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Revise the Rules for Passive Income and Passive Assets

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This proposal recommends restoration of the passive foreign investment rules to controlled foreign corporations. Its 1997 removal, on the grounds of simplification, allowed many billions of profits siphoned from the United States to be accumulated in low tax jurisdictions and then, in an incredibly complex provision backed by multinationals, brought back to the United States without tax.

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. 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. This is one of a series of Shelf Project papers on international taxation by the author. Kingson wants to express admiration and gratitude to Calvin Johnson, who created the project, appreciation to Reuven Avi-Yonah for support; and thanks to Peter Canellos for his clarifying comments on this proposal.

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Background

Passive Income

For 70 years the United States has considered there to be no legitimate reason for its taxpayers to earn passive portfolio income — interest, dividends, and stock gains from unrelated companies — outside its immediate taxing jurisdiction. When the investment was not part of an active business (like banking or insurance), taxing the income immediately was considered not to affect the ability of U.S. persons to compete abroad.

That income, defined as foreign personal holding company income, was first taxed currently just to individuals owning offshore family investment companies. The income was taxed whether it was actually distributed to them, and the purpose was to end the use of such companies so that individuals would own their passive investments and earn their passive income directly.[1]

The Revenue Act of 1962 extended the scope of that principle to undistributed passive investment income earned by foreign subsidiaries (controlled foreign corporations) of U.S. widely held multinationals. Foreign personal holding company income became a type of subpart F income taxed as if earned directly by its United States shareholder.[2]

The Tax Reform Act of 1986 further extended the scope of that rationale to include taxation of Americans who invested in foreign widely held investment companies. The stockholders of such companies were not taxed under the foreign personal holding company provisions, because the companies were widely held; and because there was no U.S. parent, the stockholders were not taxed under the subpart F rules applicable to CFCs.

Congress therefore specified a new category: passive foreign investment companies (known as PFICs). If for any year 75 percent of the income of a foreign corporation was foreign personal holding company income, or if 50 percent of its assets would produce such income, the company became a PFIC as to its then U.S. stockholders. When a stockholder finally realized the income (for example, by selling stock in the PFIC at a gain), he would incur more liability (in tax and an interest charge) than if the PFIC's income had been taxed currently. This regime induces shareholders to elect inclusion of the PFIC income as though earned by them directly. Treasury's 1986 blue book stated: "Congress did not believe that U.S. persons who invest in passive assets should avoid the economic equivalent of current taxation merely because they invest in those assets indirectly through a foreign corporation."[3]

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[1]Code sections 551-557, now repealed. Prominent Americans who used foreign personal holding companies to avoid U.S. tax included people with names such as Westinghouse, Lamont, Willys, Sloan, Scripps, Howard, duPont, Paley, Milbank, Merrill, and Lynch. *See* Tax Evasion and Avoidance, Hearings Before the Joint Committee on Tax Evasion and Avoidance, 75th Cong., June 1937.

[2]Sections 951(a)(1)(A)(i), 952(a)(2), 954(a)(1), and 954(c). Section 954(c)(6), enacted in 2006, excludes from foreign personal holding income certain income from direct, rather than portfolio, investment.

[3]Sections 1291-1298. *1986 Treasury Blue Book*, p. 1023.

Passive Assets

The argument for not taxing U.S. multinationals currently on their low-taxed business income earned through foreign subsidiaries rests on their need to compete with foreign-owned companies that enjoy little or no taxation. When those low-taxed profits are invested in assets that are no longer needed by the business, the competitive justification for not taxing the profits invested in the unneeded assets dissolves.

The Revenue Act of 1962 began the process of taxing profits unnecessarily accumulated abroad by treating assets repatriated by a foreign subsidiary — most starkly, by lending cash to its U.S. parent — as if they had been distributed as a dividend.[4] As the effectiveness of the provision was increased by various amendments, foreign subsidiaries would instead retain the unneeded assets to make portfolio investments.

To combat this, in 1993 Congress enacted section 956A, which taxed U.S. parents on the "excess passive assets" — that is, those not needed in the business — of their foreign subsidiaries. Excess passive assets were those above 25 percent of a subsidiary's assets; and the parent would include in income that excess, but only that excess. In 1997 Congress repealed the provision because of its administrative complexity and the efforts companies had to make to avoid it.[5]

Accordingly, after 1996 more than 25 percent of a subsidiary's assets could be invested in passive assets without the profits attributable to those assets being taxed to the parent. But if passive assets became more than 50 percent of the subsidiary's assets, it would become classified as a PFIC. Economically this would require the U.S. parent to pay tax currently on all of the subsidiary's future earnings, both active and passive,[6] and regardless of whether or not the assets were needed in the business.

Passive assets of subsidiaries in low-tax countries like Ireland and Singapore could build up so quickly that they would exceed the 50 percent threshold. But this became permitted in 1997, when Congress exempted subsidiaries from PFIC classification. The rationale given was that the overlap with subpart F (largely nonexistent as to unrepatriated passive portfolio assets) was so complex that multinationals could not cope.[7]

The exemption from PFIC classification and the repeal of section 956A ushered in an immense buildup of profits retained in low-tax countries.[8] Those profits, often diverted from the U.S. tax base by improper transfer pricing or unaccounted-for expatriation of intangibles, were permitted to be repatriated to the United States without any substantial tax. The American Jobs Act of 2004 in effect amnestied those profits invested in unneeded passive assets if there was a nonbinding plan to use them to create U.S. jobs.[9]

Reasons for Change

Investing in passive assets by foreign subsidiaries in tax haven countries neither increases American competitiveness nor creates American jobs. Nor did the largely tax-free repatriation of unneeded assets create American jobs. Intel, which repatriated $6.2 billion under the tax amnesty, shortly thereafter announced it was cutting 10,500 jobs, about 10 percent of its workforce.[10] Pfizer, which had $38 billion indefinitely reinvested abroad at the end of 2003, drastically cut its domestic sales force in 2006.

There is no competitive justification to have foreign subsidiaries accumulating profits abroad and placing them in passive portfolio investments equal to more than one-half of their business assets. Moreover, this may encourage the movement of U.S. operations abroad.

Recommendations

Section 1297(e) should be repealed and, as provided in the 1993 act, the status of a CFC as a PFIC should be determined with reference to the tax basis in the assets. The latter provision forecloses a claim that the foreign subsidiary does not have 50 percent of passive assets by reason of its immense intangibles (which have not been reported as transferred to it from the United States). Application of the PFIC regime would induce U.S. parent companies to repatriate rather than suffer the liability arising under that classification.[11] There may be concern that concurrent application of the PFIC and subpart F regimes might cause undue complexity. To the extent this concern is considered a serious issue, consideration could be given to restoring section 956A, with clear definitions of excess passive assets and provisions designed to prevent structures created to evade the statute.

Either change would raise substantial revenue by forcing the repatriation of unneeded earnings and, according to the arguments of the companies, create American jobs. It might also deter U.S. citizens from trying to assign compensation income to their foreign-owned companies. The assets which those companies acquire with the compensation would cause them to become PFICs. This would nullify any deferral.

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[4]Section 956.

[5]*See General Explanation of Tax Legislation Enacted in the 104th Congress*, pp. 188-189. The types of noneconomic transactions criticized as unproductive somewhat resemble the types of transactions allowed to obtain the benefit of later-enacted section 965.

[6]Section 1291.

[7]Section 1297(e). *See* H. Rep. No. 105-148 (105th Cong., 1st Sess.).

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

[9]Section 965.

[10]Editorial, "Cashing Their Chips," *The New York Times*, Sept. 8, 2006, p. A28. col. 1.

[11]It may be necessary to enact an antiavoidance rule to prevent low-taxed subsidiaries from distributing their passive assets to other foreign members of the group, through check-the-box elections or otherwise.

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