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"The Foundation Of International Tax Reform: Worldwide, Territorial, And Something In Between"

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International Tax Reform And Some Proposals To Consider

Chairman Baucus, Senator Grassley, members of the Senate Finance Committee, thank you for inviting me to speak to you today. The issues you have before you are important to me, but are probably more important to my children and grandchildren.

I. Main Street MNC Tax Adviser

I have practiced law for more than 40 years. I have been with two law firms, a Big 4 accounting firm and, for about a year and a half in 2005-2007, the Treasury Department. During that time I have practiced in the Midwest, on the West and East Coasts and, for nearly two years, in Taiwan. The views I will express are my own. They do not represent the views of the Treasury Department or of any of the law or accounting firms with which I have been associated during my career. My experiences during my tenure with those organizations, and during my time in those jurisdictions, have, of course, shaped my views.

My vantage point has been primarily that of an adviser to Main Street MNCs[1] rather than that of an adviser to Wall Street, or of an academic or a public finance economist. The view from each vantage point is different and perhaps we can together provide a collection of observations that will do some good and will minimize the harm any of one of us might cause if only the view from one vantage point were to be considered.

The proposals discussed in this statement are intended to be incremental responses to perceived problems. In the eyes of some participants in the debate, some of the proposals might seem to be more than incremental. Nevertheless, terms like "fundamental" should be reserved for changes of a different order of magnitude, such as adopting a value added tax (either in place of or in addition to the corporate income tax or the individual income tax). The issues and proposals I will discuss all assume that the United States will continue to have a corporate income tax on which we will rely for a material portion of the funding of our federal government functions. If we do add a VAT, these comments will apply to the retained corporate income tax component.

[1] A corporation with businesses conducted through subsidiaries, joint ventures and branches in more than one country.

Tax policy dealing with income from cross border trade and investment has been driven in great part by a concern that the timing and amount of U.S. taxes on foreign source income may have an important impact on business investment location decisions. Revenue needs and "fairness" are also mentioned, but usually as secondary considerations compared to the assumed economic incentives taxes "must" provide to invest within or without the United States. Some seem to think that the deferral of residual federal taxes on foreign subsidiary earnings contributes greatly to the export of jobs rather than products. I do not share that opinion.

As will be evident from my discussion, I am persuaded that the investment location argument is more ideological than empirical, whether advanced by the felt "need" to end deferral in the hope that this will bring jobs back to America (or at least keep them here) or advanced by those who assert the "need" to exempt some or all foreign source income in order for American business to survive in the new global economy. From my vantage point, ending deferral will not bring jobs back, nor will exempting foreign income usher in a golden age for American business in the global economy in which expanding foreign business will generate lots of good domestic jobs.

Instead, I see a terrain that is overgrown with weeds. A lot of good could be done if the weeds were cleaned up, but the clean up will not be a substitute for enhancing more important components of competitiveness or even of tax competitiveness. I believe that the tax burden on domestic business income is more important to tax competitiveness than the timing of U.S. residual tax on foreign subsidiary earnings. An educated workforce is far more important than tax competitiveness.

II. The Simplifying Phrases: Competitiveness, Subsidies for Foreign Investment, Fairness, the Race to the Bottom

The tax reform discussion about cross border trade and investment frequently uses one liners and even single words that seek to make the correct system self-evident. Such words and phrases include "competitiveness," "subsidies," "fairness" and "the race to the bottom." Everyone wants "our" side to be competitive against the other side; no one wants to subsidize the loss of jobs in America; everyone wants to be fair. A race to the bottom sounds like a pretty nefarious thing.[2]

Competitiveness. President Bush tasked the Advisory Panel on Federal Tax Reform with suggesting revenue-neutral means to achieve various goals, including enhanced "competitiveness" of U.S. business. In December 2007 the Treasury Department issued its own report, "Approaches to Improve the Competitiveness of the U.S. Business Tax System for the 21st Century."

One of the problems in pursuing "competitiveness" is that the various potential competitors are not always differentiated from each other. Who is competing with whom? Do we wish to protect Dell Austin (or its employees) from location preferences enjoyed by Dell Ireland?

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[2] A concern about the U.S. contribution to the race, in the form of the 1996 check the box rules, has been discussed in Rosanne Altshuler and Harry Grubert, *"Governments and Multinational Corporations in the Race to the Bottom"* Tax Notes 979 (February 27, 2006).

Do we instead think we should protect Dell Ireland against unfair tax advantages enjoyed by Lenovo Ireland? What about Lenovo China?

Taxes are a burden on business. Taxes on "our" businesses but not on "their" businesses are anti-competitive for our businesses. If we define our businesses to stop at the water's edge, we will only want to make Dell Austin competitive with Dell Ireland and we can let Dell do the best they can against Lenovo China or Lenovo Ireland in overcoming the impact of residual U.S. tax on Dell but not on Lenovo.

Assuming the residual U.S. tax exposure is important enough to affect competitiveness, and if "our" businesses compete in a global economy-one in which Dell Austin's U.S. payroll may actually increase if Dell Ireland is successful against Lenovo-we want to minimize the U.S. tax impact on Dell Ireland. And we also want Lenovo U.S. to remain a productive contributor to the U.S. economy.

We could improve competitiveness of both Dell Ireland and Dell Austin by eliminating all U.S. corporate income tax, but that is not on the table. So a balance must be struck between the benefits and burdens of each alternative. The more specific we can be about the benefits or burdens, the better off we will be.

In arguing for competitiveness, supporters assert that the tax burden on U.S. MNCs operating abroad should not be higher than the "local" taxes borne by the local competitors. In arguing against this version of competitiveness, supporters of a comprehensive end of deferral argue that U.S. MNC foreign investment is "subsidized" by the deferral of U.S. tax on undistributed earnings. The discounted present value of the deferred tax is asserted to be sufficient to be a significant contributor to the export of jobs from the U.S. to foreign countries.

Subsidies, Fairness and Race to the Bottom. These topics are addressed below.

III. The Basic Variables in Taxing Foreign Source Business Income: Time of Recognition and the Foreign Tax Credit

The two most basic components of the current federal regime for taxing U.S. MNC income from cross border trade and investment are:

(1) The provisions in Subpart F that tax a U.S. shareholder on *some* undistributed business income of a related foreign corporation before distribution to the shareholder, while the other undistributed income of the same or other related foreign corporations is not taxed to the U.S. shareholders until distributed, and

(2) The foreign tax credit that allows a U.S. taxpayer to offset U.S. federal income tax otherwise due by foreign income taxes on some or all of the U.S. taxpayer's foreign source income in the same grouping of foreign source income.

A. Time of Recognition ("Deferral")

Deferral is at the center of a debate that has been underway for at least 50 years. Deferral means recognizing some foreign subsidiary income only when actually distributed to the U.S.

shareholder. Completely ending deferral was suggested at least as long ago as 1961 after U.S. business had earlier proposed a broad territorial exemption system in 1955.

The debate over territoriality, ending deferral and business location impact has resumed in earnest since the issuance in 2005 of the JCT Options Report[3] and the President's Advisory Panel Report[4] advocating a "dividend exemption" system. In October 2007 Chairman of the Ways and Means Committee Rangel offered a variation on the dividend exemption system based on expense deferral (rather than disallowance as under the dividend exemption proposals) tied to deferred income.[5]

The debate is generally about ending deferral. That dividend exemption approach is generally referred to as a version of a territorial exemption system. The term "territorial" is very elastic and some proponents may not see it as a mechanism to end deferral. In important respects it is an end-deferral system because foreign source income would be either currently taxed or permanently exempt.

The current stated objectives for ending deferral are a collection of "original intent" purposes and a few newer purposes. Among the objectives described by proponents of ending deferral are: (1) Eliminate the effect of an asserted U.S. tax subsidy incentive to establish businesses in foreign countries rather than in the United States, (2) Protect progressive taxation of those Americans better able to pay for government, (3) End U.S. tax disincentives to repatriation of foreign subsidiary earnings, (4) Raise federal tax revenues, and, more recently, (5) Avoid a race to the bottom of the members of the community of industrialized (welfare[6]) states. The race-to-the-bottom argument is that if one country allows base erosion, there will be an unfair flow of business investment capital into that country and the rest of the (welfare state) community will follow suit. The tax base will be eroded across the developed world, and inevitably government services and transfer payments will have to be downsized.

The several objectives of ending deferral are worth examining more closely to see if something less drastic might be appropriate.

1. Discounted Present Value of Deferred Tax as a Subsidy to Encourage Inefficient Foreign Investment

Deferral of tax on foreign subsidiary earnings is supposed to be a "subsidy" that encourages U.S. MNCs to make foreign direct investment (of the job-producing sort) instead of domestic investment. The deferral of tax is characterized as an interest-free "loan" of the amount of residual U.S. tax "deferred."

[3] The STAFF OF THE JOINT COMMITTEE ON TAXATION, OPTIONS TO IMPROVE TAX COMPLIANCE AND REFORM TAX EXPENDITURES, JCS-02-05 (January 27, 2005) (the "JCT Options Report").

[4] The November 1, 2005, President's Advisory Panel report (the "Panel Report").

[5] The Rangel Bill would also dramatically curtail use of a foreign tax credit to offset U.S. tax on one or another piece of the income from foreign operations.

[6] See Reuven S. Avi-Yonah, *"Globalization, Tax Competition and the Fiscal Crisis of the Welfare State,"* 113 Harv. L. Rev. 1573 (May 2000).

The hypothetical "loan" is the present value of the U.S. tax that will be collected later. That deferred tax amount can be deconstructed further into three categories. First, there is the future U.S. tax on income generated by the foreign corporation at an ordinary rate of return on U.S. deductible expenses incurred by the U.S. shareholder to make or carry the investment in the foreign corporation that produce the income. Second, there is future U.S. tax on the incremental return on the invested amount, which is income attributable to risks assumed by the business to generate more than an ordinary rate of return. Third, there is a future tax on extraordinary income, such as income from unique intangible property. Not all taxpayers have all three kinds of income, but to stay in business the taxpayer has to generate at least some of the first category and something in the second category.

It is useful to break down the "subsidy" components because it helps to understand that the subsidy effect attributable to the ordinary rate of return on U.S. shareholder expenses can be dealt with without resort to the more drastic expedient of completely ending deferral (with the associated collateral damage to U.S. MNCs trying to operate in a global economy). If the U.S. shareholder loses the benefit of a deduction it would otherwise take for an expense incurred to produce tax deferred foreign income, the present value of that loss will be the same as ending deferral on the income of the related foreign corporation up to the amount of the ordinary return on such otherwise deductible expense.

The proponents of a complete end to deferral must believe that the collateral damage to the conduct of international business by U.S. MNCs is a price worth paying in order to achieve the other goals. If that other goal is changing investment location decisions to bring business investment back to the United States, I think they are misinformed.

I have never actually met a businessman (or even a tax executive) who was actually involved in decision-making about the tax issues of where to locate a business (that actually employed people) who would agree that his MNC employer acted to invest somewhere because of an interest-free loan of residual U.S. corporate tax if the company invested in a foreign country rather than the United States. Businesses follow customers, efficient delivery of materials and productive work forces to such an extent that tax incentives are often just an afterthought.

Efforts to strip earnings from the tax base in a high tax jurisdiction are certainly pursued vigorously, but not for the purpose of making a high tax jurisdiction a more attractive location for direct business investment. The reduction in tax is pursued as a cost-reduction goal for the purpose of retaining for the business enterprise more of the fruits of business activity. That retained income will then be spent on a wide range of corporate purposes, including lower prices to customers, higher wages to employees, distribution to shareholders, new plant and equipment, or whatever. The main goal of a U.S. MNC's tax management in seeking tax reduction is more likely to be based on improved financial statement presentation of earnings per share rather than reducing the actual cost of capital by a few basis points. The point is only that the investment-location effect relied upon as an explanation for why we need to end deferral is simply not understood by those whose behavior is supposed to be driven by this consideration.

Similarly, a low tax jurisdiction may be more attractive if its effective rate of tax on business activity is lower than if the tax burden is higher. But job-producing investments go to locations with productive labor forces or customers or other key components of actually running a profitable business. I practiced for a time in Taiwan, the place where pioneer industry tax incentives were supposedly invented. I had great difficulty getting U.S. or foreign MNCs interested in listening to a discussion of the available tax holidays until after a discussion of import and export restrictions, exchange controls, exposure of the parent company and its executives to claims by suppliers or customers, protection of intellectual property, counterfeiting, and other real risks, costs and benefits to the actual business. Tax holidays only make a difference if a business actually makes money. Actually making money is the big driver in investment location decisions. On average the totality of all U.S. MNCs may make money, but each MNC cannot count on being in that average number unless individually they respect business fundamentals, and even then success can be pretty "iffy."

Even if the subsidy assertion is true in some amount for some quantum of U.S. MNCs (no doubt, other people's clients) the investment location incentives of the tax deferral subsidy have often been exaggerated by using examples that ignore available foreign tax credits that would make the amount of the subsidy much smaller, even assuming some U.S. MNCs actually were to run the present value calculations.

The basic factual assumption used to explain the way ending deferral achieves one or more of these goals is to imagine a wholly-owned subsidiary doing business in a single low tax country. "Mobile Income" (a bad thing to be taxed as soon as possible in order to keep it from being generated) includes cross border sales income and cross border group finance income. Such cross border activities may have been a bad thing in 1961, but if we wish to discourage in 2008 multinational production, multinational sales and multinational group finance, we are really telling ourselves that we do not want our companies to be players in the global markets as configured in 2008. Multi-jurisdictional business is now conducted in a global marketplace with very rapid communication, trade blocs like the EU and NAFTA and consumer markets served by integrated marketing activities rather than in self-contained bubbles under a separate national flag for each bubble.

2. Progressive Taxation

The 2006 ABA Task Force on International Tax Reform report asserted in one part that ending deferral is also necessary in order to preserve "fairness" (progressive taxation). This beneficial effect seems to be based on a two-fold assumption. First, that the corporate income tax is borne by shareholders (the wealthier among us). I gather that assumption is the subject of vigorous inquiry among economists as to whether some of the tax burden is also borne by labor, customers and suppliers. For my purposes, I can simply assume that at least some important part of the corporate income tax is borne by shareholders.

I am concerned about the strength of the second assumption: that the shareholders of U.S. MNCs are overwhelmingly *U.S.* portfolio investors, and that any odd foreign portfolio investors in U.S. MNCs are indifferent to different levels of corporate income tax on otherwise similar *foreign* MNCs. The ABA Task Force Report asserted that the vast preponderance of portfolio investment is by investors resident in the country of incorporation of the MNC. The assertion

seems to be potentially at odds with recent reports by the Congressional Research Service that indicate that a rather large (and increasing) portion of the portfolio capital stock in the U.S. belongs to foreign portfolio equity investors.[7]

Before launching a comprehensive end of deferral, some quality time should be spent getting something better than anecdotal speculation about who owns U.S. MNCs and how sensitive those owners might be to differences in worldwide taxation of undistributed income of foreign subsidiaries. If it would make a difference, we will then need to determine whether we care. Again, it is a question of balance, but we do not seem to have enough information to strike a balance.

3. Disincentive to Repatriation

This argument seems to be that the prospect of taxation on "repatriation" may impel a U.S. MNC to make inefficient foreign investment of the deferred earnings rather than an otherwise equal or superior domestic direct investment. Ending deferral to solve this problem is entirely disproportionate to the problem.

The term "repatriation" can include a wide range of actions. The most obvious meaning would be a real dividend distribution. The taxable repatriation established by the Revenue Act of 1962[8] encompasses far more than transactions like a dividend or return on investment to the shareholders. Indeed. At first it applied a sort of three-mile-limit test to the acquisition of assets in the United States (those assets were presumed to be unnecessary to the conduct of whatever legitimate non-avoidance business might be going on abroad). In 1976 the Congress created an exception to the deemed taxable event to permit portfolio investment in unrelated party assets, and discovered that the real purpose of the provision was to reach "effective repatriation." That exception was to accommodate a perceived problem under the statute: it penalized actions we wanted to encourage.

The United States is the only country I know of that has a specific *anti-repatriation* provision *intended to prevent investment in residence-country property*. If additional U.S. direct investment by related foreign corporations is something we actually want to permit, and not to discourage or penalize, it would be a relatively simple step to amend section 956 to permit the establishment of branches or subsidiaries by the related foreign corporations. Section 956 has been amended in the past to permit U.S. investments by such companies in categories of United States property that the Congress decided were worth encouraging or at least not penalizing.

That would still leave a tax on dividend-like repatriation as distinguished from productive business investment repatriation. If we think the problem is stock buy backs, we should aim at that problem rather than just set off a cluster bomb that will have additional unintended side effects. If indeed repatriation disincentives are what we are worried about.

[7] Donald J. Marples, "*U.S. Taxation of Overseas Investment and Income: Background and Issues,*" Congressional Research Service (May 21, 2008).
[8] Section 956. Investment of Earnings in United States Property.

The Committee may find it useful to inquire into the effect (if any) of certain generally accepted accounting principles (GAAP) on repatriation. A brief summary of the interaction of FAS 94 and FAS 109 (particularly APB 23) is attached as Attachment 1. A discussion of the effect of GAAP accounting is beyond the scope of my remarks today, and CPAs will probably point out that GAAP accounting is beyond my core competence as well, but clearly GAAP treatment of residual U.S. taxes on undistributed earnings, together with the current inclusion of earnings without regard to reinvestment intentions, has a significant impact on earnings per share, and earnings per share can have a significant impact on behavior of publicly traded companies. This Committee should discuss the topic with someone who is competent to discuss the mysteries of GAAP and its investment location impact, if any.

4. Raising Federal Tax Revenue

If the justification is to raise taxes on business in order to pay for something we cannot otherwise now afford, a reality check that ought to be done is to test our confidence level that taxpayer behavior modification will not erode the intended increase in tax. In testing the assumption, it would be useful to try to determine (speculate) whether the non-U.S. business income will in any significant amount shift to foreign MNCs engaged in essentially the same businesses but that do not have a comparable exposure to accelerated collection of residual tax on undistributed income.

Another element to look at is whether portfolio capital will be induced to redeployment in foreign MNCs rather than in U.S. MNCs. The conventional wisdom has been that the "home bias" is so strong that portfolio investment is likely to be insensitive to such subtleties as the effect on after-tax earnings per share of worldwide accelerated tax vs. deferral of tax, but it would be worth a "just-in-case" check.

5. Race to the Bottom

The United States has for 40 plus years been the leader in the race to tax undistributed income and to discourage investment of foreign earnings in the home country. It is probably safe to assume that the United States is in no danger of leading the race to the bottom. My guess is that the Germans, the French, the Japanese and the rest of the OECD can take care of themselves.

If some sort of concerted action might make sense, unilateral U.S. efforts do not. We do not need to act unilaterally for the purpose of inspiring a race to the top.

B. Foreign Tax Credit ("Cross Crediting" vs. "Credit Averaging")

The second component of the core regime is the foreign tax credit. The foreign tax credit is intended to avoid double taxation (or multiple taxation) of the same income by, on the one hand, foreign governments having sufficient nexus to foreign income that they can tax it, and the United States, on the other, as the taxing jurisdiction in which the taxpayer resides. The debate about "cross crediting" results from different mental models of what is being taxed by foreign governments and whether the tax base in the United States should be reduced in whole or in part by foreign taxes.

Those who think the big problem is "cross crediting" appear to have in mind a mental model in which a single U.S. MNC has two entirely distinct businesses, one business taxed at a high rate by the only foreign country with taxing jurisdiction over that business, and the other business taxed at a low rate (or zero rate) by another foreign country with exclusive taxing jurisdiction. They see U.S. tax on low tax foreign source income offset by high unrelated foreign taxes on unrelated foreign business. Worse yet, they often see royalties received by a U.S. MNC for U.S.-developed intangible property "wrongly" treated by the Internal Revenue Code as *foreign* source. U.S. taxes otherwise due on income from U.S. value added to the intangible property can be offset by the unrelated high foreign taxes paid by the U.S. MNC.

Those who see "credit-averaging" instead of cross-crediting see a very different world. They see a global economy in which integrated businesses are conducted in or from multiple locations in many countries. For those observers the stream of income from related and integrated businesses will be exposed to tax bites in various countries that have sufficient nexus to tax some piece of the income stream. Some of the pieces of income will, from a U.S. federal tax vantage point, be subject to a high rate of foreign income tax and some to a low rate of foreign income tax. But at the end of the day there will be an aggregate amount of foreign income taxes imposed by a collection of foreign taxing jurisdictions on an aggregate amount of income from *related* foreign business.

Tax reform will be heavily influenced by the business model that tax policy makers have in mind when they try to achieve efficiency, fairness and competitiveness. No doubt there are still examples of single country businesses along the lines of what Secretary Dillon (or his Assistant Secretary for Tax Policy, Stanley Surrey) had in mind in 1961. But those examples are not particularly coincident with the business model for much of the business activity in the global economy in 2008. At least from my vantage point.

C. Careful Reform Should Accommodate the Common Global Business Model

My views tend to lie in between the book ends of those who advocate a complete end to deferral and severe curtailment of the foreign tax credit, and those who assert that American business is in serious jeopardy if broad territoriality is not enacted.

Problems that taxwriters agree need to be fixed should be fixed. Overhauling the whole international tax system just because more than 40 years have passed since 1962 would be imprudent. The relevant important changes in the world need to be agreed upon, and, if those changes indicate that the basic system is not working in some particular respect or another, that problem should be fixed.

Thus, if as some believe, there is something seriously wrong with the accumulation of income from high value U.S.-origin intangibles in a low tax country, we should address the problem in a way that minimizes collateral damage to the rest of the international business conducted by U.S. MNCs. We should not eliminate all cross crediting just to get at that problem. We should not end deferral to get at capturing income from U.S. IP in low tax countries.

It is not self-evident that generating risk-based income from IP in Ireland is bad. I sometimes wonder if the "Microsoft" Irish IP earnings problem[9] would be as alarming if it were considered in conjunction with the "Xerox" Irish IP loss problem.[10] The same basic activity led to a large loss in Xerox Ireland but to a large earnings accumulation for Microsoft. That is the nature of risk-based income allocations.

If, however, tax policy makers end up agreeing that the risk of allowing U.S.-origin IP to generate low tax income is a problem that must be solved, it might be worthwhile to address just the question of income from foreign ownership of U.S.-origin IP. My point is that overbroad sweeping changes may do much unnecessary damage to U.S. MNCs that are not conducting whatever business it is that is objectionable to tax policy makers.

I have grave concerns about the lack of information we seem to have on important aspects of the discussion. The areas about which we seem to know less than we should include (1) the present and anticipated extent of joint ventures between MNCs from more than one country, and (2) the effect of ending deferral and of limiting the foreign tax credit for U.S. MNCs upon their ability to retain existing and to attract new foreign portfolio investment capital. Pending development of reliable data on the impact of tax reform on these important issues, I recommend that we be cautious rather than adventurous in overturning the core elements of the present structure.

I also think stability in the tax environment is a useful characteristic. Again, this is another reason to fix only that which it is clearly broken (in the view of a working majority). Just being 40 years old is not a definition of "broken." It might be interesting to this committee to consider the table in Attachment 2 that summarizes the asymmetry (and some symmetry) of the 2005 proposals with the state of the tax system following the 2004 AJCA.

I am among those who see a global economy whose participants are multinational business enterprises with operations and shareholders in many countries. Some are " U.S." and some are "foreign." But all those enterprises depend on debt and equity capital drawn from portfolio investment pools in many countries, not just the one country in which they happen to be incorporated or the one country in which a corporation may do business.

I also see businesses that are often conducted as joint ventures among direct investors (MNCs) from more than one country.

I am worried that intellectual capital may be mobile, more mobile than it was when I first began to practice and the IP revolution was about to be fueled by venture capitalists in Silicon Valley and Route 128.

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[9] Glen R. Simpson, *"Irish Unit Lets Microsoft Cut Taxes in U.S., Europe,"* Wall Street Journal, November 7, 2005.
[10] James Bundler and Mark Maremont, "*How a Xerox Plan to Reduce Taxes and Boost Profit Backfired*," Wall Street Journal (April 17, 2001).

IV. Pending Tax Reform Proposals: Dividend-Exemption as a "Solution" to the "Problems" of Deferral and Cross Crediting

In 2005 the Staff of the Joint Committee on Taxation and the President's Advisory Panel on Federal Tax Reform each proposed a reform in the taxation of foreign source income. Although given quite different mandates, the recommendation of each group was a virtually identical "dividend exemption" system of taxing income from foreign direct investment.

More recently, Charles Rangel, Chairman of the Ways and Means Committee, has proposed a variation on the dividend exemption system. Under Chairman Rangel's proposal, deductions for expenses allocated to deferred income of foreign affiliates would be deferred until the associated deferred income is taken into account. As discussed below this is essentially comparable to a partial end of deferral.

The two dividend-exemption proposals basically tweak the deferral and foreign tax credit variables. Income can be moved into or out of the exempt-income pool, foreign tax credits likely to be associated with high-taxed income can be left in the exempt pool (and thereby disallowed as offsets against U.S. tax on low taxed income) and expenses can be made nondeductible or deductible by adopting different simplifying conventions about how to associate expenses with income. Labels can be assigned that fit the advocated end result: "good" foreign business income (exempt) can be labeled "active business income" while bad foreign business income can be labeled "mobile income" (taxable). Ongoing adjustments can then be made by moving income into or out of an exempt pool or by adjusting the amount of tracing to determine the amount of nondeductible expenses attributable to exempt foreign income. In many ways, however, the proposals are quite similar to a partial end of deferral across the board and a wholesale carve back on the foreign tax credit.

The similarity to ending deferral lies in the expense allocation feature which, as noted above can be economically equivalent to ending deferral on the financial rate of return of deductible amounts incurred to make or carry the investment in a foreign subsidiary, coupled with retaining the existing anti-deferral provisions for subpart F foreign base company income (now "Mobile Income"). The broad carve back on the foreign tax credit results from the separation of business income into likely high-taxed and likely low taxed elements, and then disallowing "cross crediting" because the high taxed piece is exempt.

It is a question of balance. Is the problem that we want to solve by the restructured tax regime worth the foreseeable damage that may be caused by the change?

In my view, the dividend exemption proposals made by the President's Advisory Panel and by the JCT should not be pursued.

V. So What Should Be Done (If Anything)?

A. Retain Existing Core Architecture

Federal income tax should be imposed on all business income, domestic or foreign, derived by businesses that have a prescribed minimum nexus with the United States. A foreign tax credit should continue to be allowed for foreign taxes on all foreign business income.

The United States should not extend a permanent territorial exemption to any U.S. shareholder's share of any income derived by a foreign corporation or business. All return on capital investment should be eventually taxable in the hands of the U.S. taxpayer investor, no later than upon actual or constructive receipt determined under general U.S. tax principles.

Business taxable income from foreign subsidiary operations, or joint ventures, should be determined under general U.S. tax accrual principles. Income should be taxed on a realized basis rather than earlier when the income may be only an undistributed estimated accretion to wealth, such as undistributed corporate earnings. Undistributed portfolio investment income (foreign personal holding company income) should, however, continue to be taxed to the U.S. shareholder of a controlled foreign corporation. A reasonable allowance for income on working capital should be excluded from treatment as portfolio foreign personal holding company income. With that limited exception for financial business income of a nonfinancial MNC, federal income tax on portfolio investment income should not be reduced by foreign income taxes on foreign business income.

A U.S. shareholder would be, as under present law, defined as the owner of a 10 percent or greater interest.

B. Repeal of Foreign Base Company Provisions Taxing "Mobile Income"

1. Repeal Related Party Base Erosion Components of Subpart F ("Mobile Income")

a. The Goals of Repeal

As enacted in 1962, Subpart F was intended to reach targeted base erosion activities that would permit an enterprise in a high tax jurisdiction (e.g., Germany) to lower its effective rate compared to a domestic enterprise in, say, Tennessee. The machinery was originally proposed to achieve what some refer to "capital export neutrality" but, as enacted, was limited to related party base erosion income. In the more recent past, Subpart F's base erosion provisions have been characterized as a tool to limit harmful tax competition and the resulting race to the bottom.

In my view, particularly if some elements of foreign-related expense deferral were to be adopted, the distortion in normal business practices that can result from applying Subpart F base erosion provisions could be eliminated without unacceptable cost to the fisc (or "subsidy" to a U.S. MNC). At present, before taking into account the temporary look through provisions and the self help activities based on the check-the-box regulations, Subpart F is supposed to discourage multi-jurisdiction group finance and multi-jurisdiction manufacture and sale. If it ever made sense to do discourage such activity, it does not make sense now.

It can be argued, of course, that the combination of the IRS' "check-the-box" rules (and particularly the "disregarded entity" portion thereof) and taxpayer ingenuity in dealing with base erosion arrangements make this proposal only a simplification rather than a substantive change. While that may be true in the short run, in the long run we should, and probably will, decide the deferral issue based on business activities rather than such things as "tax nothings."

The purpose of this proposal is to achieve at least four goals:

1. Accommodate the normal business model of participants in the global economy. That model is business conducted across national borders rather than in hermetically sealed national bubbles.

2. Accommodate the emergence of regional trade areas such as the European Union or the North American Free Trade Area in which goods manufactured in one country are supposed to move efficiently to other countries throughout the free trade area.

3. Facilitate U.S. MNC participation in joint ventures with non-U.S. MNCs. Joint ventures are made more difficult if one party is subject to tax pressure to distribute while the other is not. While expense allocation and deferral will have this effect, it will be possible for higher risk/higher return activities to be conducted without tax pressure to distribute premium returns.

4. Simplify the compliance burden imposed on Main Street in keeping track of previously taxed undistributed earnings with the need to make continuing adjustments for currency fluctuation, future losses, hedging gains or losses associated with inventories and anticipated inventories, . . .

This may be a contentious issue. The core premise, that existing U.S. tax policy embedded in deferral provides an incentive to invest abroad rather than in the United States, is an appealing explanation for why jobs have been lost. U.S. tax policy is something we can control. The assertion need not be correct in order to resonate with people worried about loss of jobs. In my experience, however, it has not in fact had much to do with why companies invest in the U.S. or in another country. If we take action to penalize the business sector for participating in the global economy, and the jobs do not come home, we will be worse off.

Expense allocations (such as discussed below) are also complicated, but they can be made simpler than the inherent complexity of taxing undistributed income and then adjusting the "previously taxed income" to reflect the effect of inevitable change in the amount taxed before it was actually realized. Allocated expenses can be based on the books and records of the U.S. taxpayer. Many taxpayers are already applying such provisions in order to apply the foreign tax credit limitations. Such an approach only makes sense, however, as a follow on to repealing the foreign base company sales and foreign base company services provisions, and the business income portions of foreign personal holding company provisions.

b. Foreign Base Company Sales Income

Repealing the foreign base company sales provisions would be an important step toward adjusting the U.S. tax system to the way normal business is conducted. It may be that the proponents of ending deferral have in mind a different business model than I do.

The prototypical example given to explain the merits of ending deferral is the low tax distribution affiliate that purchases from a manufacturing affiliate in a high tax country and resells the product in a country other than the place of incorporation of the distribution company or the place of manufacture. Before the creation of the EU successfully broke down many trade barriers in Europe, the normal business model might have been to set up a separate sales company in each destination country (a "good" way to do business under Subpart F). Today, the far more common structure would be to have a distribution affiliate in one or two EU countries that will sell throughout the EU. The notion that this common distribution model has been constructed to make high tax manufacturing in the EU more attractive than U.S. manufacture is at best a quaint echo of an academic hypothesis in 1961.

If a U.S. MNC has a German manufacturing subsidiary with an Irish distribution subsidiary and customers throughout the EU, then under subpart F the Irish subsidiary's income will be subject to current U.S. tax. If, instead, the German manufacturing subsidiary sells directly to customers throughout the EU, the income will not be subject to U.S. tax. And if the German manufacturing operation moves to Ireland, sales throughout the EU will not be subject to tax. Why? What is the U.S. interest in busting up normal business distribution practices? If Germany is not concerned about income earned by the Irish affiliate, why should the United States intervene to discourage Irish distribution affiliates? Indeed, Germany and Ireland have actually agreed with each other to work toward greater commercial and investment integration of their economies. It seems pointless to impose a U.S. tax on the distribution income in order to discourage that behavior (behavior modification is, after all, the core objective the foreign base company provisions).

In addition to EU destination sales, the Irish distribution company may also supply customers in other non-EU European countries, Asia and the Middle East. Again, there seems to be no point in trying to force the U.S. MNC to set up a local distribution subsidiary in each country into which it would sell. Again, the original premise of the anti-base erosion provisions dealing with multi-country sales was that they were inherently mobile and it was easy to base erode the *real* value-producer in the process: the manufacturer.

In the current environment, however, the fully integrated manufacturer model is not the exclusive means to produce products. Unrelated parties routinely produce the tangible property for unrelated parties who have provide intangible property (specifications) and selling services to the complete business activity. U.S. MNCs should not be discouraged from using related parties to do some parts of the overall process with related parties in different countries. There seems no sensible tax policy to require that there be only unrelated parties at each stage in the supply chain production and sale. Again, if the original model was correct in 1961, it is at least questionable in 2008.

c. Foreign Personal Holding Company Income from Related Parties and Working Capital Risk Management

Section 954(c)(6) has been in place for about two years and is scheduled to expire this year. It should be enacted permanently. It allows a U.S. MNC group to manage its working capital and long term investment capital in a normal way.

In addition, reasonable exceptions from even portfolio foreign personal holding company income (generally taxable currently to the U.S. shareholder) should be provided for hedging currency, interest rate and commodity risk, and for interest derived on working capital .

It seems to have been relatively easy to garner recurring support for an extender to accommodate the real world business needs of financial institutions: extend the life of Section 954(h). The real world needs of non-financial corporations to manage their financial assets, financial liabilities, interest rate risk and currency risk are no less real and ordinary. Why is it that industrial company management of those exposures should be penalized by subjecting them to U.S. tax before distribution? Simple revenue gain was not the goal in the beginning; the goal was behavior modification: Surely we do not think that U.S. MNCs should not have interest bearing assets or currency gains or losses. That view of U.S. MNCs (unencumbered by financial assets and liabilities), if ever correct, is out of touch with running a normal business in the global economy.

If deductions for U.S. expenses incurred to carry the U.S. MNCs investment in producing foreign-related income are no greater than the associated income that is taken into the U.S. tax base, there is no significant subsidy left – the financial rate of return on the financial assets should be equal to the implied cost of carrying the nondeductible expense. The financial asset will have an incremental deferral benefit only to the extent it is attributable to equity invested in the foreign subsidiary plus any retained earnings of the foreign subsidiary. This is simply not a large enough tax "subsidy" to warrant penalizing the normal management of group financial assets on a multi-jurisdictional basis.

C. Limiting Deduction for Aggregate Foreign-Related Expenses to Aggregate Foreign-Related Income

If tax policy makers conclude that foreign business activities should not benefit from deductions against domestic income, until foreign income is at least equal to the expenses incurred to produce it, that could be achieved by targeting the problem.[11] Under such an approach, a grouping principle could be developed: aggregate foreign-related expenses would be limited to the aggregate amount of foreign-related income for the year. The residual U.S. tax on deferred foreign related income would be deferred, but, in the aggregate, foreign related expenses would be paid for by foreign related income.

[11] It is not a universally agreed upon "problem."

1. The basic methodology would be to adopt the principles of allocation used for purposes of the limiting fraction in calculating the maximum amount of foreign taxes that can be offset against U.S. federal income taxes under the foreign tax credit provisions.

2. The effect of deferring a deduction for foreign-related expenses to foreign related income would be to preclude deduction of such expenses against domestic income that should be excluded from the foreign business bucket.

3. The principal items affected would be interest expense, general and administrative expense and research and experimentation expense. Allocable interest expense should be calculated by taking into account indebtedness incurred by the foreign corporation which has income treated as deferred with respect to its U.S. shareholder.

4. The class of foreign business income to which deductible expenses are to be allocated should be drafted broadly.

    a. A broadly drafted class would consist of all foreign related income attributable to active foreign related business, including business royalties, export sales, direct investment dividends and related party interest, rents and royalties from direct investment foreign affiliates. As discussed below, foreign source income might be separately adjusted to change the treatment of export sales income and royalties for U.S.-produced intangible property. Such an adjustment might be made in order to capture for the U.S. tax base the value of U.S. inputs in the income-producing process. Changing the export sales rule has been considered, and rejected, by the Congress in the past because of balance of payment concerns rather than theoretical disagreement with the economic thesis. Similar caution would still be appropriate. Export sales are foreign-related, no matter what source rule meets the need of economic accuracy. Royalties for foreign use of U.S.-origin IP warrant similar caution.

    b. Drafting the class broadly would have the advantage of much greater simplicity. It should deal with the notion that foreign related business is not covering its deductible expenses.

5. Any deferred expenses not restored as deductions would be added to the U.S. shareholder's basis in its investment in the assets producing deferred income. If that investment is disposed of, or abandoned, the tax benefit of deferred deductions would be available subject to any limits on loss deductions generally.

6. It is likely that no other country applies such complete matching of otherwise deductible foreign related expense to foreign related income. To this extent the proposal may decrease competitiveness of U.S. MNCs compared to similarly situated foreign MNCs, tax policy makers wish to reduce the risk of an anti-competitive effect. It would be possible to limit expense deferral to some fixed percentage of otherwise deferrable expense.

This approach has some facial similarity to the Rangel Bill. It is quite different in a number of respects. First, it is ancillary to repeal of the foreign base company sales and services provisions and the business-related foreign personal holding company provisions. That would avoid the effect of slicing foreign income into high tax and low tax buckets and then taxing the likely low tax piece.

Second, it would not gut the foreign tax credit. The segregation of income from the taxes on it, as would arise under the Rangel Bill credit averaging proposal, would have much the same effect as simply denying the credit under the two dividend exemption proposals. The approach outlined above would not.

D. Additional Topics for Discussion Another Day

This statement is already too long. The tax regime has been around long enough to be beset by weeds in many areas. The following areas of further inquiry might be worth looking at, but only as part of comprehensive implementation of a balanced revision to solve real problems, not just to raise more tax revenue.[12] It would be grave error merely to select revenue raisers or competitiveness stimulants. In the long run, the business community really needs stability.

Old Chestnuts

1. Modification of Export Sales Income Source Rules. Consider modifying section 863(b) (deemed foreign source rule with respect to export sales). This deemed foreign source rule has enabled crediting of foreign income tax against U.S. tax otherwise due with respect to some foreign-related income economically earned by a U.S. taxpayer from U.S. business activity.

    a. Complete repeal of foreign tax credit for foreign taxes in high tax countries is excessive and overbroad. The remedy should be limited to steps necessary to solving the problem. If the problem is the export sales source rule, the remedy should be to fix the export source rule rather than eliminate comprehensively credit averaging

[12] It is not, in fact, good policy to tax "the companies across the sea." This definition of "tax reform" was attributed to then-Chairman of the Ways and Means Committee Dan Rostenkowski in 1992. Quoted and ascribed to Chairman Rostenkowski in Michael J. Graetz, THE DECLINE (AND FALL?) OF THE INCOME TAX (New York: W.W. Norton & Company, 1997), p. 6.

of foreign taxes on income from varying pieces of a multinational business enterprise.

b. If it is good tax policy to eliminate such cross crediting, the more targeted approach is simply to modify the source rule that causes the problem.

c. If it is decided that it is not good policy to eliminate cross crediting against this category of foreign-related income,[13] this recommendation could be rejected without affecting other recommendations. Even if not foreign-source, however, such income could be treated as foreign-related income for purposes of determining whether foreign-related expenses should be deductible currently.

Old Chestnuts

2. Consider Making Intangible Property Royalty Sourcing More Symmetrical with Income From Sale of Tangible Property, Except to the Extent Otherwise Provided by Treaty. Section 861(a)(4) and 862(b)(4) could be amended to change the source rule for royalties contingent on use of intangible property outside the United States. A different rule could be provided in a bilateral tax treaty to accommodate an agreement by the United States that a foreign treaty partner could impose withholding tax on royalties.

This, like the possible re-examination of the export source rules for tangible property, would be a more targeted approach to whatever theoretical problem exists in allowing "cross-crediting." It is not necessary to abolish the foreign tax credit for all high tax foreign operations to get at this problem.

It would be important to try to determine whether this sort of change might lead to relocation of R&E activities to foreign countries. This would be undesirable, whatever the theoretical benefits of symmetrical taxation of tangible and intangible property.

Retain Core Architecture

3. Dividends, Interest, Rents and Royalties from Portfolio Investment Should be Ineligible for Cross Crediting Any Foreign Income Tax Imposed on Foreign Direct Investment Income. Reasonable working capital and business risk management income should be excluded from this category of taxable income.

[13] The Congress decided against this option in 1986. There was a stated concern about the potential impact on U.S. exports. Caution is still appropriate.

Symmetry with Other Recommendations

4. Consideration of the Tax Consequences of Transferring Taxable Income Producing Property to Foreign Affiliates Section 367 could be amended to require income inclusion by a U.S. taxpayer transferor of tangible and intangible property to a foreign affiliate. The transfer of productive assets into a tax deferred position could attract the same sort of foreign related expense deferral that would apply to current expense associated with making or maintaining an investment in a foreign direct investment and other assets and activities that produce foreign related income The includible amount might equal the sum of prior deductions allocable to the transferred property, including amortization and depreciation as well as research and development expenses. The recaptured amount would be added to basis and deducted by ratable amortization against future income from the foreign deferred income producing asset.

    a. Fair market value of the transferred property should not be used because the values of property for which there is no actual market cannot be readily determined. The ensuing war of models is time consuming and hard to administer consistently.

    b. If it were determined that a cost-based transfer for special items would be inappropriate, because of an assumed high value feature, a special rule could be developed for the potentially worrisome class of transferred property, without forcing all taxpayers into valuing assets with no ready comparables (other than the testimony of expert witnesses). Sections 367(d) and 482(d) are examples of such an approach.

Asymmetry in Treating Forms of Business Activity

5. Eliminate Separate Regimes for Foreign Business Conducted via Foreign Corporations versus Branches and Other Pass-through Entities. If we decide that certain foreign business activity should be taxed only on net income when distributed, it might make sense to consider treating all foreign business activity in the manner suggested by the Advisory Panel. The United States could treat all foreign business activities, in which a U.S. corporation has a >10% voting equity interest, as a separate entity (corporation) rather than variously as a corporation, branch or other pass-through entity based on the legal form of the business vehicle. This would eliminate electivity of tax regime for foreign business activities of U.S. MNCs, particularly loss pass through and disregarded transactions between a legal entity and its branch. This could be an example of a topic that might be ignored under the principle of only fixing what is clearly broken.

6. Joint Ventures (10/50 Companies).

The guiding principle should be to treat direct investment in controlled foreign corporations the same as direct investment in noncontrolled foreign direct investment (i.e., 10/50 companies). Certain modifications must be made with respect to portfolio investment income of a 10/50 company.

a. Foreign Related Income and Foreign Related Expenses to Include Amounts Attributable to Joint Ventures

Expenses incurred by a U.S. corporate taxpayer attributable to direct investments ($\geq$10%) in noncontrolled foreign corporations could be made part of the pool of foreign-related expenses and income from transactions with or investment in joint ventures could be foreign-related income. Any unrecovered expense would, in effect, be capitalized and added to basis of the U.S. shareholder's investment.

The same principles would apply to determine deferred income and associated deferrable expense of a 10/50 company that would apply to a controlled foreign corporation.

b. Foreign Tax Credit

All foreign taxes on foreign source business income would be taken into account and allowed to offset all U.S. tax otherwise due with respect to foreign source business income. As with controlled foreign corporations, deferred expenses, when restored and deductible, would be subject to limitations comparable to present law that would prevent offsetting foreign income tax on foreign income against U.S. tax on U.S. income (section 904(d)). There should be no "10/50 basket."

c. Foreign Personal Holding Company Income

U.S. shareholders should not be taxed on undistributed foreign personal holding company income of a non-controlled foreign corporation. Deferred expenses associated with the investment in the 10/50 company would be available as a deduction if and to the extent of foreign related income. Deferred expenses would not be "grossed up" from time incurred and deferred until restored by the foregone financial rate of return on disallowed deductions.

(i) Foreign Base Company Sales Income. No special treatment would be necessary with respect to related party sales and services income. The repeal generally of foreign base company sales income and foreign base company

services income represents a policy decision that is equally applicable to 10/50 companies.

(ii) Foreign Personal Holding Company Exclusion: Look-Through Rules Should Apply to Interest, Rents, and Royalties. No special rules would be necessary except to distinguish related party interest, rents and royalties from portfolio asset income. Such rules would be relevant with respect to PFIC treatment of a 10/50 company.

Any such items of income received by a foreign corporation from a payer in which the recipient (or any person that controls, is controlled by, or under common control with the recipient), holds more than a 10% equity interest, would not be treated as portfolio income.

Symmetry with Old Chestnut

7. Related Party Royalties for Domestic Use of Foreign-Origin Intangible Property Should Be Foreign Source to the Same Extent that Royalties for Use of U.S.-Origin Intangible Property Would Be Domestic.

a. U.S.-sourcing based on U.S. use should be retained in order to induce reciprocal treaty relief for royalties from foreign use of U.S. origin intangible property.

Core Architecture

8. Dividends And Interest From Domestic Corporations Should Remain U.S. Source To The Same Extent As Present Law And Subject To U.S. Withholding Tax Except To The Extent Otherwise Provided By Treaty.

a. This is present law.

Symmetry

9. Foreign Portfolio Investment in U.S. Business Entities

a. Present law should be retained. Dividends, interest, rents and royalties should be taxable based on gross income at appropriate withholding tax rate, subject to treaty relief.

b. Portfolio interest taxation should be made symmetrical with taxation of portfolio dividends paid to nonresident aliens and foreign corporations. The present regime favors foreign portfolio debt investment over foreign portfolio equity investment in domestic business enterprises. Interest payments erode the corporate income tax base while dividend payments do not.

10. Financial Institutions

a. Domestic: Present Law Temporary Exclusion from Subpart F Should Be Made Permanent

(i) U.S.-parented MNCs engaged in the active conduct of a banking, financing or similar business should be excluded from the regime taxing U.S. shareholders currently on undistributed foreign personal holding company income (income that is not otherwise excluded from foreign personal holding income on the basis of a related party payer). However, any income deferred from tax would result in a corresponding deferral of deductions for interest, general and administrative expense and other expenses incurred to produce such deferred foreign financing business income. Simplifying conventions should be applied to accommodate differences in currencies and other terms (maturities, interest rate basis) applicable to borrowing by such financial institutions and lending by such institutions.

(ii) If, however, foreign base company treatment of Main Street MNCs is retained, retaining section 954(h) would be asymmetrical, at least with respect to cross border transactions.

(iii) Branches and subsidiaries could be treated as separate entities (corporations). Interbranch transactions could be treated as cognizable intercompany transactions.

b. Foreign Parent Financial Institutions: Domestic Branches Could Be Treated as Separate Corporations

(i) Foreign-parented MNCs engaged in the active conduct of a banking, financing or similar business that generates U.S. source income effectively connected could be subject to corporate tax on net income. Branches could be treated as separate corporations. Interbranch transactions could be treated as transactions with tax effect. The branch profits tax should be repealed if a branch would be treated as a separate corporation.

Symmetry between Portfolio Investment in U.S. and Foreign MNCs

11. U.S. Tax-Exempt Investors

Distributions from foreign MNCs could be made taxable to U.S. tax-exempt investors, perhaps as a class of "UBTI" (subject to a contrary provision in a U.S. tax treaty with the country from which a tax-exempt investor receives a dividend.) All income from investments in domestic and foreign corporations would be taxed once to the extent attributable to a U.S. tax-exempt investor's interest therein. There are, no doubt, many policy considerations involved beyond symmetry between investment in U.S. MNCs and foreign MNCs. The symmetry issue belongs on the list

Old Chestnuts

12. Arm's Length Rules for Related Party Transactions

Occasionally, tax policy makers express uneasiness about how the arm's length rules work in different international contexts. Periodically, alternatives to the arm's length approach are floated, and no comprehensive review would be complete without an examination of the topic.

Thank you for this opportunity to speak to your Committee.

Attachment 1. A Layman's Reading Of FAS 94 And FAS 109

GAAP Accounting for Foreign Earnings and Residual U.S. Tax

I. Consolidation of All Majority-Owned Subsidiaries

Statement of Financial Accounting Standards No. 94[14] provides that generally no distinction shall be made between foreign and domestic subsidiaries. In pertinent part, the Financial Accounting Standards Board[15] explained its amendment of prior standards of U.S. GAAP:

> "This Statement . . . amends ARB No. 43, Chapter 12, 'Foreign Operations and Foreign Exchange,' to narrow the exception for a majority-owned foreign subsidiary from one that permits exclusion from consolidation of any or all foreign subsidiaries *to one that effectively eliminates distinctions between foreign and domestic subsidiaries*."[16]

As discussed below, however, the goal of equivalence between foreign and domestic subsidiaries is apparently *not* implemented in the provision for deferred tax liabilities pursuant to Statement of Financial Accounting Standards No. 109.[17] The other items that affect the consolidated statement of income and loss, and assets and liabilities are generally taken into account by applying equivalent rules to both domestic and foreign subsidiaries.

FAS 94 specifically changed the principles previously in effect under ARB No. 43, Chapter 12, 'Foreign Operations and Foreign Exchange.' Paragraphs 8 and 9 thereof (in effect prior to the 1987 adoption of amendments that became effective for accounting periods after December 15, 1988), provided:

> "In view of the *uncertain values and availability of the assets and net income of foreign subsidiaries* subject to controls and exchange restrictions and the consequent unrealistic statement of income that may result from the translation of many foreign currencies into dollars, *careful consideration should be given to the fundamental question of whether it is proper to consolidate the statements of foreign subsidiaries* with the statements of United States companies."[18]

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[14] Consolidation of All Majority-owned Subsidiaries, Statement of Financial Accounting Standards No. 94, Financial Accounting Standards Board (October 1987) (hereinafter "FAS 94").

[15] The Financial Accounting Standards Board will be hereinafter referred to as FASB. It is the source of the controlling literature used to ascertain U.S. "generally accepted accounting principles" or "GAAP."

[16] FAS 94, Paragraph 9. Emphasis added.

[17] Accounting for Income Taxes, Statement of Financial Accounting Standards No. 109, Financial Accounting Standards Board (1992, effective for years beginning after December 15, 1992) (hereinafter "FAS 109").

[18] Foreign Operations and Foreign Exchange, ARB No. 43, Chapter 12, Par. 8 (April 1972), amended and replaced by FASB October 1987, effective for years commencing after December 16, 1988, pursuant to adoption of FAS 94. Emphasis added.

It is important to note that *U.S. tax contingencies* that might affect the presentation of a "realistic" value of any foreign subsidiary income in consolidated financial statements were *not* a factor in ARB No. 43, Chapter 12, as adopted in 1972 and have never been a factor thereafter in applying the principles ("realistic" values) enunciated in FAS 94. Only *foreign* exchange controls, or *foreign exchange* translation concerns, merited explicit admonitions about the risk of an unrealistic value for undistributed income of foreign subsidiaries.

In presenting current income, gain or loss in respect of members of the consolidated group, no adjustment is made to reflect potential changes reflecting the time value of money.[19] All income, gain or loss of a foreign affiliate is taken into account without regard to U.S. tax-based friction that might impair the amount ultimately available or might delay its availability. U.S. tax effects are taken into account under a different set of rules, largely self-contained and separate from the rules for reflecting the income on which such tax might be imposed. Those rules, discussed below, govern additions to (or subtractions from) the annual provision for current and deferred tax liabilities and tax assets.

This segregation of U.S. tax effects from other effects (foreign exchange controls or foreign currency conversions) is asymmetrical, at least to a lay reader of accounting literature, with the different prescriptions for realistically taking into account other potential impairments of the value of foreign subsidiary earnings. For example, ARB No. 43, Chapter 12, "Foreign Operations and Foreign Exchange," as amended at the time FAS 131[20] was adopted in June 1997, provides:

> "4. A sound procedure for United States companies to follow is to show earnings from foreign operations in their own accounts *only* to *the extent that funds have been received in the United States or unrestricted funds are available for transmission thereto*.
>
> "5. Any foreign earnings reported beyond the amounts received in the United States should be carefully considered in light of all the facts . . . FASB Statement No. 131, *Disclosure about Segments of an Enterprise and Related Information*, discusses the requirements for reporting revenues from foreign operations."[21]

Nothing in FAS 94, or in FASB Statement No. 131 (cited in the preceding excerpt), contemplates treating potential U.S. tax as a barrier to reflecting in consolidated financial statements "foreign earnings beyond the amounts received in the United States" within the intendment of Paragraph 5 of Chapter 12 of ARB No. 43. Such exposure to incremental U.S.

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[19] "Discounting" has been ruled out. Accounting Principles Board, Opinion No. 10, Omnibus Opinion-1966" paragraph 6 ("…Pending durther consideration of this subject and the broader aspects of discounting as it relates to financial accounting in general…it is the Board's opinion that…deferred taxes should not be accounted for on a discounted basis.") See also FAS 109, paragraphs 177, 198-199.

[20] Statement of Financial Standards No. 131, "Disclosures about Segments of an Enterprise and Related Information," (Financial Accounting Standards Board, June, 1997).

[21] Accounting Research Board. ARB (Accounting Research Bulletin) No. 43, Ch. 12, "Foreign Operations and Foreign Exchange," paragraphs 4-5 (American Institute of Certified Public Accountants Committee on Accounting Principles, 1953, and amended by the Financial Accounting Standards Board, June 1997). Emphasis added.

tax, in the event of a distribution, is simply not viewed as a cognizable or measurable "restriction" on funds of foreign subsidiaries. Instead, the correct place to deal with such taxes, if taxes are to be taken into account at all, is in the annual provision for current and deferred income taxes.

II. Additions to the Provision for Current and Deferred Tax Liabilities

FAS 109 governs the treatment in financial statements of current and deferred tax liabilities.[22] Tax expense for any year consists of the sum of (i) current taxes payable plus (ii) deferred tax expense, minus (iii) current tax refunds and future refundable amounts.[23]

Discounting to present value is specifically prohibited.[24] A dollar of tax liability that may not be paid for 10 or more years in the future is added to the income tax expense for the year in which it is accruable as a full dollar, not the discounted present value of that dollar in the year it is first properly recognized as a deferred tax liability. FASB specifically rejects use of Cary Brown principles ("discounting") in measuring the financial disclosures of the amount of future tax.

In an apparent departure from the principle of equivalence between domestic and foreign subsidiaries,[25] two different rules are established for the treatment of future taxes ("deferred tax liabilities") of foreign subsidiaries and domestic subsidiaries. FAS 109 amended APB Opinion 23, Accounting for Income Taxes – Special Areas, to provide, in *replacement* Paragraph 10:

> "*Temporary Difference.* The Board believes it should be presumed that all undistributed earnings of a subsidiary will be transferred to the parent company. Accordingly, *the undistributed earnings of a subsidiary included in consolidated income should be accounted for as a temporary difference unless the tax law provides a means by which the investment in a domestic subsidiary can be recovered tax free*. However, for reasons described in FASB Statement No. 109, *Accounting for Income Taxes,* a deferred tax liability is not recognized for (a) an excess of the amount for financial reporting over the tax basis of an investment in a foreign subsidiary that meets the criteria in paragraph 12 of this Opinion and (b) undistributed earnings of a domestic subsidiary that arose in fiscal years beginning on or before December 15, 1992 and that meet the criteria in paragraph 12 of this Opinion. *The criteria in paragraph 12 of this Opinion do not apply to undistributed earnings of domestic subsidiaries that arise in fiscal years beginning after December 15, 1992, and a deferred tax liability shall be recognized if the undistributed earnings are a taxable temporary difference*." [26]

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[22] FAS 109.
[23] FAS 109, Para. 16.
[24] FAS 109, Para. 177.
[25] FAS 94, supra
[26] APB Op. 23, Para. 10 (Emphasis added).

FAS 109, in amending APB Op. 23 in 1992 thus appears to have preserved, for foreign subsidiaries only, Paragraph 12 of APB Opinion 23 that permits ignoring future U.S. taxes that would be due in the event of distribution, if and so long as the foreign nontaxable reinvestment of such earnings is expected to be for the indefinite future:

> "12. Indefinite reversal *criteria*. The presumption that all undistributed earnings will be transferred to the parent company may be overcome, and *no income taxes should be accrued by the parent company, if sufficient evidence shows that the subsidiary has invested or will invest the undistributed earnings indefinitely or that the earnings will be remitted in a tax-free liquidation*. A parent company should have evidence of specific plans for reinvestment of undistributed earnings of a subsidiary which demonstrate that remittance of the earnings will be postponed indefinitely. Experience of the companies and definite future programs of operations and remittances are examples of the types of evidence required to substantiate the parent company's representation of indefinite postponement of remittances from a subsidiary. If circumstances change and it becomes apparent that some of the undistributed earnings will be remitted in the foreseeable future but income taxes have not been recognized by the parent company, it should accrue as an expense of the current period income taxes attributable to that remittance; income tax expense for such undistributed earnings should not be accounted for as an extraordinary item. If it becomes apparent that some or all of the undistributed earnings of a subsidiary on which income taxes have been accrued will not be remitted in the foreseeable future, the parent company should adjust income tax expense of the current period; such adjustment of income tax expense should not be accounted for as an extraordinary item."[27]

The provisions of APB Op. 23, specifically Paragraph 12 thereof, apparently do not apply to undistributed income of a domestic subsidiary,[28] even if determining the correct amount of the provision is complicated. For undistributed earnings of domestic subsidiaries, the controlling concern is limited to the accurate reflection of shareholders' equity:

> "171. Not recognizing a liability for the deferred tax consequences of Opinion 23 and U.S. steamship enterprise temporary differences *overstates the shareholders' residual ownership interest in an enterprise's net earnings and net assets. The government has a claim (a right to collect* taxes*) that precludes shareholders from ever realizing a portion of the enterprise's net assets. A tax obligation is not a component of shareholders' equity*."172. The Board considered whether payment of income taxes for the Opinion 23 and U.S. steamship enterprise temporary differences might be a contingency as that term is used in Statement 5. *The Board concluded that there is no uncertainty that a tax obligation has been incurred for those temporary differences. The amount of the government's claim will never revert to the benefit of the shareholders unless there is a change in the tax law.*

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[27] APB Op. 23, Para. 12 (Emphasis added).
[28] APB Op. 23, Para. 10, quoted above.

> *The possibility of a change in the tax law in some future year is not an uncertainty as that term is used in Statement 5.*"[29]

FASB explained itself, in differentiating between deferred tax liability with respect to undistributed earnings of a domestic subsidiary and with respect to undistributed earnings of a foreign subsidiary, in part on the basis of perceived "complexity" of determining the amount of future U.S. tax (a worrisome problem even without trying to adjust (by discounting) for present values of future amounts whose distribution dates could not be confidently assumed):

> "173. Complexity was one reason Statement 96 did not require recognition of a deferred tax *liability* for Opinion 23 and U.S. steamship enterprise temporary differences. Information received from constituents has convinced the Board that calculation of a deferred tax liability for undistributed foreign earnings that are or will be invested in a foreign entity indefinitely may sometimes be extremely complex. The hypothetical nature of those calculations introduces significant implementation issues and other complexities that occur less frequently in calculations of a deferred tax liability for an *expected* remittance of earnings from a foreign entity. For that reason, the Exposure Draft proposed to not require recognition of a deferred tax liability for undistributed earnings that are or will be invested in a foreign entity indefinitely. Based on respondents' concerns about complexity, however, the Board decided to extend that exception for foreign undistributed earnings to include the entire amount of a temporary difference between the book and tax basis of an investment in a foreign subsidiary or foreign corporate joint venture that is essentially permanent in duration regardless of the underlying reason(s) for that temporary difference."[30]

The exception to the general rule applies only to foreign subsidiaries. The justification was explained as resting on, in addition to complexity concerns, two other pillars: (1) the need to compromise (sic) and (2) the omission of discounting.[31]

These rules have been re-examined by FASB from time to time since 1992, and reaffirmed most recently in connection with the FASB/IASB Convergence project.[32]

The U.S. GAAP rules do not affect the cost to the government of tax deferral, expressed with respect to any given amount of deferred tax. That cost is adequately measured by the present value analysis that measures the cost of the government having to borrow funds to carry the deferred tax. The rules *might*, however, affect location decisions, and included in such location decisions are decisions whether to repatriate undistributed earnings for potential deployment in domestic investment (at least so long as section 956 remains in its present form).

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[29] FAS 109, Para 171-172 (Emphasis added).
[30] FAS 109, Para. 173.
[31] FAS 109, Para. 169.
[32] FASB Minutes of Joint Board Meeting (of FASB and IASB), October 20, 2004, available online at www.fasb.org

Attachment 2. Comparison Of Tax Reform Proposals

The following table is a brief summary of the key points of difference (or congruence) of view between "Congressional Tax Reform" and "Advisory Panel Reform." The table does not relate to the various items on my to-do list.

Proposal	**Legislation**	**Panel Report**
1. Repeal Foreign Base Company Sales Income 2. Repeal Foreign Base Company Services Income	Proposed section 301, H.R. 5095, 107th Cong. 2nd Sess. (2002) ("Thomas Bill") would have repealed both foreign base company sales income and foreign base company services income. Proposal was reportedly dropped because of anticipated revenue estimate cost.	Recommends treatment as "Mobile Income"[33] with no deferral and no "cross crediting" for taxes on income likely to be highly taxed.[34] Mobile Income would include the present categories of "Foreign Base Company Sales Income" and Foreign Base Company Sales Services Income. See JCT Options Report footnote 428 at p. 194.

[33] Panel Report p. 240 ("income from the sale of property purchased from or sold to a related person by a foreign corporation that is neither the origin nor the destination of that property."). There is a similar reference to "certain income from personal services" that appears likely to include present-law: foreign base company services income. The JCT Options Report contained proposals very similar to the Panel Report dividend exemption system The JCT Options Report left open the possible elimination of foreign base company sales income and foreign base company services income. Footnote 428 at p. 194.

[34] Panel Report, p. 240 ("Businesses would not receive foreign tax credits for foreign taxes (including both corporate level taxes and dividend withholding taxes) attributable to Foreign Business Income….").

3. Exclude Active Financing Income from Subpart F Foreign Personal Holding Company Income	Initially adopted in Taxpayer Relief Act of 1997,[35] reversing the initial inclusion of such income in FPHC1 in the 1986 Act,[36] a provision that reversed the decision reflected in the 1962 Act[37] to exclude active financial services income from subpart F. Temporary, but regularly temporarily" extended, most recently by TIPRA.[38]	Unclear. Recommends treatment as exempt Foreign Business Income, except to the extent attributable to investment of financial institution assets.[39] Unclear if a change in present section 954(h) is intended.[40]
4. Related Party Look-Through Exclusion from Foreign Personal Holding Company Income (and thus from subpart F)	TIPRA amendments to IRC sec. 954(c) excludes all related party dividends, interest, rents and royalties, allocable to non-subpart F income of the payer CFC, from foreign personal holding company income of the payee.[41]	Exclude dividends, but not interest, rents and royalty payments that would generally be deductible under source country tax law.[42] Panel Report conceptually uses "base erosion" of foreign taxable income as important criterion to use to categorize an item as (U.S.-taxable) "Mobile Income" or exempt Foreign Business Income. The TIPRA exclusion would thus be reversed.

35 Section 1175, P.L. 105-34 (August 5, 1997).
36 Section 1201(c), P.L. 99-514 (October 22, 1986).
37 Section 12(b), P.L. 87-834. (Section 954(c)(3) as added to the Internal Revenue Code of 1954 provided that foreign personal holding company income would not include "dividends, interest or gains from the sale or exchange of stock or securities derived in the conduct of a banking, financing or similar business….").
38 Section 103(a) of "Tax Increase Prevention and Reconciliation Act of 2005," P.L. 109-222 (May 18, 2006) (hereinafter sometimes referred to as "TIPRA").
39 Panel Report, p. 241 ("Anti-abuse rules would be needed to prevent passive investment income earned by financial services businesses from being treated as Foreign Business Income.").
40 I.R.C. section 954(h) has specific, rather than "anti-abuse" tests to distinguish qualifying and nonqualifying income.
41 Section 103(b) of TIPRA.
42 Panel Report, p. 240 ("certain types of foreign active business income that is not likely to be taxed in any foreign jurisdiction.").

5. Reduce Foreign Tax Credits to simplify FTC and to enhance "cross crediting"		
a. Joint Ventures (10/50 Companies) Dividends	Several prospective legislative eliminations commencing in 1997,[43] followed by complete elimination in AJCA.[44] Intended to achieve full cross crediting for foreign income tax on all foreign source business income, whether from foreign single-country subsidiaries, joint ventures, royalties or export sales income. Intended to reverse 1986 Act limitation on cross crediting among units of a U.S. MNC and joint ventures (which were not to be treated as units of worldwide enterprise).	"Do something"[45] (But apparently not provide complete look-through as with CFCs.) If not exempt Foreign Business Income, it would be Mobile Income with no cross credit for high foreign tax on exempt Foreign Business Income. Would eliminate cross credit for high taxes on joint ventures against royalty income and export sales income. Would have effect of reinstating 1986 Act segregation of joint ventures from other units of the U.S. MNC global enterprise.[46]

[43] Taxpayer Relief Act of 1997, sec. 1105, P.L. 105-34 (August 5, 1997).
[44] American Jobs Creation Act, sec. 403, P.L. 108-357 (October 22, 2004).
[45] Panel Report, p. 240 ("Further rules would be needed to address the taxation of Foreign Business Income earned by a U.S. multinational that owns at least 10 percent of the stock of a foreign corporation that is not controlled by U.S. shareholders (so-called "10/50" companies.").
[46] STAFF OF THE JOINT COMMITTEE ON TAXATION, GENERAL EXPLANATION OF THE TAX REFORM ACT OF 1986 (H.R. 3838, 99TH CONG. 2D SESS; PUBLIC LAW 99-514) (May 4, 1987), (the "1986 ACT BLUE BOOK") p. 868.

b. Joint Venture (10/50 Companies) Interest, rents and royalties	Interest, rents and royalties to U.S. joint venture investor or to CFC joint venture investor may be eligible for general basket cross crediting if joint venture under common control with a same-country CFC lender/ licensor.[47] More direct look-through for cases in which common control of borrower/lender or licensor/licenses not present-has not been enacted.	"Do something"[48] Would eliminate cross credit for excess foreign taxes associated with dividends and branch profits of controlled and noncontrolled foreign corporations against interest, rents and royalties from controlled foreign affiliates and noncontrolled foreign affiliates.[49]
Controlled Foreign Corporation Dividends	Retain general basket cross crediting for all foreign taxes on general limitation basket comprised of high and low taxed income from related CFC and 10/50 (J.V.) dividends, active business royalties, related party dividends, interest, rents and royalties where payer under common control with payee, and look-through dividends from 10/50 (J.V.) companies.[50]	Eliminate cross crediting for high taxes on such dividends against low taxed foreign dividends, interest, rents and royalties, and export sales income.[52] Dividends are exempt if attributable to income other than Mobile Income.[53]
Interest, rents and royalties	Retains general basket category for related party CFC interests, rents and royalties in order to facilitate cross crediting.[51]	Credits associated with income that is not "Mobile Income" cannot reduce U.S. tax on Mobile Income.[54]

[47] IRC sec. 954(c)(3) provides an exception from foreign personal holding company income for interest and royalties received by a controlled foreign from a same-country related party, even if the related party is not also a controlled foreign corporation. The exclusion from foreign personal holding company income, in turn, may support general basket treatment under IRC section 904(d)(2)(A).
[48] Panel Report, p. 240. See Note 45 above.
[49] Panel Report, p. 240. See Note 34 above.
[50] AJCA. See Note 44 above.
[51] Id.
[52] Panel Report p. 240. See Note 34 above.
[53] Panel Report pp. 105, 239, 240.
[54] Panel Report, p.240 (no foreign tax credit for any foreign tax associated with Foreign Business Income).

6. Expense Allocations to Reduce FTC Limitation: Worldwide Interest vs. U.S. Group Interest Only	Reduce U.S. interest allocable to foreign source income to account for foreign interest expense incurred to produce foreign source income. Intention is to increase amount of foreign source income, the U.S. tax on which can be reduced by high foreign taxes on foreign business income.[55] This was first proposed as an amendment to the Senate version of legislation that became the Tax Reform Act of 1986[56] and finally enacted in AJCA.	Deny all foreign tax credits on income likely to be subject to high foreign tax. Excess foreign taxes on such income cannot reduce U.S. tax on other foreign source income. Reverses the result of the change in interest expense allocation by another means.[57]
7. Eliminate separate foreign tax credit basket for financial services income of financial services business.	Financial services income of a financial services taxpayer will be general basket income permitting cross crediting of excess foreign taxes on other general basket income and vice versa.	Any such income that is exempt Foreign Business Income will have no foreign tax credit. Any such income that is Mobile Income cannot benefit from cross crediting of excess foreign taxes on other foreign general basket income. Unlikely to have excess credits on "Mobile Income."

55 AJCA, sec. 401.
56 S. Rep. No. 313, 99th Cong. 2d Sess. 376 (1985).
57 Panel Report discussion of level playing field at pp. 104-105, 133-134.