with which the U.S. has an income tax treaty or which taxes income at rates comparable to the U.S. rate. Some OECD countries limit their exemption systems to countries with which they have tax treaties or to income taxed at a certain level abroad; others do not. We consider first the potential structure an exemption system applicable generally to active business income without regard to whether the income is generated in a treaty jurisdiction and without regard to the rate at which it is taxed by the foreign country where it is earned.

Following the practice of other nations which exempt foreign source income, such an exemption would apply generally to the branch profits of any U.S. corporation and to dividends received by U.S. corporate taxpayers from foreign corporations. This means that interest income and royalty income, both of which are deductible abroad and therefore not subject to foreign income tax, would be subject to U.S. tax. Under current law, U.S. businesses are often able to shelter interest and royalties earned abroad from U.S. tax through foreign tax credits. Thus, an exemption system would increase the tax on this type of income for many U.S. companies compared to current law.\(^4\)

Definition of Active Business Income

Since active business income but not other types of income earned abroad would generally be exempt, it becomes essential to determine what constitutes eligible active business income. The Internal Revenue Code today does not provide any direct precedent. Nonetheless, the current Code does provide guidance, which probably would be used in defining eligible active business income. Identifying business income eligible for exemption and determining how to treat income not eligible for exemption raise questions parallel to those under current law in determining what income earned through foreign corporations should be taxed currently or eligible for deferral of U.S. tax until repatriated and how the foreign tax credit should apply when that income is subject to U.S. tax. Business income eligible for exemption might be defined first by excluding income that is “passive,” drawing on existing Code provisions that identify and tax currently types of passive income earned abroad, particularly Subpart F of the Code. The rationale for excluding passive income from exemption parallels that for taxing such income currently under Subpart F.

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\(^4\) Income received by U.S. corporations from foreign corporations in the form of interest and royalties could conceivably be exempt on a look-through basis (i.e., if allocated to the exempt income of the payor). While such an approach would generally be consistent with our foreign tax credit rules today, it would be unprecedented among countries adopting an exemption system, because it would allow income to go untaxed in both the interest or royalty paying jurisdiction (assuming the interest or royalty is deducted and does not generate a substantial withholding tax) and the interest or royalty earning jurisdiction. Consequently, any exemption system would likely subject interest and royalties from abroad to U.S. tax, as foreign source income eligible for a foreign tax credit.
Because such income has no nexus to business activity, it is highly mobile and easily shifted abroad to low or no tax jurisdictions. Thus, exempting such income would create an unacceptable incentive to move assets offshore and potentially would lose large amounts of revenue. Consequently, income that constitutes passive income (technically foreign personal holding income) under Subpart F (mostly interest, dividends, rents and royalties) would not be eligible for exemption. Special rules will be necessary when such amounts are earned by entities in which a U.S. corporate taxpayer has a certain minimum ownership interest. (In the latter case, as we discuss below, “look-through” rules would be applied to characterize some types of passive income.) The distinction between income eligible for exemption and non-exempt passive income would raise definitional issues similar to those long debated under Subpart F. For example, banks, securities dealers, insurance companies and other finance-related businesses earn interest and other types of “passive” income that are considered active business income under current law; we believe that such businesses should probably be eligible for exemption as are other active businesses, at least when their financial-service business is located predominately in the country of incorporation.5

Once passive income earned abroad by U.S. corporations is excluded from exemption—as we believe it should and will be—the risk occurs that an exemption system might become about as complex as current law. For example, every active foreign business utilizes working capital, and earns passive income from the temporary investment of such capital. Without a de minimis rule which ignores small amounts of passive income, every corporation will have to take into income some amount of passive income and presumably calculate foreign tax credits allowable with respect to such income. A de minimis rule based on a proportion of total gross income or total assets might promote substantial simplification by allowing the income of foreign corporations engaged in an active business to be completely exempt without leading to an unacceptable level of tax planning.6

A separate question is whether other “non-passive” types of Subpart F income should be exempt from U.S. taxation. In some cases, for example, Subpart F currently taxes certain sales and services income. In most cases such sales and services income, which is active business income, is taxed currently under Subpart F because of the ability of taxpayers to locate the activities that generate this income in low-tax jurisdictions thereby minimizing both U.S. and foreign source-based income taxes. These Subpart F rules were first adopted in 1962 and some business organizations have recently called for revision, urging, for example, that the transfer pricing rules are adequate to address “abuse” cases (NFTC, 1999). The fundamental policy issue to be faced by an exemption system is whether these (and other) types of “mobile” active foreign business income, which can sometimes be moved to low tax jurisdictions, should be eligible for exemption. Transfer pricing enforcement throughout the OECD has become more vigorous and sophisticated. A simpler system would no doubt result if the transfer pricing rules (which in this case would be enforced by the country from which the sales or services income is deflected to a low or no tax jurisdiction), rather than an exclusion from exemption, could be relied on to constrain tax avoidance.

5 The Dutch, for example, have a foreign tax credit regime that applies to foreign financial services income on the ground that this income is often subject to low or no income tax abroad.
6 We believe that to accomplish effective simplification, such a de minimis rule should be based on assets or gross income and not limited to a specified dollar amount as is currently the case under Subpart F.
A further question is whether certain types of foreign source active business income that are not likely to be taxed in any jurisdiction on a source basis should be eligible for exemption. For example, income from personal services, which is foreign source income when the services are performed outside the United States, is generally treated as active trade or business income. However, when the services are not attributable to a local fixed base in the nation where they are performed, most countries do not tax the services on a source basis. Similarly, shipping, telecommunications and other types of income from international waters and space clearly are active business income, but these kinds of income typically are not taxed by any foreign jurisdiction unless they are earned by a company residing in that jurisdiction. Many companies earning these kinds of income are resident in low-tax jurisdictions. Extending exemption to such income would inevitably be controversial.

Finally, it will be necessary to determine whether exemption applies to gain on the sale of assets in connection with an active business. A consistent exemption policy should provide that gain on the sale of assets would be exempt if the assets generate exempt income. For example, gains on the sale of business assets used in a foreign branch would be exempt (and losses would be disallowed) if the income from such assets would be exempt.

Likewise, gain on sales of shares in a foreign corporation should also logically be exempt if the dividends of the entity would be exempt, since the gain reflects the present value of the future stream of potentially exempt income. Where not all of the income of the foreign corporation would be eligible for exemption, however, the appropriate treatment of gain when shares are sold is not obvious. An allocation between exempt and non-exempt gain might be required, but such a rule would be complex and the basis for making such an allocation is not completely clear. In principle, gain attributable to retained active business earnings should be exempt. This could be accomplished by adapting the rules of current law that recharacterize gain on the sale of shares of a foreign corporation as a dividend to the extent of retained earnings; the recharacterized dividend would be exempt to the extent that an actual dividend would be exempt. However, exempting gain attributable to the appreciation in the value of assets that produce passive income seems inappropriate, thus probably making necessary a look-through rule when shares of a qualifying foreign corporation are sold. In essence, the purpose of such a look-through rule would be to tax gain attributable to appreciation of passive or other non-exempt assets.

TREATMENT OF NON-EXEMPT INCOME EARNED BY U.S. TAXPAYERS

Foreign Tax Credits

The discussion above makes clear that not all foreign source income earned by a U.S. corporation will be eligible for exemption. Non-exempt income would surely include foreign source interest, rents and royalties not attributable to an active foreign business, dividends on portfolio stock, income from export sales not attributable to an active foreign business and any other types of active business income (perhaps such as space or shipping income or interest and royalties attributable to an active business) that are specifically determined to be ineligible. However, to the extent that these types of income are potentially subject to foreign tax (including withholding tax) on a source

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7 Here we are suggesting modifications to the rules under §1248 of the Internal Revenue Code.

8 Rules would be necessary to determine such amounts on a per share basis.
basis, the U.S. should make an effort to avoid double taxation. Thus, as under today’s rules, such income should probably continue to be allowed a credit for the foreign taxes paid on that income.

If a foreign tax credit is permitted for any income, in principle all the questions that exist today regarding limitations on foreign tax credits would have to be resolved. However, if the nonexempt income were limited to only these classes of income, much simplification would be possible. For example, given this limited application, a single worldwide foreign tax credit limitation could be applied. A worldwide limitation seems reasonable since taxpayers almost always will be subject to tax abroad on these types of income at rates lower than the U.S. corporate tax rate, and therefore they will almost always have foreign tax credit limitations in excess of creditable foreign taxes. A single worldwide limitation would be far simpler than the baskets of current law, and the fact that taxpayers would virtually always have excess foreign tax credit limitations both permits additional simplifying changes and lowers the stakes in applying some rules that would be retained.

If, however, averaging of credits across types of income is of great concern, separate limitations might be applied based on categories of income (similar to today’s limitations) or types of taxes (e.g., withholding taxes versus income taxes normally applied to residents). Finally, a separate limitation could be applied to each item of foreign source income not eligible for exemption (much like the so-called “high-tax kickout” limitation on passive income under the current foreign tax credit). However, we see no justification for this level of complexity. In a system that generally exempts active business income, we do not find any policy justification for multiple separate limitations that outweighs the simplification advantages of a single worldwide foreign tax credit limitation.

Treatment of Non–Exempt Foreign Corporation Earnings

If not all income earned by a foreign corporation is eligible for exemption, the question occurs whether non–exempt income should be subject to current inclusion by U.S. corporate shareholders or, alternatively, should not be taxed in the U.S. until distributed as a dividend. Most passive types of income are today subject to current inclusion under Subpart F when earned by controlled foreign corporations. Investors in non–U.S. controlled foreign corporations, which earn mostly passive income, may be subject to current taxation (or roughly equivalent consequences) under the Passive Foreign Investment Company (PFIC) regime or other “anti–deferral” regimes. We see no reason that shifting from a foreign tax credit to an exemption system should delay the imposition of U.S. tax on passive income (which exceeds a de minimis amount) that is taxed currently under present law. Thus, we assume that the U.S. would continue to subject passive types of foreign source income to current inclusion.

If some types of active business income also are not exempt, a decision must be made whether to subject that income to

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9 Some analysts have suggested that the fact that U.S. companies would typically have excess foreign tax credit limitations might stimulate other countries to raise taxes, especially withholding taxes. The trend, however, is very much in the direction of lower withholding taxes. The tax treaty between the U.S. and the United Kingdom signed in 2001, for example, is the first time the U.S. has agreed to a zero withholding rate on dividends. We do not believe a shift by the U.S. from a credit to an exemption system would halt or reverse this trend.

10 See, for example, the discussion below of allocation of research and development expenses.

11 As we indicated earlier, we do regard shifting to an exemption system as a proper occasion to reconsider the scope of Subpart F with respect to active business income.
current taxation. Here we believe that avoiding the complexity of having three categories of income for U.S.-controlled foreign corporations—exempt income, currently included income and deferred income—is sufficiently important to argue for current taxation of all non-exempt income. If non-exempt income is taxed currently and dividends are exempt, the timing of dividends becomes of no consequence under U.S. tax law. On the other hand, if a category of deferred income is retained, look-through treatment of dividends might be necessary.

Assuming that all income of U.S. controlled foreign corporations is either exempt or currently included, rules are necessary to measure the income in two categories. For example, rules allocating expenses between the two categories of income would be necessary. Likewise, loss recapture rules (similar to those in Subpart F today) would be necessary to prevent losses from income-producing activities from permanently reducing non-exempt currently includable amounts.

In addition, an “indirect” (or “deemed-paid”) foreign tax credit would be appropriate to allow U.S. corporate taxpayers to claim foreign tax credits for foreign taxes paid by foreign corporations on non-exempt income. Such a foreign tax credit would require rules allocating foreign taxes between exempt and currently includable income. The rules would also require integration with the foreign tax credit limitation rules discussed above with respect to foreign source income earned directly by U.S. taxpayers. Thus, many of the foreign tax credit issues that exist today would remain although they would apply to a much smaller category of income earned by foreign corporations and therefore might be substantially simplified.

DISTINGUISHING AMONG U.S. CORPORATE SHAREHOLDERS

In addition to rules establishing the scope of exemption and the treatment of dividends received from foreign corporations, it becomes necessary to decide whether all U.S. corporate shareholders should be entitled to exemption. In theory, the answer to this question should be yes; otherwise some international double taxation at the corporate level will occur. However, applying an exemption system, as discussed above, requires that U.S. corporate shareholders receive significant amounts of information from those foreign corporations in which they have the requisite level of ownership. The U.S. recipient would, for example, have to know the amount of the foreign corporation’s passive earnings and the amount of foreign taxes imposed on those earnings. It thus seems impractical to apply an exemption system on a look-through basis to all U.S. corporate shareholders of foreign corporations.

In determining whether U.S. tax applies currently or is delayed until earnings are repatriated and for foreign tax credit purposes under current law, the U.S. has

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12 If current taxation of active business income is unacceptable, we would probably opt for expanding the scope of the exemption rather than establishing a third category of deferred income.

13 Three alternatives exist for allocating dividends between exempt and non-exempt income: pro rata allocation, treating dividends as paid out of exempt income first or treating exempt income as paid out last. Today’s law applies a pro-rata approach for foreign tax credit purposes (i.e. dividends are allocated pro rata to each foreign tax credit limitation category). A pro rata rule seems the most equitable and appropriate rule, but also is the most complex rule. On the other hand, treating non-exempt income as paid out first seems unduly harsh, and stacking exempt income last may undermine the rules governing passive income and create too great an incentive to shift such income abroad. We believe that with an appropriate de minimis rule (as discussed above) and limiting the Subpart F definition of non-exempt income to passive income (as discussed above) applying a look-through rule on a pro rata basis is the best alternative if a look-through rule for dividends is needed.
three different regimes relevant to this issue:

1. Subpart F limits deferral but allows foreign tax credits to shareholders owning 10 percent or more of the voting stock in controlled foreign corporations (CFCs). (CFCs are defined as foreign corporations in which U.S. persons each owning 10 percent of the voting stock own a total of more than 50 percent of the stock by vote or value).

2. To avoid international double taxation, the “indirect” foreign tax credit is allowed to U.S. corporations that own at least 10 percent of voting stock in a foreign corporation which is not a CFC.

3. No foreign tax credit and no limitation on deferral applies to a U.S. corporation whose ownership in a foreign corporation is less than 10 percent of the voting stock.

In designing an exemption system these categories should be rethought. Today a U.S. corporation, which owns less than 10 percent of the voting stock of a foreign corporation, is treated as a “portfolio” investor. Full double taxation of foreign source income at the corporate level is justified largely on the assumption that such corporate investors cannot get the information necessary to determine their foreign tax credits under U.S. law.

A 10 percent voting stock threshold could also be adopted for distinguishing “portfolio” from “direct” investment for the purpose of applying exemption. The issue remains, however, whether U.S. corporate investors owning less than 10 percent should be fully taxed or fully exempt on dividends (and capital gains). If, as we assume, rules similar to the current Passive Foreign Investment Company regime continue to apply to all investors in foreign corporations that hold predominately passive assets, dividends (and gains) from non-PFIC foreign corporations might be treated as exempt by U.S. corporate shareholders owning less than 10 percent of voting stock in all cases without requiring any significant information and without creating undue potential for tax planning mischief.

A second question is whether any distinction should be made in the application of an exemption system to U.S. corporations that own more than 10 percent but not more than 50 percent of a foreign corporation—in other words, to direct investment in non-CFCs. That decision should probably turn on the kinds of limitations that apply to passive income and whether obtaining the necessary information to apply these limitations would be onerous for U.S. minority shareholders.

Under legislation recently passed by Congress, beginning in 2003, the foreign tax credit look-through rules will be applied to 10 percent owners of non-U.S.-controlled foreign corporations, although Subpart F will continue to apply only to foreign corporations meeting the definition of a controlled foreign corporation. An exemption system might reconcile these disparities, applying similar rules to all 10 percent or greater corporate shareholders. This would be much simpler than current law. Alternatively, despite the complexities, an exemption system might follow a path similar to current law, ex-

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14 We have no basis for assessing whether adequate information would be made available to corporate investors with smaller voting interests, 5 percent, for example. The 10 percent threshold is common throughout the OECD.

15 Because the dividend received deduction of §243 of the Internal Revenue Code, in effect, exempts only 70 or 80 percent of dividends paid by U.S. companies to U.S. parents, there may be concern with providing full exemption for dividend payments by foreign subsidiaries to U.S. parents, notwithstanding the potential imposition of foreign taxes on dividends from abroad. If so, an exemption for 70 or 80 percent of foreign source dividends would respond to this concern without adding complexity.
empting all active business income on a look-through basis, but requiring current inclusion only from foreign corporations that are controlled by U.S. shareholders. This would, however, require creation of a “deferral” category for “10/50” shareholders in foreign corporations, which would add considerable complexity. Countervailing difficulties might result, however, if current inclusion is required with respect to undistributed passive earnings of foreign corporations which U.S. shareholders do not control. In such cases, the U.S. corporation may not be able to obtain the payment of sufficient dividends by the foreign corporation to cover the U.S. tax cost. Under such circumstances, creating a limited class of deferred foreign income might be a practical alternative.

The desire for simplification coupled with concerns about imposing current U.S. tax in circumstances where a corporation cannot compel sufficient dividends to pay the tax suggests a third alternative. Perhaps two categories of investors could be created, for example, by expanding the category of “portfolio” investors to those U.S. corporations that own less than 20 percent of the foreign corporation (by vote and value) and applying an exemption regime with current taxation of non-exempt income to all larger investors.16 It is likely that a 20 percent or greater investor will be able to participate meaningfully in corporate decisionmaking, including decisions about paying dividends. We believe this alternative has merit as a way of balancing simplification and equity concerns.

TREATMENT OF TAXPAYERS OTHER THAN CORPORATIONS

Finally, the question arises how to tax foreign source business income of U.S. investors other than corporations. Foreign business income earned directly by individuals could be eligible for exemption. However, since under the U.S. classical system corporate earnings are fully taxed when distributed to non-corporate shareholders, an exemption for dividends paid by foreign corporations to non-corporate U.S. taxpayers would make little sense.17 The fundamental question is whether all income of such persons that is earned through foreign corporations should be currently included (subject to foreign tax credits) or whether the taxation of some or all of that income should be deferred until repatriated. Parity with corporate investors argues for deferral at least of earnings that would not be currently included by a U.S. corporate owner, and it may well also be simpler to defer taxation of such income to individuals (whether earned directly or through mutual funds) until dividends are paid.

ALLOCATION OF EXPENSES

Under an exemption system along the lines we have described above, there would be three general categories of gross income: U.S. source income, foreign source exempt income, and foreign source non-exempt income. Expenses allocable to U.S. source income would not be affected by changing from a credit to an exemption system. And presumably amounts allocable to non-exempt foreign source income would be taken into account in determining the (one or more) foreign tax credit limitation amounts, much like our rules today. However, because (as we have discussed) U.S. corporations would typically have excess foreign tax credit limitation amounts, much like our rules today. However, because (as we have discussed) U.S. corporations would typically have excess foreign tax credit limitation amounts under an exemption system, the stakes of that alloca-

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16 If U.S. companies or other persons own more than 50 percent of the foreign corporation, a 5 or 10 percent threshold (rather than the 20 percent suggested in the text) could apply.

17 This raises the question whether foreign withholding taxes should be creditable to individual shareholders, including whether such credits should be flowed through mutual funds, as under current law. Reexamining this treatment of such portfolio investments by individuals is beyond the scope of our endeavor here.
tion would be far lower than is currently the case. Indeed, usually nothing would turn on such an allocation. On the other hand, expenses allocable to exempt foreign income are properly described as deductions incurred to earn exempt income, which the Code typically disallows. Such deductions should be disallowed or allowed only to the extent they exceed exempt income in any year and are subject to recapture out of exempt income in subsequent years. To the extent the rules allocate expenses to exempt income they will take on heightened importance compared to today’s deduction allocation rules. Under an exemption regime, such allocation rules potentially will disallow an amount of otherwise deductible expenses; under current law they serve only to limit foreign tax credits for taxpayers who have excess foreign tax credits.

Consequently, rules will be necessary for allocating expenses to each category of income. To begin with the most important example, interest expense allocation rules will clearly be necessary. But because of the serious consequences to taxpayers that would result from disallowing interest deductions allocated to exempt income, it becomes essential to rethink the rules. A system that allocates interest expense first to interest income (whether or not eligible for exemption) with the remaining interest expense allocated to each category of income pro rata based on assets, but taking worldwide assets into account, would be a better starting point than current law.\footnote{Current law applies a “water’s-edge” rather than worldwide allocation, and was adopted in the 1986 Tax Reform Act for revenue reasons. §864(e) of the Internal Revenue Code. A worldwide allocation would generally allocate interest expense worldwide based either on gross income or assets. The “water’s-edge” approach of current law excludes borrowing from foreign subsidiaries in making the allocation of interest expense. Some commentators argue that “tracing” rules, similar to those used abroad, are appropriate (Shaviro, 2001). Virtually all commentators regard worldwide allocation as superior to water’s-edge allocation (e.g., Brumbaugh and Gravelle, 1999; Sullivan, 1999). Further discussion and analysis of interest allocation rules is not possible within the space limitations of this article.}

We have assumed throughout this article that in an exemption regime, following the general practice in other OECD countries, royalties from foreign corporations would be non-exempt income (and that a complementary rule imputing royalties to foreign branches of U.S. taxpayers would be adopted). Under these circumstances, providing for the allocation of research and development (R&D) expenses would be essential, but would have less serious consequences for taxpayers than current law. R&D expenses need not be allocated to foreign dividend income or to branch profits because the dividend payor or branch would be separately paying a royalty that would be taxable in all cases.\footnote{We are assuming continuation of current law requirements that the use of intangible assets abroad requires a payment back to the U.S. owner (e.g., §367(d) of the Internal Revenue Code). A comparable rule applicable to branches would become necessary under an exemption system along the lines we are discussing here.} Thus, R&D expenses need be allocated only between foreign source income eligible for a foreign tax credit (such as royalty income) and domestic source income. As we have discussed above, in an exemption system, any foreign tax credit limitation will typically be applicable only to income subject to withholding tax and passive trade or business income and therefore would not likely limit the available foreign tax credits of most non-financial multinational corporations. Since the allocation of R&D expense under current law is important only for taxpayers with excess foreign tax credits, how much R&D expense is allocated to foreign source income under an exemption system should have little or no effect on U.S. taxes. Therefore an exemption system would not raise the serious policy issues that exist for R&D allocation under the current foreign tax credit system.

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Finally, as with interest expenses, the rules that provide today for the allocation of a portion of general and administrative expenses as “stewardship expenses” to foreign source income would become much more important than under current law because such expenses might be allocated to exempt income and disallowed as a deduction. By definition these expenses are not properly charged out to foreign corporations. (Otherwise the expenses would be directly allocated to the income from the charge and thus fully deductible.) If these expenses were allocated to exempt earnings, they would not be deductible in any jurisdiction, an inappropriate result for expenses that clearly are current costs of earning business income. Consequently, it would be important to define the category of allocable “stewardship expenses” narrowly in an exemption regime.  

OTHER STRUCTURAL ISSUES

Many other issues present in our foreign tax credit system would persist in an exemption system. For example, transfer pricing issues that arise today would continue to be important under an exemption system, although the incentives would be different in many cases. There would, for example, be an incentive to lower royalties and increase dividends in an exemption system (Grubert and Mutti, 2001; Grubert, 1998; Grubert and Mutti, 1991). Depending on the scope of the exemption, transfer pricing issues might become even more important. The changes we have suggested limiting Subpart F to passive income under an exemption system, for example, assume transfer pricing enforcement by OECD nations in lieu of the Subpart F “base–company” rules when sales or service income is shifted to low or no tax jurisdictions. Likewise, to the extent that rules for determining the source of various categories of income cause problems under current law, these problems would remain important in an exemption system.

The U.S. tax treatment of transfers of property from a U.S. company to a foreign corporation would also continue to be an issue, but rules simpler than those in force today could be adopted in an exemption regime. The transfer to a foreign corporation of assets that gave rise to exempt income prior to the transfer ought to be non–taxable. The transfer of other assets should generally be taxed, but where the income from those assets would continue to be fully taxed either because the assets relate to a U.S. trade or business or because such income (and gain from the sales of related assets) will be subject to current inclusion to all of the shareholders of the foreign transferee, it should not be necessary for the U.S. to impose tax at the time of the transfer.  

If an exemption system has only two categories of income—exempt income and income currently taxed—and therefore eliminates the category of deferred income for U.S. corporate investors in U.S.–controlled foreign corporations, substantial simplification could be achieved by eliminating those provisions that under present law terminate deferral in specific circumstances. For example, the provision

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20 Each of these expense allocation issues will exist not only for U.S. taxpayers earning exempt and/or non-exempt foreign income, but also for foreign corporations that have U.S. corporate shareholders that may potentially receive exempt dividends. For such corporations, deductions would need to be allocated between exempt and non-exempt income. Presumably resolutions of these issues similar to those described in the text would be applied for purposes of determining the exempt income of such foreign corporations.

21 Rules for the transfer of substantial holdings of shares in a foreign corporation to another foreign corporation would not be necessary to the extent gain on the sale of the shares would be completely tax exempt. However, since, as discussed above, complete tax exemption is not likely to be the rule with respect to all sale of shares transactions, gain recognition agreements or other similar rules would likely be necessary with respect to transfers of shares where gain is not recognized.
that treats foreign corporate loans back to U.S. affiliates (and other similar transactions) as constructive dividends to the shareholders could be eliminated. Likewise, the regulations that terminate deferral in certain inbound and foreign-to-foreign reorganization transactions could also be eliminated.

MORE LIMITED EXEMPTION ALTERNATIVES

The exemption system we have described above is premised on the assumption that active foreign source business income would generally be eligible for exemption (except perhaps for some types of active business income now subject to current inclusion under Subpart F). In such an exemption system, all income of eligible U.S.-owned foreign corporations would be divided between exempt income and currently includable income. Some commentators, however, have urged more limited exemption systems, implying that only income taxed comparably to the taxation of U.S. domestic corporate income should be exempt (Graetz, 2001; President’s Task Force on Business Taxation, 1970). For example, an exemption system might subject so-called “tax haven” income to U.S. tax even though the income is attributable to an active trade or business outside of the United States. Such a result might be achieved by denying exemption to all income earned in listed tax haven countries or to all income earned in non-treaty countries. Alternatively, exemption might apply only to active business income earned in countries specifically specified by the U.S. Treasury or countries with a statutory (or an effective) tax rate higher than a specified minimum rate, for example, 75 percent of the U.S. rate.

Any of these more limited forms of exemption would make it more difficult to treat all non-exempt income of U.S. controlled foreign corporations as currently includable. If, for example, an exemption system were limited to active business income earned in a treaty country, the current inclusion of similar active business income earned by foreign corporations doing business in (and subject to tax by) non-treaty countries would place great pressure on whether a treaty is in force. Similar pressures would occur if the distinction between exemption and current inclusion turns on the tax rate of the foreign country. Thus, as a practical matter, if a more limited form of exemption system were adopted, three categories of income—exempt income, deferred income, and currently includable income—for dividends from eligible U.S. owned foreign corporations might result. Such a system would likely be at least as complex as today’s system. The anti-deferral rules of today’s law would continue in force and the rules discussed above with respect to exempt income would also be necessary. On the other hand, if the exemption is limited to income in countries with relatively high tax rates, the justification for reducing the number of baskets for determining the limitation of foreign tax credits—i.e., that companies would be in an excess limitation position—would be as strong as with a broader exemption system.

TRANSITION ISSUES

The most important transition issue in moving from the current foreign tax credit system to exemption is the treatment of income earned by foreign corporations in periods prior to exemption but not yet repatriated to or taxed by the United States. The issue is whether and how U.S. tax should be imposed on future dividends treated as paid out of such deferred income and to gain on the sale of stock of such corporations. Several alternatives are possible. The simplest approach would be to forgive the U.S. tax on such income with all dividends eligible for exemption (ignor-
ing whether it would qualify as exempt income if earned currently). Taxation of gain on the sale of stock would be unaffected by retained pre–exemption system earnings. Such a generous approach would be consistent with Congress’ decision to not tax accumulated DISC income when the FSC regime was enacted in 1984.\(^{22}\) In that instance, however, Congress had never intended to tax accumulated DISC income, whether or not the DISC regime was changed. Such forgiveness of tax seems unlikely here.

An alternative would be to enact an ordering rule for dividends that would subject dividends paid out of pre–exemption earnings as taxable but eligible for foreign tax credits. If the pre–exempt earnings were treated as being paid last, the complexity of an additional category of earnings would be minimized for a large number of taxpayers. A precedent for this alternative can be found in both the rules applicable to C corporations that elect S corporation status and in the enactment of the 1986 foreign tax credit limitation rules. Presumably, under such a regime gain on the sale of stock in foreign corporations would be taxed as a deemed dividend (with accompanying foreign tax credits) to the extent of pre–exemption retained earnings.

A third alternative would be to levy a toll charge on existing corporate direct investments in foreign corporations as a condition for exemption of dividends in future periods. We regard this as the least appealing alternative. As a practical matter, it would give taxpayers an election between deferral and exemption. It also would provide a large incentive for companies to separate future business income–generating activities from current earnings and profits, a complex task which we have no doubt tax planners could readily accomplish if the stakes are sufficiently large.

CONCLUSION

We have attempted here to identify the issues that Congress must resolve if it were to replace the existing foreign tax credit system with an exemption for active business income earned abroad. In this discussion we have stuck rather close to present law in addressing how these issues might be resolved under an exemption system. In other words, we have treated a potential change to exemption as an incremental move in U.S. international tax policy rather than viewing such a shift as an occasion to rethink fundamental policy decisions reflected in current law.

Our analysis reveals that virtually all of the questions that must be answered in a foreign tax credit regime must also be addressed in an exemption system. There is little simplification necessarily inherent in moving to an exemption system, but such a move does provide an opportunity to reconsider a variety of issues that might simplify the taxation of international business income. While, in principle, much simplification of current law is possible without abandoning the foreign tax credit, it may be politically unrealistic to think that such simplification will occur absent a substantial revision of the existing regime, such as that entailed in enacting an exemption system.

Our analysis suggests that much of the complexity of an exemption system occurs in the scope and treatment of non–exempt income. If this category generally can be limited to passive non–business income with meaningful \textit{de minimis} rules applied

\(^{22}\) The DISC regime, enacted in 1971, in effect exempted from U.S. tax a portion of profits from U.S. exports if earned by a qualifying domestic subsidiary of the U.S. exporter. The subsidiary was known as a DISC. Following a decision under GATT that DISC constituted an illegal subsidy to exports, Congress replaced the DISC regime with the FSC (Foreign Sales Corporation) regime, which Congress hoped would be acceptable because of the foreign nature of the FSC. The WTO held the FSC regime also to be an illegal export subsidy.
to the treatment of such income, the impact of these rules can be minimized. Surely the basket system limiting foreign tax credits could be eliminated. Moreover, under an exemption system along the lines we have described here, the timing of the payment of dividends would be of no consequence. Thus, under an exemption regime significant simplification could be achieved for many companies and the costs of complying with U.S. international tax rules might well decrease substantially for U.S. corporations.

Acknowledgments

This paper is based on a presentation at the Brookings Institution/International Tax Policy Forum Conference on Territorial Income Taxation held in Washington, D.C. on April 30, 2001. We thank Rosanne Altshuler and James Hines, Jr. for helpful comments, and Janine Shissler for research assistance.

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