REFORMING THE TAXATION OF FOREIGN DIRECT INVESTMENT BY U.S. TAXPAYERS*

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OUR TASK TODAY IS TO "CHERRY-PICK" AND discuss one or more of the tax reform ideas included in the 2005 report of the President's Advisory Panel on Federal Tax Reform. There is a little irony in this assignment, given the Panel's admonition to consider its recommendations as a comprehensive whole rather than piecemeal. As some Panel members have pointed out, adoption of only certain of the recommendations, such as the expensing of capital investments, without making other reforms, such as changing the tax treatment of interest, may produce a less coherent tax system than the one we already have.

Nevertheless, one important Panel recommendation that can be profitably considered in isolation is its proposal to adopt a dividend-exemption system for certain foreign-source earnings.[1] A similar proposal was recommended in 2005 by the Joint Committee on Taxation staff.[2] This proposal addresses an area in significant need of reform and continues to be a viable one despite the change in political climate since issuance of the report.

Under the Panel's proposal, foreign-source active business income of U.S.-controlled foreign corporations and branches would be exempt from U.S. tax both at the time the income is earned and when it is later repatriated in the form of a dividend. Other foreign-source income, encompassing investment income and certain "mobile" forms of active income, would be taxed by the United States as it is earned, in the same manner as under current subpart F. Non-dividend payments to controlling U.S. taxpayers from investments abroad, such as interest and royalties, would be fully taxed by the United States.

The foreign tax credit would play a much more limited role under the Panel's proposal. Credit would be permitted only for foreign taxes paid on foreign-source income that is taxed by the United States. Because much of this income would bear low rates of foreign tax, foreign tax credit baskets would be eliminated and there would be only a single, "overall" limitation on the availability of the foreign tax credit. A portion of the deductions for interest and overhead-type expenses allocable to the exempt foreign-source income would be disallowed for U.S. tax purposes.

I will briefly discuss why the Panel's recommendation should represent an improvement over current law, compare it to a proposal to repeal deferral altogether and to international tax reform ideas recently put forward by House Ways and Means Committee Chairman Rangel, and then describe three possible modifications to the Panel's proposal.

THE UNHAPPY STATE OF CURRENT LAW

Current law provides very favorable tax treatment to U.S. persons making foreign direct investments. The taxpayer generally can defer paying U.S. tax on any active business income from the investment throughout the period of the initial investment and its later redeployment in other foreign locales. Moreover, through cross-crediting and other techniques, the taxpayer generally can reduce considerably the magnitude of any U.S. tax on repatriation. Grubert and Mutti reported that in 1995, the repatriation tax raised the equivalent of only a 5 percent tax on all repatriated nonfinancial business income that represented, of course, a much lower rate if measured against *all* such income, both repatriated and not repatriated.[3] It is little wonder, then, that if the tax benefit from the U.S. deduction of expenses allocable to this very low-taxed income is also taken into account, current law may well provide a better-than-U.S.-tax-exemption result for some U.S. taxpayers with active business income from foreign direct investments.[4]

In providing this favorable result to active business income, current law places the U.S. taxable event at the "back-end," at the time of repatriation. The U.S. tax consequence is both elective as to timing and "non-transparent," in the sense that the ultimate amount of any U.S. tax liability will vary with how the investment is made and redeployed,

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potentially changing foreign and domestic tax rates and laws between the time of investment and the tax consequence, and other factors. When strategies to reduce the amount of the repatriation tax prove to be unavailing, the design of current law distorts the free flow of capital back to the United States.[5]

These effects have been exacerbated by recent administrative and legislative developments. The "check-the-box" rules that took effect in 1997 increased the attraction of foreign investment and the advantage of delayed repatriations by providing taxpayers with an easy way to shift their foreign income to low-tax countries without U.S. tax consequences.[6] This practice was essentially codified for three years in 2006.[7] Another very recent administrative change to narrow the scope of activity that constitutes "substantial assistance" to a controlled foreign corporation (CFC) for purposes of determining whether the CFC has foreign base company services income, has further enhanced the tax advantage of foreign investment.[8] In addition, legislative changes enacted in 2004, including liberalization of the foreign tax credit limitation rules, have had the same effect.[9]

The 2004 legislation also included passage of the infamous "homeland investment" provision effectively allowing taxpayers to repatriate their foreign earnings at a 5-1/4 percent tax rate for, generally, a 1-year period following enactment of the law.[10] The basic rationale for the provision was the business downturn in the United States and the domestic need for the capital located outside the country. Since Congress has not yet figured out a way to repeal the business cycle, one assumes that the same need will arise again with perhaps the same solution, despite Congressional assurances to the contrary. Thus, even though the homeland investment provision has now expired, its historical existence has increased the distortive effects of current law by enhancing the perceived return from a foreign investment and value of parking any such investment offshore.[11] To those few businesses that previously "played by the rules" and repatriated income at the cost of full or close to full U.S. tax, the clear lesson is "fool me once, shame on you, fool me twice, shame on me." The recent experience with the provision also showed how much capital was, in fact, "trapped" outside the United States, or was at least situated in a way where a 5-1/4 percent repatriation tax looked like a bargain.[12]

In summary, the U.S. tax treatment of foreign direct investment by U.S. persons has become so favorable as to exert a potentially powerful lure in favor of such investment. At the same time, the law serves in some cases to block, or at least delay, the return of such investment and accumulated earnings back to the United States when it would be sensible to do so. Many empirical studies have documented the sensitivity of locational and financing decisions of multinationals to tax considerations.[13]

PANEL'S PROPOSAL AS IMPROVEMENT OVER CURRENT LAW

The Panel's proposal would change the tax treatment of foreign direct investment in modest but important ways. Although it would exempt foreign active business income from U.S. taxation, the overall proposal would increase the U.S. effective tax on foreign investment because of its changes to the treatment of U.S. deductions and foreign tax credits.[14] These changes should also reduce some of the incentive under current law to locate intangible property in low-tax countries since credits for high foreign taxes on active income would not be available to shield any U.S. residual tax on foreign-source royalty income.[15] For the same reason, however, the proposal would provide greater reason for U.S. taxpayers to develop their intangible assets offshore and then to repatriate their income as dividends rather than royalties.

The proposal also changes the timing and transparency of the principal U.S. tax consequence relating to foreign active business income by denying a portion of U.S. tax deductions rather than imposing U.S. tax at repatriation. In adopting an "open door" stance towards the return of foreign investment in the form of dividends, the proposal should reduce the economic distortion at that margin as well as the transactions costs incurred under current law to overcome the repatriation barrier.

After comparing the state of the law as of the mid-1990s with a dividend-exemption proposal similar to the Panel's proposal, Altshuler and Grubert (2001) found that there was "no consistent or definitive evidence that [investment] location decisions would be significantly changed" if the dividend-exemption approach were adopted.[16] The Panel explained this initially surprising finding in the following way:

> For some firms, the U.S. international tax system produces tax results that are as good [as] or even better than those that would apply under a ter-

> ritorial system. Exempting active foreign-source income repatriated as a dividend from U.S. tax provides no additional incentive to invest abroad if, in response to the current tax system, firms have already arranged their affairs to avoid the repatriation tax.[17]

The Altshuler and Grubert conclusion should only be strengthened if they were to compare *today's* state of the law with the modified version of the Panel's proposal I will describe shortly.[18]

The impact of the Panel's proposal on overall tax compliance and administrative costs is uncertain.[19] Certainly, there will be much greater controversy than under current law regarding the proper allocation of deductions. In addition, transfer pricing problems may become more severe as U.S. taxpayers attempt to take maximum advantage of the active income exemption and also to locate U.S.-exempt income in the most favorable foreign jurisdiction. On the other hand, given the very favorable treatment of active business income under current law, much of that planning already takes place today.[20] In addition, as noted, the Panel's proposal may reduce somewhat the attraction of locating intangible assets in low-tax countries. There should also be reduction in foreign tax credit planning and efforts to avoid the repatriation tax.

Making changes to the international tax rules is a tricky business. For the most part, the taxpayers affected are big boys with lots of money at stake and *very* well-advised. As Marty Ginsburg likes to say, there is high probability that no matter how carefully crafted a change, the affected taxpayers and their advisors will "do you in."[21] Still, I resist the notion that this very real concern should paralyze policy makers into accepting a world which produces better-than-exemption consequences for some U.S. taxpayers making foreign investments and, in the process, generates significant distortion and administrative cost.[22]

COMPLETE REPEAL OF DEFERRAL

An alternative to the Panel's proposal, which would potentially reduce the distortive effect of the law on the choice of both investment location and repatriation but in a manner different from the Panel's proposal, would be to repeal deferral altogether. If deferral were repealed, then direct investment by U.S. taxpayers outside the United States would generally be taxed in the same manner as domestic investment. Furthermore, since U.S. taxation of foreign income would have taken place when the income was earned, the repatriation of after-tax earnings would no longer be a taxable event.[23]

Although a repeal of deferral is generally associated with a goal of capital export neutrality, or CEN, it alone would not achieve that high theoretical ground. CEN would require both unlimited crediting, and potentially U.S. refunding, of taxes paid abroad, something that surely will not occur,[24] as well as comparable tax treatment of domestic and foreign losses. In addition, repeal of deferral would not remedy, and indeed might exacerbate, distortions in the location of U.S. portfolio investment. So long as U.S. and foreign corporations are not taxed alike, tax considerations would still influence the location of such capital. Recent research by Desai and Dharmapala (2007a) has shown the potentially large impact taxes have on that economic decision.[25] Thus, like current law and the Panel's proposal, a repeal of deferral would still leave us in the nebulous realm of the second best.

More generally, although a complete repeal of deferral would create greater conformity at one margin – the tax treatment of domestic and foreign direct investment by U.S. taxpayers – it would do so only at the cost of producing greater *non*-conformity at two others. First, it would increase the difference between the U.S. tax treatment of inbound and outbound investment. With deferral completely repealed, the latter would more closely resemble a true "worldwide" system of taxation, but the former would continue to be largely a system under which only U.S. source income is taxed. The greater divergence in these two sets of tax results will place much greater pressure on the tax residence rules that determine whether a taxpayer is subject to one regime or the other.

To be sure, it might be possible to accompany a full repeal of deferral with a reform of the tax residence rules. For example, the existing U.S. "place of incorporation" rule[26] for corporations might be supplemented by a "real seat" rule such as one that determines a corporation's residence for tax purposes based on the location of its day-to-day management activity.[27] But this manner of reform becomes more problematic when one considers the second type of nonconformity increased by a full repeal of deferral – the greater divergence in the outbound taxation rules of the United States

with those of other countries. Currently, virtually all countries permit deferral or exemption of home country taxation of foreign active business income earned by their residents through foreign subsidiaries.[28] If the United States completely repealed deferral, it would break with this international consensus and open up many attractive alternative venues for corporations that desire to escape the U.S. rule. With so many options available, a "real seat" corporate residence rule adopted by the United States would create clear risk that headquarters and associated economic activity of multinationals would be moved offshore (or set up offshore at the outset). This possibility should be contrasted with the current law situation where alternative venues for firms that wish to relocate for tax purposes (or locate in a favorable tax jurisdiction from the start) are pretty much limited to the fewer, generally less attractive, jurisdictions without rigorous CFC-type rules.

A goal of pure capital export neutrality has also never been the policy throughout the entire tax history of this country.[29] The closest we came was in 1962 when the Kennedy Administration urged repeal of deferral for income from foreign investments in developed countries, but even then, there is some question whether the legislative initiative was designed more to favor domestic investment during a period of economic downturn rather than to achieve any sort of "neutrality."[30] In any event, the end result of that legislative effort was the blend of compromises encompassed by current subpart F.

It is hard to see what changes occurring since 1962 might warrant a complete rethinking of deferral today. Since that time, economic opportunities outside the United States and foreign competition have increased, and the United States has changed from being principally a capital exporting country to one whose economy relies increasingly on both capital exports and imports. Which of these developments would justify a repeal of deferral? Moreover, in part because of the United States' dominant economic role in the world in 1962, this country might reasonably have expected any change in the tax treatment of foreign direct investment to be copied by other countries, something that in fact transpired when the United States enacted subpart F. Would such an expectation be reasonable today if the United States completely repealed deferral? If not, then as previously noted, a repeal of deferral by the United States would move this country further away from international tax norms and thereby be antagonistic to another policy objective, which is to achieve greater international conformity in the tax treatment of cross-border income.[31]

Supporters of complete repeal might take heart from current prospects for Democratic control of the White House and both Houses of Congress beginning in 2009. Of course, it is worth remembering that Democrats also controlled all of those levers of power in 1962 when subpart F, and not repeal of deferral, was enacted. Indeed, the Democratic control in Congress in 1962 was by a much greater margin than will be likely in 2009.[32]

Supporters might nevertheless hope that the current generation of Democrats would be different from those in 1962.[33] Recall, however, that in the 2004 Presidential campaign, John Kerry only supported a partial repeal of deferral. In addition, he advocated repatriation relief similar to what was eventually enacted, whereas the Bush Administration opposed that relief to the very end.[34] Thus, I doubt very much that change in party control will result in a major shift in basic attitudes towards deferral and the taxation of foreign direct investment. To repeal deferral, how much change would be needed in the Congress (and in the society that Congress mirrors) that approved the homeland investment provision by wide margins just three years ago, and how long would it take to see that transformation?

CHAIRMAN RANGEL'S INTERNATIONAL TAX REFORMS

Would a more modest modification, such as the recent proposal by Chairman Rangel, be preferred over the Panel's proposal? Under the Rangel bill, U.S. deduction of expenses allocable to deferred foreign-source income would generally be delayed until such time as the income becomes subject to U.S. tax upon repatriation. The repatriation tax would remain the same as under current law. In addition, taxpayers would be required to calculate their foreign taxes and earnings and profits on a consolidated basis after taking into account all of their CFCs, with the result that at repatriation, they could claim credit for only a pro-rata share of foreign taxes equal to the portion of all deferred income represented by the repatriated amount. Thus, taxpayers would lose their current-law ability to minimize their U.S. residual tax at repatriation by bringing back only high-foreign tax earnings.[35]

The Rangel bill contains some creative ideas although it would seem to complicate an already horrendously complex set of laws. Like the Panel's proposal, the Rangel bill would reduce the attractiveness of foreign investment and make some of the U.S. tax consequence of such investment more transparent. The main weakness of the bill is its failure to reduce any of the distortion that arises at the time of the repatriation decision. The "carrot" of releasing some deferred deductions at that juncture would appear to be more than offset by the "stick" of restricting the availability of foreign tax credits. The net result may therefore be a higher repatriation barrier than under current law. It is difficult for me to understand why this country or any country would want to design or maintain a tax system that discourages the repatriation of earnings.

Although it retains deferral and the basic compromise worked out in 1962, the Rangel bill responds to concerns that current law induces too much foreign investment principally for tax avoidance purposes. Let me therefore suggest some possible modifications to the Panel's proposal that address this same concern while still retaining the key benefits of the proposal.

POSSIBLE MODIFICATIONS TO PANEL PROPOSAL

Although the structure of the Panel's proposal – to "move up" the potential adverse tax consequences of foreign investment by disallowing certain deductions, while at the same time establishing an "open door" policy to the future repatriation of foreign earnings – is a promising one, it is a separate question of how best to distinguish exempt from non-exempt foreign-source income. Obviously, there is a lot of controversy surrounding that question today, with some contending that subpart F taxes the equivalent of active income after taking into account modern business practices,[36] and others claiming that it still fails to tax foreign income generated purely for tax avoidance purposes.[37] The Panel's proposal potentially heightens the importance of getting this balance correct, and I could see changes being made to the definition of exempt income going in either direction or partly in both. I do not see the adoption of the Panel's proposal as a signal that the United States is leading or joining an international "race-to-the-bottom" regarding the tax treatment of foreign-source income.

In that vein, I would think one modification Congress ought to consider is to require exempt income to be "subject to tax" somewhere.[38] This condition would be added to whatever other requirements are used to define the exempt category of income. In differentiating between foreign investment undertaken in a locale where there is real business activity and that made principally for tax avoidance purposes, a "subject to tax" condition may not be a bad delineator. The condition would respond to concerns that dividend-exemption might induce too much purely tax-motivated foreign investment. Such a requirement would also take some of the pressure off of the transfer pricing rules and possibly help to slow the practice of designing foreign transactions to produce income having no source until policy makers have had a chance to reform the source rules.[39]

The problem is in defining what it means to be "subject to foreign tax." A "black list" or "white list" of specific source countries seems like a nonstarter, especially since one assumes certain trading partners which grant favorable tax treatment to U.S. investment would never be placed on the "black list."[40] A focus on tax rates is also problematic. Nominal or statutory rates in a foreign country are pretty much meaningless for this purpose, and average or effective tax rates would raise difficult questions regarding timing provisions in the foreign tax law.[41] From an administrative standpoint, it would not seem sensible to have the exempt/non-exempt determination fluctuate very much from year to year when a taxpayer simply continues the same investment in the same manner in the same country.

One other possible way to approach this issue is to focus on whether the income is earned in a country with which the United States has a comprehensive income tax treaty.[42] Other countries determine the exempt status of foreign income in this way,[43] and the United States has used the test for other purposes, such as whether dividends from a foreign corporation are entitled to the 15 percent rate.[44] This type of provision would be respectful of our treaty partners while also increasing the incentive of countries to enter into tax treaties with the United States. It would be directly responsive to "competitiveness" concerns by permitting U.S. tax exemption of active business income in the principal locations where real business competition exists. Also, by relying upon its existing treaty network, the United States would potentially have easy access to the type of information necessary to implement the rule. Finally, although the provision

would be in the nature of a "white list," it would be a bipartisan one previously developed by both Republican and Democratic Administrations through their past treaty policy.[45]

The successful repatriation of large amounts of income at the 5-1/4 percent tax rate leads to a second possible modification – would it be possible to retain some low-level repatriation tax rather than exempt the earnings altogether?[46] This issue is likely to be tied to the question of deduction disallowance, with some arguing in favor of retaining a small tax in lieu of any loss of deductions. Some foreign countries follow this approach.[47] For reasons previously stated, this idea should be resisted. It would clearly take away from the expected structural improvements provided by the Panel's proposal and would negate much of the reason for making the proposed change. On the other hand, I would be more open to possible retention of a small repatriation tax *in addition to* a disallowance of deductions if Congress felt impelled to retain some type of "safety net." Indeed, this combination would seem to achieve a similar consequence to the Rangel bill but in a more administrable way.

A final modification deals with transition – should the "open door" policy proposed by the Panel apply to the repatriation of *all* foreign earnings or only those accumulated after the change in law? The 2004 homeland investment provision drained some accumulation but no doubt, more has accumulated since the provision expired and more will accumulate in the future before any change in law. The staff of the JCT recommended exempting only future earnings, which would have the unfortunate result of requiring two sets of rules to be maintained forever.[48] The Panel's proposal, on the other hand, would apply to all earnings, no matter when accumulated, thereby offering another, even greater, windfall to many U.S. persons making foreign investment.[49] Perhaps not surprisingly, my preference would be to stick with the JCT staff approach. Favorable stacking rules could probably put off most of its complexities for most taxpayers. But I could also see some type of compromise developed to offer a bargain rate for actual or deemed repatriations of past accumulations, which would thereby allow most taxpayers to proceed in the future under only a single set of rules. I certainly would not begin the process by offering full exemption for repatriation of all earnings, no matter when accumulated.

Notes

1 President's Advisory Panel on Federal Tax Reform (2005, pp. 102-05, 132-35, 239-43).

2 U.S. JCT (2005, pp. 186-97).

3 Grubert and Mutti (2001, p. 2).

4 See President's Advisory Panel on Federal Tax Reform (2005, p. 104); U.S. JCT (2005, p. 189); ABA Tax Section (2006, p. 689). This conclusion is reached even without taking into account highly aggressive tax avoidance techniques sometimes used today, such as the claiming of credits for foreign taxes on income not taxed by the United States. The U.S. tax authorities will need to combat vigorously these types of strategies no matter what set of tax rules are ultimately adopted. Cf. Lokken (2006, pp. 770-771); Prop. Reg. § 1.901-2(f) (2006).

5 See Desai, Foley, and Hines (2001, p. 849); Grubert and Mutti (2001, pp. 21-23). An application of the "new view" of dividend taxation shows that if the repatriation tax is invariant over time, the tax does not distort the repatriation decision. The reason is that the more repatriations are delayed, the greater the amount of "trapped" earnings outside the United States and therefore the greater the future repatriation tax liability. See Hartman (1985, pp. 115-18). But for a variety of reasons, the conditions necessary for this result to occur do not exist. Cf. Altshuler, Newlon, and Randolph (1995) (attributing changes in repatriation behavior to endogenously and exogenously caused changes to the tax cost of repatriation); Altshuler and Grubert (2003) (showing effect of different repatriation strategies on both investment and repatriation decisions). The repatriation decision also has an important financial accounting effect. Companies are not required to book any U.S. income tax expense with respect to foreign earnings designated as "permanently reinvested" abroad. If a firm subsequently repatriates such earnings, it must record an expense for any resulting U.S. income tax liability. See APB Op. No. 23; Krull (2004).

6 See Treas. Reg. § 301.7701-2, -3; U.S. Department of the Treasury (2000, pp. 62-64, 68-70); Altshuler and Grubert (2006); Lokken (2005). Table 1 shows the declining average foreign income tax rates over the period encompassing tax years 1986-2002 of the 7,500 largest U.S.-controlled foreign corporations in those years.

7 I.R.C. § 954(c)(6) (effective for taxable years 2006-08).

8 Not. 2007-13, 2007-5 I.R.B. 410 (change effective beginning in 2007).

9 I.R.C. § 904(d) (generally effective for taxable years after 2006). Another important change, presently scheduled to take place in taxable years after 2008, is a modification to the interest allocation rules that would also make foreign investment more attractive. See I.R.C. § 864(f) (to be effective for taxable years

after 2008). Recent legislative proposals, however, would either delay or repeal this scheduled change. See U.S. Congress (2007b), as approved by the House Ways and Means Committee would delay change until after 2017; U.S. Congress (2007a) would repeal change.

[10] I.R.C. § 965.

[11] See U.S. JCT (2005, p. 193); cf. Grubert and Altshuler (2006, pp. 22-23).

[12] See Weiner (2007) (reporting preliminary analysis from SOI indicating over $300 billion of earnings repatriated pursuant to the homeland investment provision).

[13] For summaries of earlier studies, see Clark (2000), Hines (1997), Hines (1999). See also supra note 5.

[14] Grubert and Mutti (2001, p. 13), concluded that the overall burden under current law, meaning the repatriation tax plus the cost of avoiding that tax, is smaller than the tax cost under a dividend-exemption approach similar to the Panel's proposal. Consistently, they estimated that dividend-exemption would raise revenue relative to current law, an estimate confirmed by the Joint Tax Committee with respect to a dividend-exemption proposal slightly different from the Panel's. Grubert and Mutti (2001, pp. 38-40); U.S. JCT (2005, p. 427). Grubert (2001) showed that estimated revenue gains from dividend-exemption are likely to persist even after taking into account anticipated behavioral changes of shifting some overhead expenses outside the United States and converting some U.S.-taxable foreign-source royalty income into exempt dividend income.

[15] Grubert and Altshuler (2006, p. 11), estimate from Treasury data for tax year 2000 that about two-thirds of foreign-source royalty income was shielded from U.S. tax by credits for foreign tax imposed on income repatriated through dividends.

[16] Altshuler and Grubert (2001, p. 790); see also Grubert and Mutti (2001, pp. 12-13, 24).

[17] President's Advisory Panel on Federal Tax Reform (2005, p. 135).

[18] As Repetti (2007, pp. 316-18) has noted, increasing the transparency of the tax consequence of cross-border direct investment could be viewed as a two-edged sword because some U.S. taxpayers, such as young companies with limited planning opportunities under current law, may find the tax result under a dividend-exemption system to be predictable and favorable enough to induce greater foreign investment. On the other hand, if the effective tax rate on foreign investment increases as expected under dividend-exemption, some mature companies which presently make maximum use of tax-reduction opportunities may find foreign investment to be less attractive. Both of these consequences would be affected by the changes in the law since earlier studies and the suggested modifications to the Panel's proposal.

[19] For discussion of likely compliance and administrative issues under a dividend-exemption approach, see ABA Tax Section (2006, pp. 722-27); Ault (2003); Fleming and Peroni (2005, pp. 1560-68); Graetz and Oosterhuis (2001); Kleinbard (2007, pp. 550-55); McDaniel (2007).

[20] See U.S. Department of the Treasury (2007, pp. 36, 55-61) (reporting tax return data consistent with existence of non-arm's length pricing or income shifting among related parties); Bosworth et al. (2007); Sullivan (2004a, 2004b, 2004c, 2006).

[21] McDaniel (2007, p. 299) refers to this aspect of U.S. law as its "tax culture."

[22] For a general critique of current law and support for reform, see ABA Tax Section (2006, pp. 716-17).

[23] For discussion of a complete repeal of deferral, see U.S. Department of the Treasury (1993, pp. 46-52); U.S. Department of the Treasury (2000, pp. 88-90); ABA Tax Section (2006, pp. 731-35); Brumbaugh and Gravelle (2007, pp. 16-18); Fleming, Peroni, and Shay (2000); Peroni, Fleming, and Shay (1999, pp. 507-19). It is beyond the scope of this comment to discuss the administrative issues raised by a full repeal of deferral, but many difficult questions would need to be resolved.

[24] No limit on the use of the foreign tax credit existed in the United States for the first three years (1918-21) a credit was allowed, but no refunding of the credit was granted. With the fall of high U.S. tax rates after World War I, an overall limit was placed on the credit in 1921 and it has been a fixture of the tax law ever since. See Graetz and O'Hear (1997, pp. 1054-55).

[25] See Desai and Dharmapala (2007a) (strong influence of differing home and host country taxation on location of U.S. portfolio investment); Desai and Dharmapala (2007b) (large effect of JGTRRA's differential treatment of foreign-source dividends on U.S. portfolio choices). See also Avi-Yonah (2006, p. 578) (different integration benefits provided by foreign and domestic corporations to U.S. shareholders would bias their choice of portfolio investment); NFTC (2001, pp. 122-23) (different taxation at corporate level biases location of portfolio investment capital); Fleming, Peroni, and Shay (2000, p. 847); Merrill (1999, p. 1803).

[26] I.R.C. § 7701(a)(4), (5) and (30).

[27] See President's Advisory Panel on Federal Tax Reform (2005, p. 135); U.S. JCT (2005, pp. 178-81).

[28] See President's Advisory Panel on Federal Tax Reform (2005, pp. 242-43); Ault and Arnold (2004, p. 377); NFTC (2001, p. 69).

[29] See NFTC (2001, pp. 37-38); Peroni, Fleming, and Shay (1999, p. 470).

[30] In addition to urging broad repeal of deferral, the Kennedy Administration supported enactment of a new tax credit for domestic investment. See Graetz (2001, p. 275); Merrill (1999, p. 1802); NFTC (2001, pp. 42-

43). On the other hand, some years earlier, Stanley Surrey (1956), Assistant Treasury Secretary for Tax Policy in the Kennedy Administration, had written critically of deferral and other features of the U.S. international tax system on general policy grounds. An earlier change that resulted in a partial repeal of deferral was in 1937 when the foreign PHC provisions were enacted.

[31] See U.S. Department of the Treasury (1993, p. 2); Frisch (1990, p. 590). Earlier this year, the U.K. Revenue and Customs and U.K. Treasury (2007) published a discussion document on proposals to adopt a participation exemption system in the United Kingdom somewhat similar to the Panel's proposals.

[32] The 87th Congress (1961-63) had 65 Democrats and 35 Republicans in the Senate, and 263 Democrats and 174 Republicans in the House. The 88th Congress (1963-65) had 67 Democrats and 33 Republicans in the Senate, and 258 Democrats and 177 Republicans in the House. Source: Congressional Quarterly (2000).

[33] When I was in public service, I was often reminded by various members of Congress that the current generation of Republicans were not the same as my father's or my grandfather's generation.

[34] See Avi-Yonah (2004, pp. 477-78).

[35] See U.S. Congress (2007a) § 3201 (adding proposed Code §§ 975-977).

[36] See Scarabello (2005); Oosterhuis (2006a).

[37] See Shay (2004, pp. 33-36).

[38] See ABA Tax Section (2006, pp. 722-23, 730); Shay (2006). Other countries that maintain an exemption system commonly include some type of "subject to tax" condition on exempt income. See U.S. JCT (2006, pp. 34 (France), 38 (Germany), 41 (Netherlands), 44 (Singapore)). It is common for income tax treaties to contain a different term, "liable to tax," that determines what persons qualify as residents of a treaty country and are therefore potentially entitled to treaty benefits. See OECD 2005 Model Tax Convention on Income and on Capital, Art. 4(1); U.S. 2006 Model Income Tax Convention, Art. 4(1). As explained in the text, my "subject to tax" condition would be different from how "liable to tax" has been interpreted for tax treaty purposes.

[39] See U.S. Department of the Treasury (2000, pp. 75-81); Avi-Yonah (1999, p. 587); Kleinbard (2007, p. 559) (discussing problem of "stateless income"); Noren (2001, p. 339) (describing increase in this practice as "nightmare scenario").

[40] See Oosterhuis (2006b, p. 89); cf. Rosenbloom (2001, p. 1554) (would permit U.S. exemption of business income attributable to permanent establishments in "foreign countries that have full-blown, purposively administered, income tax systems, and which can be trusted, in most cases, to impose tax on persons having a substantial nexus with their soil").

[41] See U.S. Department of the Treasury (1993, pp. 12, 42-43); Oosterhuis (2006b, p. 89).

[42] Cf. U.S. Department of the Treasury (1993, pp. 13, 42-43) (suggests possible use of tax treaty network as starting point for identification of countries where exempt income could be earned); Rosenbloom (2001, p. 1545); Graetz (2001, p. 331).

[43] See, for example, Canada. See Ault and Arnold (2004, p. 373); Merrill et al. (2006, p. 802).

[44] I.R.C. § 1(h)(11)(C)(i)(II).

[45] Table 2 shows that roughly five-sixths of the foreign income and taxes of the largest 7,500 CFCs in tax year 2002 were reported by those incorporated in the major treaty countries. The income and tax reported, however, were not necessarily earned in or paid to the treaty country and perhaps in part for that reason, Table 2 also shows that the average foreign income tax rate of the CFCs in treaty countries was very similar to that of all of the largest CFCs.

[46] See Shaviro (2003).

[47] See U.S. JCT (2006, p. 37) (Germany taxes 5 percent of repatriated amounts in lieu of disallowing deductions). France also exempts only 95 percent of earnings at repatriation even though it generally disallows the deduction of expenses allocable to exempt income. However, it does not have detailed statutory rules specifying the manner of disallowance. U.S. JCT (2006, pp. 34-35); Ault and Arnold (2004, p. 376).

[48] U.S. JCT (2005, pp. 191-92).

[49] President's Advisory Panel on Federal Tax Reform (2005, p. 240).

Table 1

Pre-Tax E&P, Foreign Income Taxes, and Average Foreign Income Tax Rates of 7,500 Largest Controlled Foreign Corporations of U.S. Corporations with Total Assets of $500 Million or More, Selected Tax Years 1986-2002 ($ millions)

(1) Tax Year	*(2)* Current E&P (less deficit) before taxes	*(3)* Foreign income taxes (net)	*(4)* Avg. tax rate (col. (3)/col. (2))
1986	56,591	19,229	33.98%
1988	79,811	23,930	29.98%
1990	88,688	23,937	26.99%
1992	69,613	18,472	26.54%
1994	98,428	23,268	23.64%
1996	141,010	32,395	22.97%
1998	143,840	34,745	24.16%
2000	207,576	43,143	20.78%
2002	200,670	38,610	19.24%

Note: Data is from 7,500 largest CFCs of U.S. parent corporations with total assets of $500 million or more in each selected year. In tax year 2002, the 7,500 largest CFCs accounted for 92.5% of total end-of-year assets, 81.7% of total receipts, and 89.9% of current E&P (less deficit) before taxes reported by all active CFCs of such U.S. parent corporations.

Source: Redmiles & Wenrich (2007) (Fig. D) and Masters & Oh (2006), p. 200.

Table 2

Pre-Tax E&P, Foreign Income Taxes, and Average Foreign Income Tax Rates of 7,500 Largest Controlled Foreign Corporations of U.S. Corporations with Total Assets of $500 Million or More, by Selected Treaty Country of Incorporation of CFC, Tax Year 2002 ($ millions)

(1) Countries with tax treaties satisfying § 1(h)(11)(C)(i)(II) (Not. 2006-101)	*(2)* Current E&P (less deficit) before taxes	*(3)* Foreign income taxes (net)	*(4)* Avg. tax rate (col. (3)/col. (2))
Australia	4,069	951	23.37%
Austria	888	170	19.14%
Barbados	323	7	2.17%
Belgium	2,842	408	14.36%
Canada	18,204	5,060	27.80%
China	2,133	188	8.81%
Cyprus	37	4	10.81%
Czech Republic	411	113	27.49%
Denmark	9	62	688.89%
Finland	164	47	28.66%
France	5,721	1,320	23.07%
Germany	6,427	1,803	28.05%
Greece	94	39	41.49%
Hungary	499	43	8.62%
India	168	96	57.14%
Indonesia	804	289	35.95%
Ireland	14,682	792	5.39%
Israel	609	73	11.99%
Italy	3,892	1,182	30.37%
Japan	12,143	3,148	25.92%
Korea	2,005	582	29.03%
Luxumbourg	5,085	377	7.41%
Mexico	7,439	1,884	25.33%
Netherlands	32,587	5,197	15.95%
New Zealand	612	94	15.36%
Norway	553	274	49.55%
Phillipines	898	111	12.36%
Poland	443	149	33.63%
Portugal	895	149	16.65%
Russian Federation	363	45	12.40%
Slovak Republic	48	13	27.08%
South Africa	425	109	25.65%
Spain	3,620	1,389	38.37%
Sweden	994	250	25.15%
Switzerland	14,456	1,017	7.04%
Thailand	496	109	21.98%
Trinidad and Tobago	68	21	30.88%
Turkey	116	61	52.59%
Ukraine	44	15	34.09%
United Kingdom	20,674	4,804	23.24%
Venezuela	749	155	20.69%
Total, treaty countries listed	166,689	32,600	19.56%
Total, all geographic areas	200,670	38,610	19.24%
% treaty countries listed/ all geographic areas	83.07%	84.43%	

Note: Separate data was not available for the following additional qualifying treaty countries: Bangladesh, Egypt, Estonia, Iceland, Jamaica, Kazakhstan, Latvia, Lithuania, Morocco, Pakistan, Romania, Slovenia, Sri Lanka, and Tunesia.
Note: Data is from 7,500 largest CFCs of U.S. parent corporations with total assets of $500 million or more in tax year 2002. In that year, the 7,500 largest CFCs accounted for 92.5% of total end-of-year assets, 81.7% of total receipts, and 89.9% of current E&P (less deficit) before taxes reported by all active CFCs of such U.S. parent corporations. Data represents amounts reported by CFCs with place of incorporation in selected treaty countries and does not necessarily represent income earned in and taxes paid to that country.
Source: Masters & Oh (2006) (Table 2).

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