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Business Income and The Foreign Tax Credit

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This proposal recommends that tax law neutralize the advantages of operating in low-tax countries and repatriating from high-tax countries in three ways. One, determining foreign tax credit with respect to overall foreign profits; two, preventing voluntary repatriation from high-tax countries under section 956 and disguised repatration from low-tax countries; and three, by ascertaining when profits of low-tax countries result from stealth transfers of intangibles.

The proposal is made as a part of the Shelf Project, a collaboration by tax professionals to develop and perfect proposals to help Congress when it needs to raise revenue. Shelf Project proposals are intended to raise revenue, defend the tax base, follow the money, and improve the rationality and efficiency of the tax system. This is the second in a series of Shelf Project international tax proposals by the author. The first was "Revise the Rules for Passive Income and Passive Assets," *Tax Notes*, Jan. 28, 2008, p. 535.

The tax community can propose, follow, or edit proposals at http://www.taxshelf.org. A longer description of the Shelf Project is found at "The Shelf Project: Revenue-Raising Proposals That Defend the Tax Base," *Tax Notes*, Dec. 10, 2007, p. 1077, *Doc 2007-22632*, or *2007 TNT 238-37*.

Shelf Project proposals follow the format of a congressional tax committee report in explaining current law, what is wrong with it, and how to fix it.

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I. U.S. and Foreign Income

Foreign income taxes paid may be credited against — that is, reduced dollar for dollar — U.S. income tax.[1] Section 904 initially limits the amount of the credit to the U.S. tax on foreign income. This recognizes that for income earned abroad, the United States is willing to subordinate its residence country taxing rights to a source country. But for income earned here, the United States has taxing rights as both source and residence country, so it does not subordinate those rights by allowing credit for foreign tax paid.

An illustration for simplicity uses a 33⅓ percent U.S. tax rate:

	Foreign	U.S.
Income	100	20
Foreign Tax	40	0
Pre-Credit US. Tax	33	6.67
Credit	*(33)*	*0*
Net U.S. Tax	0	6.67
Excess Credit	6.67	0

II. Active Business and Passive Income

To discourage the earning of low-taxed or untaxed passive income abroad, the credit limitation next applies separately to the categories of foreign active business income and foreign passive income. The following example shows why[2]:

	Without Baskets		With Baskets	
	Active	Passive	Active	Passive
Income	100	20	100	20
Foreign Tax	40	0	40	0
Pre-Credit U.S. Tax	40		33	6.67
Credit	*(40)*		*(33)*	*0*
Net U.S. Tax	0		0	6.67
Excess Credit	0		6.67	0

The U.S. tax on passive income is the same as if the passive income were — as in the previous example — U.S. source. This prevents domestic corporations from obtaining more foreign tax credits by earning foreign-source interest (from deposits in a foreign bank) than if they earned U.S.-source interest (from deposits in a domestic bank).

[1]Section 901.

[2]Section 904(d). Foreign tax credit categories are colloquially referred to as baskets.

A. Active Business Income

The active business category, however, does not distinguish between high-taxed and low-taxed active business income earned abroad. Tax credits may be used fungibly against U.S. tax on either.

Active Business Basket		
	Canada	Singapore
Income	100	20
Foreign Tax	40	0
Pre-Credit U.S. Tax	40	
Credit	(*40*)	
Net U.S. Tax	0	
Excess Credit	0	

Although the Reagan Treasury had proposed fragmenting the active business basket between high- and low-taxed countries,[3] Congress decided against it. The 1986 blue book explained why: ''In general, Congress believed that the overall limitation was consistent with the integrated nature of U.S. multinational operations abroad.''[4]

B. Exports

One-half the net income from exports, which are neither part of integrated operations abroad nor generally taxed abroad, is considered foreign-source active business income.[5] Accordingly, excess credit from a high-tax country can eliminate U.S. tax on 20 of export foreign-source income just as it does on 20 of income from Singapore.

I. Active Business Basket		
	Canada	Foreign Source Exports
Income	100	20
Foreign Tax	40	0
Pre-Credit U.S. Tax	40	
Credit	(*40*)	
Net U.S. Tax	0	

Congress clearly intended that result.[6] But combining the credit for high- and low-taxed jurisdictions assumed that excess credit from repatriations would be used against low-taxed income from ''integrated . . . operations abroad,'' whereas the inventory source rule assumed that it will be used against profits from activities in the United States. There could of course be enough credit to offset U.S. tax on both, but this often is not the case.

Unrepatriated Low-Taxed Profits and Exports			
	Canada	Foreign Source Exports	Singapore
Income	100	20	20
Foreign Tax	40		0
Pre-Credit U.S. Tax	33	6.67	0
Credit	(*40*)		
Net U.S. Tax	0		

There is no precredit U.S. tax on the 20 of Singapore profits, because they are not currently distributed from the Singapore subsidiary. Their inclusion in U.S. income (and U.S. tax) is therefore deferred until they are repatriated as dividends. Had the 20 of Singapore profits been repatriated currently, the excess 6.67 of tax credit from Canada would have been used up against the 6.67 of U.S. tax on those profits, and the 20 of export profit would have been fully taxed. Selective deferral — repatriation from Canada but not Singapore — allows the 6.67 of excess credit to eliminate tax on that 20 of export income.[7]

These are not small amounts. Intel Corp., which repatriated $6.2 billion under the one-time low rate of section 965, earlier had successfully litigated the source of its export income to use its foreign tax against exports rather than against the unrepatriated $6.2 billion.[8] The U.S.-owned buildup in assets from 1999 through 2002 in Ireland alone approached $75 billion.[9]

The legislative history of the active business (general) basket envisaged that excess credits from high-tax countries would be used against repatriation from low-tax countries. But as just illustrated, companies can use high-tax credits to eliminate U.S. tax on exports instead. This credit mismatch skews its intended use.

C. Credit Mismatches

The recent case of *Guardian Industries*[10] allowed a greater mismatch by permitting the use of credits *only*

[3]2 *Tax Reforms for Simplicity, Fairness and Economic Growth — The Treasury Department Report to the President* 386-387.

[4]General Explanation of the Tax Reform Act of 1986, at 862.

[5]Reg. section 1.863-3(b).

[6]Section 865(b). The 1986 blue book states that repeal of the inventory source rule ''would create difficulties for U.S. businesses operating abroad.'' 1986 blue book at 918.

[7]For ease of illustration, this traces use of the credit to U.S. tax on the Singapore profits. As a technical matter, the entire credit of 40 is used fungibly against the 66.67 of U.S. tax on 140 of foreign-source income. (The 6.67 of excess credit could equally be used against interest or royalties from a foreign subsidiary, under a ''look-through'' rule that includes such items as active business income if they are paid out of business profits.)

[8]*Intel Corp. v. Commissioner*, 100 T.C. 612, *93 TNT 137-15* (1993), *aff'd*, 76 F.3d 976, *Doc 95-9585*, *95 TNT 206-80* (9th Cir. 1995).

[9]Martin A. Sullivan. ''Data Show Dramatic Shift of Profits to Tax Haven Countries,'' *Tax Notes*, Sept. 13, 2004, p. 1189, *Doc 2004-17844*, or *2004 TNT 177-1*.

[10]*Guardian Industries Corp. v. United States*, 2004 U.S. App. Lexis 3927, *Doc 2007-4863*, *2007 TNT 38-14* (Fed. Cir. 2007). The

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against income that was not repatriated. In that case, tax was paid by a Luxembourg company, which U.S. tax law did not consider to exist, while the profits on which the tax was imposed remained in Luxembourg companies which U.S. tax law *did* consider to exist. Similar mismatches of credit and income occur, as stated in recent proposed Treasury regulations, because "much effort is expended to transfer foreign tax credits without transferring the underlying economic ownership of property"; and advantage is taken of countries' differing ideas about what is debt and what is equity.[11] Proposed regulations also try to prevent analogous mismatches through noneconomic partnership allocations of foreign tax among members of the same corporate group.[12]

D. A Look-Through Recommendation

The foreign tax credit uses rules that look through a foreign subsidiary to determine the character of a parent's foreign-source income; its amount; and in section 902 — the earliest look-through rule — the taxes deemed paid. For character, section 904(d)(3) looks through to characterize interest and royalties as the profits from which a subsidiary pays them.[13] More broadly, section 864(e) and (f) determine the amount of foreign-source income by allocating interest deductions for income and deductions of an entire affiliated group, without taking into account either corporate entities or whether profits are repatriated.

The recommendation would use this overall look-through concept to determine the amount of foreign tax credit. Like interest deductions, they would be allocated on a group basis without regard to repatriation. This would prevent the mismatches that occur under current law by the tracing of taxes solely to profits repatriated from high-tax countries. For example, under the recommendation, a U.S. parent with 40 of tax on 100 of profits from Canada but no other profits earned abroad could use the excess 6.67 of credit against U.S. tax on 20 of export income. But if the company also had 20 of untaxed and undistributed profits in Singapore, the excess 6.67 could not be so used. This reflects the fact that *solely with respect to operations abroad*, the group has no excess credit: It has paid 40 of foreign tax on 120 of foreign profit, the same tax and 33⅓ percent rate (40/120) that the United States would impose. As a result, five-sixths of the 40 foreign tax, 33.33, would be allocated to the current U.S. tax imposed on the five-sixths of profits (100/120) repatriated. The remaining 6.67 would be allocated to future U.S. tax imposed on the 20 of unrepatriated Singapore profits rather than current U.S. tax on the 20 export income. The reason is that there would be no excess credit on operations abroad.[14]

This concept fits both with current law's attribution of foreign subsidiary earnings and taxes to an overall period and similar measurement of a domestic group's foreign income for that overall period.[15] To see how it might work, suppose that for three years 6.67 of D's foreign tax credit from Canada were allocated to 20 of exempt Singapore profits. For U.S. tax purposes, the books would look like this:

	Year 1	Year 2	Year 3
Pretax Singapore profits	20	20	20
Canadian tax allocated	6.67	6.67	6.67
Posttax profits	13.33	13.33	13.33

At the end of the third year, Singapore distributes to D 13.33, one-third of its pooled 40 posttax profits. D would treat 6.67 — one-third of the total three-year 20 tax allocated to the three-year 60 of pretax profits — as having been paid with respect to the one-third of 40 repatriated posttax profits. D therefore would include in income 20, the sum of the 13.33 posttax profits distributed and the 6.67 tax deemed paid on them. The result is an effective 33⅓ percent foreign tax credit rate on both current and future repatriations, the actual rate incurred on the parent's overall foreign operations.

E. The Advantage of Fungible Credits

Tax law seesaws. Cross-crediting foreign taxes against both high- and low-taxed income, as well as the interest allocation regulations, treat an affiliated group as a single entity. Selective deferral, on the other hand, fosters mismatches by attributing income and taxes to each separate entity. Check-the-box regulations exacerbate this by allowing the taxpayer to choose whether an entity is separate.

By contrast, the recommendation treats the group only as a whole. It therefore takes to a consistent and logical conclusion the Tax Reform Act of 1986 rationale of not

court specifically reserved decision on the Treasury's response in proposed regulations. REG- 124152-06, *Doc 2006-14649*, *2006 TNT 150-6*.

[11]REG-156779-06, *Doc 2007-8012*, *2007 TNT 62-10*.

[12]T.D. 9121, *Doc 2004-8485*, *2004 TNT 77-10*.

[13]Section 904(d)(3).

[14]Deferring tax credit for realized but not yet recognized income from Singapore resembles deferring domestic deductions until a similar category of accrued profits becomes taxable. *See* section 1092(a)(3); reg. sections 1.904-6, 1.960-1 and -2.

[15]Sections 902(c) and 904(f). Under the loss recapture rule, if in year 1 foreign deductions exceed foreign income by 100, they will be allocated to 100 of domestic income. If in later years foreign income exceeds deductions by 100, the year 1 deductions become reallocated from domestic income and reduce foreign income — from, say, 100 to zero. Foreign tax of 33 creditable in the later years therefore cannot be credited, because over the multiyear period foreign income and the corresponding foreign tax credit limitation have been zero.

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tracing credits separately to high- and low-taxed active business income, based on the assumption that foreign operations are integrated.

Resistance on the grounds of complexity rates easy dismissal. Large corporations do not resist a *relief* proposal because it requires work — the best recent example being section 965. Recent legislation in the foreign tax credit area, both fair and greeted with approval, contains very complex provisions that grant relief for domestic losses.[16]

In fact, the recommendation would on balance simplify.[17] It would eliminate the immense effort — the study of areas from entity classification to partnership allocations — that goes into planning credit mismatches. Reducing the benefit of mismatches would blunt the incentive to find them.

Under the suggestion, Guardian Industries would have had to allocate taxes to its subsidiaries' earnings even though they were not included in income.[18] Although some benefit would remain, the effort might well not warrant the result. As further simplification, the provision might well exclude companies with considerable leeway or an effective tax rate on foreign operations of, say, 90 percent of the U.S. rate.[19]

III. Repatriation

A. Repatriation From High-Tax Foreign Subs

Dividends distributed by a foreign subsidiary to its U.S. parent are included in gross income. The earnings and profits attributable to distributed property can alternatively be repatriated by having a subsidiary lend money to or invest in stock of its U.S. parent. The Revenue Act of 1962, which enacted subpart F, included provisions that treated earnings invested in U.S. property — most significantly, funds made available to the U.S. parent — as income. As the Senate committee report stated: ''Generally, earnings brought back to the United States are taxed to the shareholders on the grounds that this is substantially the equivalent of a dividend paid to them.''[20]

At the time, the U.S. corporate tax rate was about 50 percent, and any inclusion of income by treating indirect repatriation as a dividend would almost certainly result in U.S. tax. Section 956, which defined what constituted a foreign subsidiary's investment in U.S. property, was a section to avoid.

Now, however, the corporate tax rate is 35 percent; and corporations have been using section 956 affirmatively to accomplish selective deferral — that is, to include in income amounts that carry with them high foreign tax credits while deferring inclusion of untaxed or low-taxed earnings.

> *Example*: U.S. parent P owns foreign subsidiary F, which in turn owns second-tier foreign subsidiary FS. F has 100 of earnings, on which it has paid no tax. FS has 100 of earnings, on which it has paid 40 of foreign tax. If FS distributed 60 to F, which in turn distributed the 60 to P, the 60 dividend from F to P would carry with it a credit of 15.[21] By contrast, if FS were to lend 60 to P, the investment would be treated as a dividend from FS directly to the parent. The loan would therefore result in a 60 income inclusion carrying with it a foreign tax credit of 40 (60/60 x 40).

This technique assumes new importance because an alternative method of achieving the 40 credit has disappeared. That method was distribution by FS to F of a 60 dividend, formerly treated as subpart F income with foreign tax credit as if paid directly from FS to P. New section 954(c)(6) excludes the FS dividend from F's subpart F income. But section 956 can create the same result — a 60 dividend with 40 of foreign tax credit to P.[22]

B. Recommendation

It is recommended that sections 951(a)(1)(B) and 956 be amended to give the secretary regulatory authority to determine whether amounts invested in U.S. property by a foreign subsidiary be included in the income of its domestic parent. For example, regulations might provide that amounts are in effect treated as a dividend if credit for foreign tax is less than 90 percent of the U.S. tax rate (as in section 954(b)(4)), but are not so treated if the effect is to use expiring foreign tax credit carryovers. The taxpayer would be required to report investments in U.S. property as a dividend and to indicate the resulting increase or reduction in tax.[23]

C. Repatriation From Low-Taxed Foreign Subs

Tax law, including the statutory language of section 956, assumes that parent stock owned by a subsidiary

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[16]*See* sections 864(f) and 904(g), which rectify the one-sided allocations of sections 864(e) and 904(f), respectively. *See also* section 904(f)(3)(D), which remedies a gap that arose from not recapturing a parent's interest deductions allocated to exempt foreign subsidiary income.

[17]The tax credit regime of subpart F, which differs from that for unrepatriated profits not currently includable in income, would keep its current method of tracing to items of income. Tracing also would be retained for taxes afforded credit only by treaty and thus limited to specific income. *See* U.K.-U.S. tax treaty, art. 24, para. 3.

[18]*Guardian* showed the weakness of selective deferral by crediting taxes attributable *only* to profits not included in income.

[19]This would parallel the 90 percent rate that can exclude an item of income from subpart F. Section 954(b)(4).

[20]S. Rept. No. 1181, 87th Cong., 2d Sess., at 88 (1962).

[21]F would be considered to have 160 of earnings on which it had paid 40 of taxes. The 60 dividend would therefore carry with it a credit of 15 (60/160) x 40).

[22]*See* David R. Sicular, ''The New Look-Through Rule: W(h)ither Subpart F?'' *Tax Notes*, Apr. 23, 2007, p. 349, *Doc 2007-8611*, *2007 TNT 79-37*, text at examples 13 and 14.

[23]This change would be needed even if under a prior recommendation foreign tax credits outside subpart F were determined with reference to a group's overall accumulated profits and taxes. Since subpart F income is low-taxed income, for credit purposes foreign taxes must be traced to low-taxed income inclusions from items like bank interest and related-party sales. To separate section 956 from the rest of the subpart F structure is not feasible.

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constitutes an asset of value rather than unissued stock of the group. Under that reasoning, a subsidiary's purchase of parent stock (from either the parent or the parent's shareholders) does not reduce the subsidiary's assets and therefore does not represent a constructive distribution of the purchase price by the subsidiary.

An extreme example best shows the construct. The sole asset of P, which has 100 shares outstanding, is stock of S, whose sole asset is 100 in cash. S uses the 100 to buy all 100 shares from the P shareholders. Under Rev. Rul. 80-189, new parent corporation S has an asset — the P shares — with a basis of 100. Actually, however, the group has ceased to exist (until P or S stock is reissued to a third party). Before Rev. Rul. 80-189, the IRS would have considered S to have distributed the 100 to P in liquidation, and P to have redistributed the 100 to its own shareholders in redemption of all its stock (liquidation). The reasoning of that ruling — that P stock was an asset in the hands of S — allowed a U.S. parent company listed on the New York Stock Exchange to expatriate itself to Panama without incurring U.S. corporate tax.

The facts are set forth in *Bhada v. Commissioner*.[24] A Panamanian subsidiary of McDermott Corp., a publicly held domestic parent, issued its own stock and cash for all the stock of the parent. The government — possibly feeling constrained by Rev. Rul. 80-189 — did not argue that McDermott had received and distributed cash and subsidiary stock to the public shareholders. The 1984 blue book,[25] with obvious reference to McDermott, analyzed the transaction as a distribution of the Panamanian subsidiary — but that is not current law.

This might seem an arcane point, but IBM has apparently used the reasoning to achieve repatriation of 12.5 billion from foreign subsidiaries without including that amount in its corporate income.[26] By contrast, the consolidated return regulations correctly treat debt bought by a member of the group as retired, and intercompany debt sold by a member of the group as reissued. That concept, within or outside consolidated returns, should apply to stock of a parent.

That parent stock owned by a subsidiary is essentially unissued stock reflects economic reality. If the subsidiary distributes the stock back to its parent, where it literally becomes unissued stock, net assets of the group remain unchanged.

The concept has the added advantage of removing (at a specified ownership level of, say 80 percent) the question of a subsidiary's tax cost in parent stock.[27] The current construct has allowed both expatriation without corporate tax (McDermott) and repatriation without tax (IBM).

For subsidiaries, foreign or domestic, stock of a parent or affiliate would not be considered an asset. Instead, the parent stock would be treated as unissued stock of the group. The provision would apply to an ownership level of 80 percent, as do sections 332, 338, 368(c), and 1504.

IV. Reporting the Expatriation of Intangibles

U.S. multinationals, as previously mentioned, earn and retain large profits in low-tax jurisdictions. This is particularly true of companies with valuable intangibles relating to patents or know-how. Efforts to police intercompany pricing and the contribution of intangibles to foreign subsidiaries continue,[28] although the IRS cannot know as well as a company what specific intangibles produce its foreign subsidiaries' profits. In one case, for example, the company emphasized the value of its intangibles to stockholders and customers, but denied to the government that it had any.[29]

It would be within the capability of large corporations (and indeed they often make an internal analysis to allocate profits among divisions) to locate intangibles that produce profits. They should therefore be asked to identify them — not required to describe their know-how or trade secrets, but to identify which of their foreign subsidiaries have intangibles and how those subsidiaries developed or obtained them.

V. Recommendation

It is recommended that U.S. corporations with a certain threshold of gross receipts in their foreign subsidiaries report and describe the intangibles responsible for the subsidiaries' profits. A return on the subsidiaries' tangible assets — calculated either with reference to tax basis or appraised value, at the taxpayer's option — can be ascribed to the tangibles.

Any profits in excess of that return — with a leeway of perhaps 25 percent — would be considered a return on intangibles. The taxpayer would attach to its return the amount it earned for those intangibles, identify them without revealing information useful to its competitors, and describe how the foreign subsidiary developed or otherwise acquired the intangibles.

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[24]892 F.2d 39 (6th Cir. 1989).

[25]General Explanation of the Tax Reform Act of 1984, at 448.

[26]*See* William M. Bulkeley, ''IBM Hones the Stock Buyback,'' *The Wall Street Journal*, May 30, 2007, at A4.

[27]Similarly, section 956 would not consider an investment in a parent's stock an investment in U.S. property. The subsidiary would simply have distributed funds and received unissued stock of the parent.

[28]Sections 367 and 482.

[29]*Hospital Corporation of America v. Commissioner*, 81 T.C. 520 (1983).

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