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# The Silver Lining: The International Tax Provisions of the American Jobs Creation Act – A Reconsideration

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## 1. INTRODUCTION: THE ACT AND ITS CRITICS

The American Jobs Creation Act of 2004 (the "Act"), passed by the US Congress on 12 October and signed into law by President Bush on 22 October 2004, has been greeted by general dismay by various critics (including a front-page story in *The New York Times*).[1] The Act has been described as overloaded with "pork" and giveaways to special interest groups like tobacco farmers. The critics contend that the only achievement of the Act, the repeal of the "extraterritorial income" (ETI) regime that was ruled by the WTO to be a prohibited export subsidy, is dwarfed by 633 pages of special interest legislation.[2] Even the Bush Administration distanced itself from the Act, contending that the ETI repeal could have been achieved with much less pork attached.[3]

These critiques may be true, although they display a somewhat unrealistic sense of what kind of legislation is likely to be enacted less than a month before an election. What the critics of the Act fail to notice, however, is that in addition to the ETI repeal, the Act has three highly important positive features related to simplification, fairness and closing loopholes in the US international tax regime.

First, the Act contains the most far-reaching simplification of the US international tax regime in many decades. Specifically, the Act finally (after many failed attempts over the course of the last two decades) reduces the number of anti-deferral regimes from six to three. More controversially, but in this author's opinion correctly, the Act also reduces the number of foreign tax credit "baskets" from nine to two. These two steps by themselves will go a long way to reduce the complexity and transaction costs of the US international tax regime.

Second, the Act also resolves several problems that go back to the 1986 Tax Reform Act and which, for revenue reasons, involved blatant unfairness towards US resident individuals and corporations. The Act eliminates the exclusion of foreign debt and assets in calculating the allocation of worldwide interest expense, which frequently leads to double taxation. The Act also addresses the one-sided application of the overall foreign loss rule to reduce the foreign tax credit limitation. In addition, the Act eliminates the double taxation resulting from reducing the foreign tax credit for alternative minimum tax purposes.

Finally, the Act addresses several notorious loopholes in the US international tax legislation. The Act erects a barrier against "inversion" transactions in which a US corporation becomes a subsidiary of a foreign corporation in order to escape the reach of Subpart F. The Act also finally gives some teeth to the expatriation rule for individuals, which is also the culmination of a legislative battle lasting for over a decade.

The Act does not address the most controversial issue in US international taxation, namely, the appropriate scope of the anti-deferral rules. The Act does take one step forward towards territoriality by enacting a temporary lower rate for repatriations of the deferred profits of US multinationals. While this move is controversial, its ultimate meaning will only be known over time, and it can be interpreted as consistent with a move both towards limiting deferral and towards expanding it.

This article addresses the most prominent international provisions of the Act, but does not discuss every international provision since many of them involve relatively small issues. Instead, the article highlights the major changes achieved by the Act. The article also does not discuss the multitude of domestic provisions contained in the Act (e.g. the Subchapter S simplification and anti-tax shelter provisions), leaving that for another day.

1. "H.R. 4520, American Jobs Creation Act of 2004", 2004 *Tax Notes Today* (*TNT*) 196-10 (8 October 2004); Andrews, Edmund L., "How Tax Bill Gave Business More and More", *The New York Times*, 13 October 2004, Sec. A, Col. 3.
2. "Ways and Means Democrats Criticize 'Special Interest Provisions' in Jobs Bill", 2004 *TNT* 196-36 (8 October 2004).
3. "Snow Shares Administration's Views on ETI Repeal Bill with Top Taxwriters", 2004 *TNT* 194-19 (6 October 2004).

## 2. SIMPLIFICATION PROVISIONS

### 2.1. Anti-deferral regimes

Before the Act, the United States had six anti-deferral regimes, enacted progressively in the period from 1913 to 1986:
– the accumulated earnings tax (1913), in US Internal Revenue Code of 1986, as amended (IRC) Secs. 531 to 537;
– the personal holding company rules (1937), in IRC Secs. 541 to 547;
– the foreign personal holding company rules (1937), in IRC Secs. 551 to 558;
– the foreign investment company rules (1962), in IRC Secs. 1246 to 1247;
– Subpart F (1962), in IRC Secs. 951 to 964; and
– the passive foreign investment company rules (1986), in IRC Secs. 1291 to 1298.

The proliferation of these rules is a classic example of how the US tax code becomes more and more complex. Each rule was designed to address perceived problems with the previous rules, but the enactment of a new rule was not accompanied by abolishing the previous rules, so that they all operated simultaneously. Coordination rules were sometimes adopted (e.g. the rule adopted in 1997 that a "controlled foreign corporation" (CFC) under Subpart F cannot also be a "passive foreign investment corporation" (PFIC)). However, in order to prove that the US shareholders of a foreign corporation were entitled to defer tax on the corporation's profits until they were distributed, it was necessary for tax lawyers to establish that *none* of the anti-deferral rules applied; thus, each had to be carefully studied in turn. The result was a mind-numbing degree of complexity.

Moreover, there was a very considerable degree of overlap among the rules. For example, the personal holding company (PHC) and foreign personal holding company (FPHC) rules are very similar to each other, and both are designed to tax foreign corporations that earn primarily passive income and are controlled by five or fewer US individuals ("incorporated pocketbooks"). The reason for having two regimes was that the PHC regime taxes the PHC directly, while the FPHC regime taxes the US shareholders on a deemed dividend, and in 1937 it was believed that the United States could not tax a foreign corporation directly on foreign-source income. This belief has now been abandoned, so that both the PHC and FPHC regimes apply to foreign corporations (Congress was so sure about the jurisdictional rule in 1937 that it forgot to exclude foreign corporations from the PHC rules). Moreover, both regimes are redundant with the much more modern PFIC rules that have a similar definition of passive income, but do not require any degree of control by US shareholders. Similarly, the foreign investment company (FIC) regime has been rendered obsolete by the enactment of the PFIC rules.

In 1992, Congress twice passed, but the first President Bush vetoed for unrelated reasons, legislation that would have reduced the number of anti-deferral regimes. Thus, the United States has been stuck with the six regimes for over a decade despite widespread, bipartisan agreement that they should be reduced. The Joint Committee on Taxation recommended the reduction to three regimes in its 2001 report on simplification, but nothing was done for over three years.[4] Finally, the passage of the Act afforded the necessary vehicle for adopting this major simplifying move.

The Act simply abolishes the FPHC and FIC regimes since they are redundant with the PFIC regime.[5] The PHC rules have been clarified by excluding foreign corporations, as was intended by Congress in 1937. The United States is thus left with only three anti-deferral regimes: the accumulated earnings tax rules, which rarely apply and can be safely ignored in most cases, and the two major regimes, PFIC (largely for small individual shareholders) and Subpart F (for multinational corporations).

The two remaining regimes are still too complex. For example, the PFIC regime has three alternative ways to calculate the tax liability on the deferred profits of a PFIC – by applying an interest charge to an actual distribution or disposition, by electing current taxation on a deemed dividend, or by marking the shares of the PFIC to market. None of these rules is ideal. The current taxation option depends on the PFIC providing the US shareholders with the requisite information, which it frequently will not do for small shareholders; the mark-to-market option applies only to publicly-traded PFICs and is unpopular because it requires paying tax on what might be ephemeral stock market gains; and the interest charge method is very complicated. Thus, the American Bar Association (ABA) Taxation Section has recommended restricting the PFIC rules to wealthy shareholders (who can afford to deal with the complexity) by adopting a *de minimis* exclusion; this author supports such a move.[6]

Subpart F is also very complex as well as obsolete: the line that it draws between the types of income that do and do not benefit from deferral depends on an outdated assumption that passive income can be earned overseas without significant foreign tax, but active income cannot. This author has argued elsewhere for adopting a different line, between high-taxed and low-taxed foreign income, and Senator John Kerry has advocated yet another line (between income from sales in the CFC's country of incorporation and income from sales elsewhere).[7] The resolution of this issue, which is highly politicized, must await the new Bush Administration.

4. Joint Committee on Taxation, *Study of the Overall State of the Federal Tax System and Recommendations for Simplification* (April 2001), at 834. See Avi-Yonah, Reuven S., "Making Sense of U.S. International Taxation: Six Steps Toward Simplification", 55 *Bulletin for International Fiscal Documentation* 9/10 (2001), at 493.
5. Act, Sec. 413; "Managers' Statement on Corporate Tax Bill", 2004 *TNT* 196-11 (7 October 2004) (hereafter "Legis. Hist."), Title III, Sec. 13.
6. "ABA Taxation Section Testimony at W&M Oversight Panel Hearing on Code", 1999 *TNT* 102-64 (25 May 1999).
7. See Avi-Yonah, Reuven S., "U.S. Notice 98-11 and the Logic of Subpart F: A Comparative Perspective", 16 *Tax Notes International* 1797 (8 June 1998); see also Avi-Yonah, Reuven S., "The Ingenious Kerry Tax Plan", 103 *Tax Notes* 477 (26 April 2004).

## 2.2. Foreign tax credit baskets

Since 1986, the US foreign tax credit regime has been determined by both an overall limitation (restricting the credit to the US tax rate multiplied by foreign-source income) and a "per category of income", or "basket", limitation (applying the overall limit separately to each of several baskets) (IRC Secs. 904(a) and (d)). Before the Act, there were nine such baskets: (1) passive income, (2) high withholding tax interest, (3) financial services income, (4) shipping income, (5) dividends received from certain non-controlled ("10/50") foreign corporations, (6) dividends from domestic international sales corporations (DISCs), (7) foreign trade income, (8) distributions from foreign sales corporations (FSCs), and (9) any other income ("general limitation" income) (IRC Sec. 904(d)).

The rationale behind the baskets was that, if a US corporation was in an excess credit position because its foreign taxes exceeded the general limitation, it had an incentive to earn low-taxed foreign-source income so as to increase its limitation. This incentive to invest abroad rather than in the United States violated capital-export neutrality (CEN) and encouraged tax competition by foreign tax havens. By adopting the baskets, the 1986 Tax Reform Act sought to prevent US multinationals from averaging high-taxed active income with low-taxed passive income, as well as high-taxed passive income with low-taxed passive income.[8]

It is doubtful how well the baskets achieved their desired purpose. In particular, the statistics of the US Internal Revenue Service (IRS) indicate that, despite the baskets, US multinationals were able to credit 98% of their foreign taxes.[9] One primary reason was the ability to average, in the general basket, the high-taxed and low-taxed active income. Critics have therefore proposed that the US should superimpose a per-country limitation on top of the baskets (an idea that was proposed and rejected as unduly complex in 1986). In addition, the baskets sometimes had perverse results, such as discouraging the formation of 50/50 joint ventures between US and foreign corporations (because of the 10/50 basket, which was partially abolished in 2002) or the 4.9% withholding rate on interest in the United States–Mexico tax treaty (to avoid the high withholding tax interest basket, which applies from 5%).

As this author has argued previously,[10] the baskets are misguided because their fundamental rationale (preserving CEN) only applies to corporations in an excess credit position. This can be illustrated by the following example, in which the taxpayer invests first in a high-tax foreign country, Foreign Country A:

Example

| | Foreign Country A |
|---|---|
| taxable income | 100 |
| foreign tax | 50 |
| US tentative tax | 35 |
| foreign tax credit (FTC) limitation | 35 (35% x 100) |
| foreign tax credit | (35) |
| net US tax | 0 |
| total tax | 50 |
| after-tax income | 50 |
| excess credit | 15 |

The taxpayer now can choose between investing to earn an additional 100 in the United States or in Foreign Country B, which has no income tax. If the taxpayer invests in the United States, the result will be:

| | Foreign Country A | United States |
|---|---|---|
| taxable income | 100 | 100 |
| foreign tax | 50 | 0 |
| US tentative tax | 35 | 35 |
| FTC limitation | 35 (35% x 100) | 0 |
| foreign tax credit | (35) | 0 |
| net US tax | 0 | 35 |
| total tax | 50 | 35 |
| after-tax income | 50 | 65 |
| excess credit | 15 | |

If the taxpayer invests in Foreign Country B, the result will be:

| | Foreign Country A | Foreign Country B |
|---|---|---|
| taxable income | 100 | 100 |
| foreign tax | 50 | 0 |
| US tentative tax | 35 | 35 |
| FTC limitation | 70 (35% x 200) | 70 |
| foreign tax credit | (50) | 0 |
| net US tax | (15) | 35 |
| total tax | 35 | 35 |
| after-tax income | 65 | 65 |
| excess credit | 0 | |

Thus, in this case, the taxpayer has an incentive to invest in Foreign Country B and not in the United States, which violates CEN.

But consider a taxpayer in an excess limitation position because the taxpayer invests first in Foreign Country B:

| | Foreign Country B |
|---|---|
| taxable income | 100 |
| foreign tax | 0 |
| US tentative tax | 35 |
| FTC limitation | 35 (35% x 100) |
| foreign tax credit | 0 |
| net US tax | 35 |
| total tax | 35 |
| after-tax income | 65 |
| excess limitation | 35 |

The taxpayer can now choose between investing to earn an additional 100 in the United States or in Foreign Country A, which has an income tax levied at 50%. If the taxpayer invests in the United States, the result will be:

| | Foreign Country B | United States |
|---|---|---|
| taxable income | 100 | 100 |
| foreign tax | 0 | 0 |
| US tentative tax | 35 | 35 |
| FTC limitation | 35 (35% x 100) | 0 |
| foreign tax credit | 0 | 0 |
| net US tax | 35 | 35 |
| total tax | 35 | 35 |
| after-tax income | 65 | 65 |
| excess limitation | 35 | |

8. For a classic defence of the baskets, see Kingson, Charles I., "The Foreign Tax Credit and Its Critics", 9 *American Journal of Tax Policy* 1 (1991).
9. "SOI Winter 1994-5 Bulletin", 95 *TNT* 66-43 (5 April 1995).
10. See Avi-Yonah, supra note 4.

If the taxpayer invests in Foreign Country A, the result will be:

| | Foreign Country B | Foreign Country A |
|---|---|---|
| taxable income | 100 | 100 |
| foreign tax | 0 | 50 |
| US tentative tax | 35 | 35 |
| FTC limitation | 70 (35% x 200) | 70 |
| foreign tax credit | 0 | (50) |
| net US tax | 35 | (15) |
| total tax | 35 | 35 |
| after-tax income | 65 | 65 |
| excess limitation | 20 | |

Thus, CEN is *not* violated in this case: the taxpayer is indifferent between investing in the United States or in Foreign Country A. The only difference is the revenues of the US Treasury, which are 70 if the investment is made in the US, but only 20 if the investment is made in Foreign Country A.

The general conclusion is that the basket system is needed to protect CEN only for taxpayers in an excess credit position, but not for taxpayers at the limit or in an excess limitation position. Since most US multinationals are currently in a neutral or excess limitation position, it is questionable whether the baskets are needed to protect CEN.

More generally, one has to remember that the imposition of the foreign tax credit limitation in the first place violates CEN. It is a necessary concession to reality, however, because an unlimited credit offers too much incentive to other countries to raise their tax rates at the expense of the US Treasury. But having made that concession, it does not appear sensible to this author to add a highly complicated basket system just because, for some taxpayers, there will be an incentive to invest elsewhere depending on the precise order of their investments. In the end, the worst thing that can happen from allowing cross-crediting will be that taxpayers can always credit all of their foreign taxes, which they also seem to be able to do today with much transactional complexity and planning. Full crediting of the foreign taxes imposed primarily on active income is consistent with CEN. Therefore, this author would have supported abolishing the baskets and permitting taxpayers to cross-credit freely.[11]

The Act does not go quite that far. Presumably, the revenue effect of freely permitting multinationals to credit all foreign taxes by averaging them with low-taxed foreign-source passive income was too negative. But the Act does advance significantly in the same direction by abolishing (from 2007) all the baskets except the general limitation and passive baskets.[12] Financial services income, shipping income and distributions from former DISCs and FSCs will fall into the general basket, while high withholding tax interest will fall into the passive basket. Dividends from 10/50 corporations are granted look-through treatment and thus will fall into the same basket as the underlying income (Act, Sec. 403).

Critics have assailed this provision as a violation of CEN and as an incentive for US multinationals to invest in low-tax foreign countries.[13] While this is true in some situations, the number of US multinationals in an excess credit position was limited even before the ability to average across baskets. This is in part because the foreign corporate tax rates have declined and in part because of transactions designed to reduce the effective foreign tax rate.[14] The change in the interest allocation rules described below will further reduce the number of taxpayers in an excess credit position. Thus, this author believes that this reform, which represents a major simplification of the US foreign tax credit rules, is worth it.

## 3. FAIRNESS PROVISIONS

### 3.1. Interest expense allocation

Before 1986, interest expense was allocated by comparing the US to the foreign assets ratio of each US and foreign corporation separately. Thus, assume that P is the US parent of a group of corporations that includes D, a domestic corporation, and D's subsidiary F, a foreign corporation, and that D and F each have USD 1,000 in assets. If D were to borrow funds and pay USD 100 in interest expense, that expense would be allocated USD 50 to US-source income and USD 50 to foreign-source income because D has USD 1,000 in US assets (directly) and USD 1,000 in foreign assets (the stock of F). If P were to borrow funds, however, the entire USD 100 in interest expense would be allocated to US-source income because all of P's assets (the D stock) are domestic. Thus, borrowing by P would maximize the group's ability to use any foreign tax credits for the taxes imposed on F because no interest expense would be allocated to reduce D's foreign-source income (a dividend from F).

The allocation of the USD 100 of P's interest expense to US-source income at P's level resulted from an inconsistent concept. For purposes of filing consolidated tax returns – that is, combining the income and deductions of P and D – the separate existence of the D stock was disregarded. But for purposes of apportioning P's interest deduction, the D stock was treated (before the enactment of IRC Sec. 864(e)(1) in 1986) as a distinct opaque asset – an asset that produced US-source income. The D stock would generate US-source dividends to P since less than 80% of D's *gross* income was from foreign sources (see IRC Sec. 861(c)(1)). This fact was taken into account even though D's dividends to P were not taxed, pursuant to the consolidated return theory that P and D should be treated as a single entity.

IRC Sec. 864(e)(1) disregards the stock of D for both apportionment and consolidated return purposes. Thus, since the combined P and D assets consist of USD 1,000

11. With one caveat: The foreign tax must indeed be imposed on the taxpayer, and transactions that generate artificially high foreign tax credits on minimal or no profits must be struck down. Unfortunately, the US Treasury recently withdrew Notice 98-5, 1998-3 *IRB* 49, and the standards imposed by its replacement (Notice 2004-19, 2004-11 *IRB* 606) are too vague. More enforcement is needed in this area to prevent results like the one reached in *Compaq Computer Corp. v. Commissioner*, 113 T.C. 214 (1999), reversed, 277 F.3d 778 (5th Cir. 2001).
12. Act, Sec. 403; Legis. Hist., supra note 5, Title III, Sec. 3.
13. See Fleming, J. Clifton and Robert Peroni, "Eviscerating the Foreign Tax Credit Limitations and Cutting the Repatriation Tax – What's ETI Repeal Got To Do With It?", 104 *Tax Notes* 1393 (20 September 2004).
14. See e.g. the transactions described Notice 98-11, 1998-6 *IRB* 18.

domestic and USD 1,000 foreign assets, the USD 100 of interest expense is allocated equally between foreign and domestic income – USD 50 to each – just as if D had incurred the expense directly.

As enacted in 1986, however, Sec. 864(e)(1) did not apply its consolidated approach to include the debt incurred by foreign corporations. Thus, assume that D is a domestic corporation and F is its foreign subsidiary, that they each have USD 1,000 in assets, and that they incur USD 50 of interest expense on USD 500 of debt to unrelated parties. In this case, D's interest expense is allocated USD 33 to US-source income and USD 17 to foreign-source income, while all of F's USD 50 is allocated to foreign-source income because D has USD 1,000 in US assets and USD 500 in foreign assets (the value of the F stock, reduced by its debt), while all of F's assets are foreign.

The allocation of D's interest expense is based on comparing the USD 1,000 in domestic assets to the value of the F *stock* held by D (as D's foreign asset), which is only USD 500 because of F's debt. F's assets and interest expense are not taken into account in this calculation. This reaches a result that is both illogical and unfair, especially given the pro-government result reached by IRC Sec. 864(e)(1) (requiring the aggregation of all domestic subsidiaries). If D had incurred the entire USD 100 of interest expense, it would have had USD 50 of US-source income and USD 50 of foreign-source income (because its assets are 50% domestic and 50% foreign).[15] If D's assets are to be determined on a look-through basis by disregarding the stock of domestic subsidiaries, it switches premises to disregard F's liabilities for purposes of apportioning the interest expense.[16] On revenue grounds, however, Congress rejected this result in 1986 and confined direct apportionment to the assets held by the US consolidated group.[17]

The Act changes this result from 2008 onward by providing a one-time election under which the taxable income of the domestic members of an affiliated group from sources outside the United States is generally determined by allocating and apportioning the interest expense of the domestic members of a "worldwide affiliated group"[18] on a worldwide-group basis (i.e. as if all members of the worldwide group were a single corporation) (the "worldwide fungibility election"). If a group makes this election, the taxable income of the domestic members of a worldwide affiliated group from sources outside the United States is determined by allocating and apportioning the third-party interest expense of those domestic members to foreign-source income in an amount equal to the excess (if any) of (i) the worldwide affiliated group's worldwide third-party interest expense multiplied by the ratio which the foreign assets of the worldwide affiliated group bear to the group's total assets, over (ii) the third-party interest expense incurred by the foreign members of the group to the extent such interest would be allocated to foreign sources if the provision's principles were applied separately to the foreign members of the group.

Thus, if the D/F group in the example above made the election and D borrowed the entire USD 1,000, D's USD 100 of interest expense would be allocated based on directly comparing the D/F affiliated group's USD 1,000 in US assets to its USD 1,000 in foreign assets, so that USD 50 would be allocated to US-source income and USD 50 to foreign-source income. If F borrowed the entire USD 1,000, all of its interest expense would be allocated to foreign-source income based on its assets (since the provision applies only to the interest expense of domestic corporations). If D borrowed USD 500 and F borrowed USD 500, all of F's interest expense would be allocated to foreign-source income and all of D's interest expense would be allocated to US-source income (because there is no excess of the worldwide interest expense (USD 100) multiplied by the foreign to US asset ratio (50%), or USD 50, over the interest expense incurred by F (USD 50)).

This is the correct result, and it is also more congruent with following the books and allocating D's interest expense to US-source income and F's interest expense to foreign-source income. Since most other countries follow the books for this purpose, the new rule is likely to produce less excess foreign tax credits (which can result if the foreign jurisdiction regards F as having more income than the US does because of the allocation of US-booked interest expense to F). Meanwhile, however, the new rule does not abandon the basic concept of fungibility of interest expense within a consolidated group, which is needed to prevent manipulation by taxpayers (as illustrated by the pre-1986 rule, explained above).[19]

Another interesting aspect of the new rule is that, since it allocates interest expense on the basis of the worldwide assets of a consolidated group, it brings the United States one step closer to using global formulary apportionment for consolidated groups. If expenses can be allocated using formulas (in this case, based on assets), so can income. Hopefully, this will lead to a reconsideration of the use of formulas in the transfer pricing context as well, which is essential to achieving meaningful simplification in that area.[20]

15. The F stock would be worth USD 1,000 because F would have no debt.

16. Although F's USD 500 liability increases the asset apportionment ratio from 1,000/2,000 (if D had incurred the entire USD 1,000 liability) to 1,000/1,500, the result is akin to giving a corporation a deduction, rather than a credit, for foreign taxes. Borrowings incurred by a foreign subsidiary should be the equivalent of borrowings incurred by its domestic parent, not just a proportion thereof.

17. The correct result could be reached if D borrowed the entire USD 1,000 and on-lent USD 500 to F because then the reduction in value of the F stock would be offset by holding the note from F, so that D would have USD 1,000 in US assets and USD 1,000 in foreign assets. The IRS, however, has adopted a complicated "CFC netting rule" to prevent this attempt by taxpayers to correct the unfairness described above. See Treas. Reg. 1.861-10(e).

18. The term "worldwide affiliated group" means a group consisting of (i) the includible members of an affiliated group and (ii) all the CFCs in which such members in the aggregate meet the ownership requirements of IRC Sec. 1504(a)(2) either directly or indirectly through applying IRC Sec. 958(a)(2) or through applying rules similar to those of Sec. 958(a)(2) to the stock owned directly or indirectly by domestic partnerships, trusts or estates. IRC Sec. 864(f)(1)(C).

19. For a different view, see Shaviro, Daniel, "Does More Sophisticated Mean Better? A Critique of Alternative Approaches to Sourcing the Interest Expense of US Multinationals", 54 *Tax Law Review* 353 (2001).

20. See Avi-Yonah, supra note 4.

### 3.2. Overall domestic loss

If a taxpayer's losses from foreign sources exceed its foreign-source income, the excess or overall foreign loss may offset its US-source income. Present law, however, eliminates this double benefit (reduction of US tax and, in a later year, full allowance of a foreign tax credit with respect to foreign-source income) by imposing an overall foreign loss recapture rule (IRC Sec. 904(g)). Under this rule, a portion of foreign-source taxable income earned after an overall foreign loss year is recharacterized as US-source taxable income for foreign tax credit purposes. Under current law, however, if a taxpayer incurs losses from US sources in excess of foreign-source income, no foreign tax credit can be claimed for the taxes paid abroad. If the taxpayer then earns US-source income and foreign-source income in the following taxable year, present law does not recharacterize any portion of the US-source income as foreign-source income to reflect the fact that the previous year's US-source loss reduced the taxpayer's ability to claim foreign tax credits. This one-sided application of the rule is manifestly unfair and was again adopted in 1986 for revenue reasons.

The Act applies a re-sourcing rule to US-source income in cases in which a taxpayer's foreign tax credit limitation was reduced as a result of an "overall domestic loss". In order to provide parity in the treatment of overall foreign losses and overall domestic losses and to prevent the double taxation of income, under the Act a portion of the taxpayer's US-source income may be characterized as foreign-source income (in any succeeding taxable year) in an amount equal to the lesser of (i) the amount of "unrecharacterized" overall domestic loss (for years prior to the succeeding year) and (ii) 50% of the taxpayer's US-source income for such succeeding taxable year. Any US-source income recharacterized under the Act is allocated among and increases the various foreign tax credit baskets in the same proportion that those baskets were reduced by the prior overall domestic loss. This provision applies to losses incurred in taxable years beginning after 31 December 2006.[21]

### 3.3. Foreign tax credits and the AMT

Under present law, taxpayers are subject to an alternative minimum tax (AMT) which is payable, in addition to all other tax liabilities, to the extent it exceeds the taxpayer's regular income tax liability. In the case of corporate taxpayers, the tax is imposed at a flat rate of 20% on the alternative minimum taxable income (AMTI) in excess of an exemption amount that phases out. The AMTI is the taxpayer's taxable income increased by certain tax preferences and adjusted by determining the tax treatment of certain items in a manner that limits the tax benefits resulting from the regular tax treatment of those items.

Taxpayers are generally permitted to reduce their AMT liability by an AMT foreign tax credit. The AMT foreign tax credit for a taxable year is determined under principles similar to those used in computing the regular foreign tax credit, except that (1) the numerator of the AMT foreign tax credit limitation fraction is foreign-source AMTI and (2) the denominator of that fraction is total AMTI. Taxpayers may elect to use as their AMT foreign tax credit limitation fraction the ratio of foreign-source regular taxable income to total AMTI.

Under current law, however, the AMT foreign tax credit for any taxable year may generally not offset a taxpayer's entire pre-credit AMT. Rather, the AMT foreign tax credit is limited to 90% of the AMT computed without any AMT net operating loss deduction and the AMT foreign tax credit. For example, assume that a corporation's AMTI is USD 10 million and that the corporation has no AMT net operating loss deduction and no regular tax liability. In the absence of the AMT foreign tax credit, the corporation's tax liability would be USD 2 million. Accordingly, the AMT foreign tax credit cannot be applied to reduce the taxpayer's tax liability below USD 200,000.

This limitation is manifestly unfair since it directly produces double taxation: the USD 200,000 tax liability to the United States is duplicated by a USD 200,000 tax liability to a foreign jurisdiction. There is no justification for this other than raising revenue and a wish to see corporations pay some US tax. The Act correctly repeals the limitation so that a corporation subject to the AMT can fully offset it with foreign tax credits for taxes actually paid on foreign-source income.[22]

## 4. LIMITS ON EXPATRIATION

### 4.1. Corporations

From 1997 onward, over 20 publicly-traded US corporations engaged in "inversion" transactions in which their shareholders exchanged the shares of the US corporation for shares of a newly formed Bermuda entity. Thus, the Bermuda corporation became the parent, and the US corporation its wholly-owned subsidiary. The purpose of these transactions was twofold: (a) to enable new foreign subsidiaries of the Bermuda corporation to be formed without being subject to Subpart F (since only 10% or more US shareholders count for Subpart F purposes, so that the ultimate ownership by the US public did not matter), and (b) to reduce the US-source income of the US corporation by making deductible interest and royalty payments to the Bermuda parent without triggering the Subpart F inclusions for passive income (since the Bermuda parent is not a CFC).[23]

In 1994, the IRS announced that these types of transactions would be subject to tax at the shareholder level, but this did not stop the trend since the tax savings were at the corporate level. After 11 September 2001, these transactions began to attract negative publicity, and at least one corporation abandoned its planned inversion midstream under pressure. Legislation to prevent inversions has been introduced numerous times, but the Act finally incorporates anti-inversion provisions, effective for inversions

21. Act, Sec. 302; Legis. Hist., supra note 5, Title III, Sec. 2.
22. Act, Sec. 241; Legis. Hist., supra note 5, D, Sec. 1.
23. See Avi-Yonah, Reuven S., "For Haven's Sake: Reflections on Inversion Transactions", 95 *Tax Notes* 1793 (17 June 2002).

after 4 March 2003 (when the anti-inversion legislation was first introduced).[24]

The Act defines two different types of corporate inversion transactions and establishes a different set of consequences for each type. The first type of inversion is a transaction in which, pursuant to a plan or a series of related transactions: (1) a US corporation becomes a subsidiary of a foreign-incorporated entity or otherwise transfers substantially all of its properties to such an entity in a transaction completed after 4 March 2003; (2) the former shareholders of the US corporation hold (by reason of holding stock in the US corporation) 80% or more (by vote or value) of the stock of the foreign-incorporated entity after the transaction; and (3) the foreign-incorporated entity, considered together with all companies connected to it by a chain of greater than 50% ownership (i.e. the "expanded affiliated group"), does not have substantial business activities in the entity's country of incorporation, compared to the total worldwide business activities of the expanded affiliated group. The Act denies the intended tax benefits of this type of inversion by deeming the top-tier foreign corporation to be a domestic corporation for all purposes of the IRC.[25]

The second type of inversion is a transaction that would meet the definition of an inversion transaction described above, except that the 80% ownership threshold is not met. In such a case, if at least a 60% ownership threshold is met, a second set of rules applies to the inversion. Under these rules, the inversion transaction is respected (i.e. the foreign corporation is treated as foreign), but any applicable corporate-level "toll charges" for establishing the inverted structure are not offset by any tax attributes, such as net operating losses or foreign tax credits. Specifically, any applicable corporate-level income or gain required to be recognized under IRC Secs. 304, 311(b), 367, 1001, 1248 or any other provision with respect to the transfer of CFC stock or the transfer or license of other assets by a US corporation as part of the inversion transaction, or after such transaction to a related foreign person, is taxable, without being offset by any tax attributes (e.g. net operating losses or foreign tax credits). This rule does not apply to certain transfers of inventory and similar property. These measures generally apply for a ten-year period following the inversion transaction.

There have been no reported inversion transactions since the anti-inversion legislation was first introduced in 2003, presumably because taxpayers wanted to see the precise shape of the legislation. Now that the anti-inversion legislation has been enacted, taxpayers may try to find loopholes in it, which would require further action.[26]

Nevertheless, it is never a good reason not to stop a glaring loophole just because the solution may itself have problems. Inversions were a serious challenge to the ability of Congress to impose taxes on US corporations. If nothing had been done, Subpart F would be in serious jeopardy. Thus, the anti-inversion provisions are a significant step forward.

### 4.2. Individuals

The United States is unique in taxing its citizens on their worldwide income even when they reside elsewhere. Thus, moving out of the United States is insufficient to stop worldwide taxation; it is also necessary to abandon US citizenship.

For a long time, IRC Sec. 877 attempted to limit the ability to reduce taxes by expatriation by subjecting certain former citizens to tax for a ten-year period as if they were still citizens. US tax treaties preserve the United States' ability to do so. IRC Sec. 877, however, was a notorious paper tiger because it required the IRS to show that the expatriation was tax-motivated and, in most cases, the IRS failed to do so.

In 1996, the late Senator Daniel Patrick Moynihan attempted to strengthen IRC Sec. 877 by imposing tax on a deemed sale of assets upon expatriation. Republicans in Congress, however, managed to block the Moynihan proposal and substitute a weak set of rebuttable presumptions, which again were easy to avoid in practice.

The Act finally does something real about tax-motivated expatriations by replacing the subjective determination of tax avoidance as a principal purpose for relinquishing citizenship or terminating residence under present law with objective rules.[27] Under the Act, a former citizen or former long-term resident is subject to an alternative tax regime (i.e. in general, taxed as if he/she were still a citizen) for a ten-year period following citizenship relinquishment or residence termination, unless the former citizen or former long-term resident: (1) establishes that his/her average annual net income tax liability for the five preceding years does not exceed USD 124,000 (adjusted for inflation after 2004) and his/her net worth does not exceed USD 2 million or, alternatively, satisfies limited, objective exceptions for dual citizens and minors who have had no substantial contact with the United States; and (2) certifies under the penalties of perjury that he/she has complied with all US federal tax obligations for the five preceding years and provides such evidence of compliance as the Secretary of the US Treasury may require.

The alternative tax regime does not apply to an individual for any taxable year during the ten-year period following citizenship relinquishment or residence termination if the individual is present in the United States for more than 30 days in the calendar year ending in such taxable year. The

24. Act, Sec. 601; Legis. Hist., supra note 5, Title X, A, Sec. 1.
25. In determining whether a transaction meets the definition of "inversion" under the Act, the stock held by members of the expanded affiliated group that includes the foreign-incorporated entity is disregarded. For example, if the former top-tier US corporation receives stock of the foreign-incorporated entity (e.g. "hook" stock), the stock would not be considered in determining whether the transaction meets the definition. Similarly, if a US parent corporation converts an existing wholly-owned US subsidiary into a new wholly-owned CFC, the stock of the new foreign corporation would be disregarded. Stock sold in a public offering related to the transaction is also disregarded for these purposes.
26. This author has proposed a simpler solution that would incorporate a "managed and controlled" test into the definition of "US corporation" since inverted entities invariably continue to be managed from the United States. Such a test may still be desirable if it turns out that there are technical loopholes in the enacted provisions.
27. Act, Sec. 604; Legis. Hist., supra note 5, Title X, A, Sec. 4.

individual is treated as a US citizen or resident for that taxable year and is therefore taxed on his/her worldwide income.

Before the Act, US citizens could move abroad, relinquish their citizenship and avoid US taxation on foreign-source income (e.g. capital gains on the sale of appreciated stock). As long as they were able to establish some connection to the country to which they moved, such expatriations were successful. It remains to be seen whether such expatriations will continue under the Act, but the replacement of subjective standards with a rule targeted at rich expatriates was long overdue.

## 5. A MOVE TOWARD TERRITORIALITY?

Perhaps the most controversial portion of the Act is a temporary (one year) reduction of the tax rate on actual dividends from CFCs from 35% to 5.25%.[28] The intent is to encourage US multinationals to repatriate earnings that were "trapped" overseas by deferral and by the dividend tax, thus hopefully creating more US jobs.

This provision has been broadly criticized as providing a windfall to those US multinationals that benefited from deferral by keeping their profits overseas, while penalizing those multinationals that repatriated their income and paid the full dividend tax.[29] Moreover, the provision's actual impact on job creation is uncertain because US multinationals are free to use the funds in any way they wish (except to pay executive compensation) and money is fungible.

This author has no view on the job-creating aspect of this provision, but believes that the critique is overstated. The repatriation rate of US multinationals before this provision was very low (about 16%), and almost all of those dividends carried full foreign tax credits; thus, the actual revenue collected was minimal. Meanwhile, there is little question that the tax on dividends impeded the repatriation of low-taxed foreign earnings. A tax that changes behaviour while collecting almost no revenue is a bad tax.

A broader perspective on this question is needed. Fundamentally, a multinational should be regarded as a single taxpayer: the artificial distinction between branches and subsidiaries has little real life meaning for most multinationals and, in the post check-the-box environment, these distinctions have become even more meaningless.

If this perspective is adopted, dividends and other forms of transfer within a multinational should be disregarded, just as they are in a domestic consolidated group. Thus, from this perspective, it makes sense not just to reduce the tax on dividends from CFCs to their US parent, but to eliminate the tax completely. It is only the fictional separate entity treatment of the parent and the subsidiaries which justifies taxing these dividends. Given the real life impediments to the free transfer of funds within a multinational that the tax on dividends creates and the minimal revenue it generates, the tax on dividends should be abolished.

It is important to note that this result holds whether or not the United States taxes the foreign-source earnings of CFCs, i.e. whether or not deferral applies. Clearly, where deferral does not apply, dividends should not be taxed. The fact that deferral does apply to some income does not change the result: dividends should still not be taxed.

Opponents of deferral would say, however, that this situation is different from a consolidated return because, in that case, the subsidiaries are subject to US tax, whereas in the foreign situation, they are not subject to US tax and may not be subject to tax at all. But this is an argument in favour of abolishing deferral, not taxing dividends.

There are two ways of approaching the taxation of multinationals. The first is to say that, given the primacy of source-based taxation of active income in the international tax regime, multinationals should be taxed only at source. This would lead to pure territoriality, with foreign-source income not being taxed either when earned or when distributed.

There are, however, two major problems with a purely territorial approach. First, in the current tax world, the source of income is an elusive concept, and transfer pricing follows the artificial separate accounting rule and allows for shifting income between jurisdictions. In this context, adopting territoriality would lead to the need for much more enforcement of transfer pricing and source rules, which would greatly reduce the simplification benefits of such a move. If the United States had formulary apportionment with a requirement of real presence in a country (e.g. payroll and assets) in order to book profits there, territoriality would be much more attractive.

Second, in a world with rampant tax competition, active income can be earned abroad without being subject to significant tax because of the prevalence of targeted tax regimes ("production tax havens"). Territoriality encourages such competition and means that multinationals pay much less than one level of tax on active income.

Because of these two considerations, this author has been opposed to territoriality. Instead, the optimal result would be to abolish deferral in cooperation with the other OECD Member countries, as envisaged by the OECD's project on harmful tax competition. This would take care of the competitiveness issue since 85% of multinationals are headquartered in the OECD Member countries.

If such cooperation cannot be achieved, the United States should still act unilaterally to restrict deferral either by extending Subpart F to all low-taxed foreign-source income of CFCs or (as Senator Kerry suggested) by limiting deferral to sales within the CFC's country of incorporation. In practice, these proposals are likely to amount to the same thing because countries do not need to give tax breaks to multinationals that sell into the country's domestic market (which is not movable).

Whatever approach is adopted for deferral, however, should not govern the treatment of dividends from CFCs.

28. Act, Sec. 271; Legis. Hist., supra note 5, Title II, G, new IRC Sec. 965. Technically, the lower rate is accomplished by granting an 85% dividends-received deduction. No foreign tax credits are available for the taxes imposed on the deductible portion of the dividend.
29. Fleming and Peroni, supra note 13.

They should not be taxed in either a deferral or a non-deferral world, either because they were taxed already (if there is no deferral) or because taxing them just impedes moving capital within a multinational and generates no revenue (if deferral persists). Thus, the temporary reduction of the tax rate on actual dividends from CFCs (in new IRC Sec. 965) should be made permanent.[30] This would focus the debate where it belongs, namely, on the proper scope of deferral.

## 6. CONCLUSION

It is evident that the Act contains much that is positive beyond satisfying the United States' WTO obligations by repealing the ETI regime. The Act achieves significant simplification (reduction in the number of anti-deferral regimes and baskets), increases fairness (the interest allocation rule, the overall domestic loss rule, and the foreign tax credit for the AMT rule), and closes long-standing loopholes (the expatriation provisions). Even the much maligned repatriation provision can be defended as consistent with both approaches to deferral.

More needs to be done to achieve further simplification consistent with the basic goals of the US international tax regime. Most importantly, the United States should consider moving further in the direction of formulary apportionment, as the European Union is considering for inter-EU payments. This would greatly relieve the pressure on transfer pricing and sourcing. The United States should also simplify the source rules and Subpart F and abandon the US withholding tax on outgoing payments. The Act takes two steps out of the six recommended in this author's previous article,[31] and it also contains many other improvements. Contrary to the prevailing view, at least in its international provisions, the Act is a significant step forward.

30. And the rate can be reduced to zero. Presumably, the 5.25% rate was needed for revenue reasons (and this tax may in fact generate some revenue).
31. See Avi-Yonah, supra note 4.