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Making Sense of U.S. International Taxation: Six Steps Toward Simplification

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I. INTRODUCTION

The Joint Committee on Taxation of the U.S. Congress issued a three-volume study in April 2001 entitled *Study of the Overall State of the Federal Tax System and Recommendations for Simplification* (Joint Committee Study).[1] Among the more than 100 recommendations of the Joint Committee Study, ten relate to international taxation. Of these, only one can be regarded as achieving significant simplification – the proposal to reduce the number of anti-deferral regimes from six to two.[2] The other recommendations were limited to relatively minor changes of detail in various international provisions.[3] Even these small steps toward simplifying the notoriously complex U.S. international tax rules, however, were not included in the Economic Growth and Tax Relief Reconciliation Act of 2001, signed into law on 7 June 2001.

This article suggests some more fundamental ways to simplify the U.S. international tax rules. In order to do so, one needs a coherent picture of what U.S. international taxation is trying to achieve. The article therefore first outlines the two fundamental principles or goals of U.S. international taxation: the single tax principle and the benefits principle. The article then describes six proposals to simplify U.S. international taxation in accordance with the two principles described earlier. The final part concludes.

II. THE TWO PRINCIPLES UNDERLYING U.S. INTERNATIONAL TAXATION

In previous works, this author described two fundamental principles underlying the U.S. international tax regime (and, in his view, the international tax regime in general): the single tax principle and the benefits principle.[4] The single tax principle states that income from cross-border transactions should be subject to a single imposition of income tax – not more and not less. The benefits principle states that the rate of the single level of tax imposed on income from cross-border transactions should depend on whether the income is active (from a source under the taxpayer's control) or passive (from a source not under the taxpayer's control). Active income should be subject to tax primarily at source, while passive income should be subject to tax primarily on a residence basis.[5]

This author has argued elsewhere that the fundamental structure of U.S. international taxation can be understood as reflecting these two principles.[6] Specifically, the United States (like other countries that tax residents on a worldwide basis) divides the world into "U.S. persons" and "non-U.S. persons". U.S. persons are taxed on worldwide income, while non-U.S. persons are taxed only on U.S.-source income. In each case, the applicable tax rules depend on the active/passive income dichotomy. In the case of non-U.S. persons, passive U.S.-source income is taxed by imposing a gross-based withholding tax, while active U.S.-source income is taxed on a net basis. In the case of U.S. persons, passive income is taxed currently, while active income benefits from deferral or (because of the foreign tax credit) exemption. The resulting structure looks as follows:

World			
U.S. persons (taxed on all income)		Non-U.S. persons (taxed on U.S.-source income only)	
Passive income	Active income	Passive income	Active income
(current tax) high tax	(deferral/exemption) low tax	(gross tax) low tax	(net tax) high tax

1. Joint Committee on Taxation, *Study of the Overall State of the Federal Tax System and Recommendations for Simplification, Pursuant to Section 8022(3)(B) of the Internal Revenue Code of 1986* (April 2001).
2. A similar proposal was twice enacted by Congress in bills that were vetoed by the President in 1992.
3. These recommendations were: increasing the Subpart F de minimis amount; enacting a look-through rule for 10/50 companies; allowing deemed paid credits for controlled foreign corporations held through foreign partnerships; conforming the possessions credits; modifying the uniform capitalization rules for international transactions; eliminating the secondary withholding tax; eliminating the U.S.-source tax on certain capital gains; and updating the U.S. Model Income Tax Convention. All of these are useful, but minor, steps toward simplification.
4. See generally Avi-Yonah, Reuven S., "The Structure of International Taxation: A Proposal for Simplification", 74 *Texas Law Review* 1301 (1995); and Avi-Yonah, Reuven S., "International Taxation of Electronic Commerce", 52 *Tax Law Review* 507 (1997).
5. For a normative justification of these principles, see id., "International Taxation of Electronic Commerce".
6. See Avi-Yonah, "The Structure of International Taxation: A Proposal for Simplification", supra note 4.

The designations "high tax" and "low tax" reflect the actual operation of the rules. Non-U.S. persons are subject to low taxation on passive income because of the myriad exemptions and reductions applicable to passive income, ranging from treaty-based reductions to source rules (e.g. capital gains) to specific exemptions (e.g. the portfolio interest exemption). Non-U.S. persons are subject to considerably higher taxation on active income, i.e. income effectively connected with a U.S. trade or business. U.S. persons are subject to high taxation on passive income because it is taxed currently and foreign tax credits are usually not available because of the basket system. U.S. persons are subject to low taxation on active income because of the availability of deferral and the ability to cross-credit within the general basket.[7]

In theory, this regime presents a coherent whole that implements the single tax and benefits principles. Active income is taxed primarily when earned by non-U.S. persons (at source), and this is supposed to be reflected in low or no taxation in their country of residence. Passive income is taxed primarily when earned by U.S. persons (on a residence basis), and this is supposed to be reflected in low taxation on a source basis. In practice, there is reason to doubt whether single taxation of either active or passive income is achieved. Source-based taxation of active income can be avoided, for example, by falling under the permanent establishment threshold, which may be easier to do with the advent of electronic commerce. In other jurisdictions, source-based taxation can also be avoided by taking advantage of the myriad preferential regimes (such as tax holidays) for active income. Residence-based taxation of passive income depends on adequate information exchange, which is lacking in many jurisdictions. Because of these problems, a significant proportion of cross-border income may in fact escape taxation altogether.[8] These are not particularly American problems, however, and the rest of this article ignores them as they defy unilateral solutions.

III. SIX STEPS TOWARD SIMPLIFICATION

A. Simplify the source rules

The source rules (I.R.C. § 861 et seq.[9]) are complex in themselves. In addition, the fact that each category of income has its own source rule causes significant transactional complexity as taxpayers try to manipulate the source of income so that the resulting substantive tax rule will be to their advantage. Moreover, the differentiation between the various categories is very difficult and gives rise to much litigation and elaborate regulatory exercises.[10]

In order to simplify the source rules, one needs to understand how they relate to the benefits principle. In general, the source rules can be divided into formal ones (where the source is under the taxpayer's control) and substantive ones (where it is not). Formal rules include the rules for dividends and interest (residence of the payer, since corporate residence is under the taxpayer's control), capital gains (residence of the seller), and purchased inventory (the title passage rule). Substantive rules include the rule for royalties (place of use), services (place of performance), manufactured inventory (50% sourced to place of production and 50% to place of sale), and real estate (location of property).

In general, this classification corresponds to the active/passive dichotomy: active income is sourced under a substantive rule, while passive income is sourced under a formal one. This makes sense because the United States, under the benefits principle, has a stronger interest in taxing active income than passive income at source and, therefore, cares less about permitting taxpayers to avoid source-based taxation of passive income (by manipulating the formal source rule) than active income. The two exceptions are royalties, which are active income in many cases, and sales of purchased inventory, where the rule was intended to be substantive (when title passage meant something, such as passing the risk of loss), but became formal due to non-tax legal developments (the Uniform Commercial Code).

Ideally, however, one would like to have only two source rules: one for passive income and the other for active income. This would prevent the endless arguments about income classification from having much bite. What rules are appropriate? In the case of passive income, the United States has only a residual interest in taxing the income if residence-based taxation is lacking (e.g. because there is no treaty and hence no information exchange). Thus, it seems that a sensible rule would be *to classify as U.S. source any passive income that is deductible from U.S. active income* – i.e. interest and royalties that are deductible by taxpayers (U.S. or non-U.S.) against their U.S.-source income. Other forms of passive income that are not deductible (dividends and capital gains) would not be U.S. source because the United States will already have exacted one level of tax from the underlying corporate income, and that should suffice.

In the case of active income, the key is to have a single source rule that avoids the need to distinguish between royalties, services and sales. Given that the underlying goal is to tax U.S.-source active business income, the appropriate source rule would be *to treat as U.S. source any active income that is effectively connected with a U.S. trade or business, regardless of its character*. This, of course, begs the question of what is "effectively connected", but this problem is resolved if the formulary apportionment proposal advocated below (see III.C.) is adopted.

The above analysis relates to source rules for inbound transactions. The source rules, however, are also important for outbound transactions because of the foreign tax credit

7. See id. for much more detail on this structure and its normative justification.

8. See Avi-Yonah, Reuven S., "Globalization, Tax Competition, and the Fiscal Crisis of the Welfare State", 113 *Harvard Law Review* 1573 (2000).

9. All references to the U.S. Internal Revenue Code are to the Internal Revenue Code of 1986, as amended (I.R.C.).

10. For litigation, see e.g. *Commissioner v. Wodehouse*, 337 U.S. 369 (1949) (royalties or capital gains); *Karrer v. United States*, 152 F.Supp. 66 (1957) (royalties or services); and *Boulez v. Commissioner*, 83 T.C. 584 (1984) (royalties or services). For regulations, see e.g. Treas. Reg. § 1.861-18 (the software regulations).

limitation. But there is no reason why the source rule for this purpose should be the same as the inbound source rules. Rather, it seems that, given the purpose of the foreign tax credit (to prevent double taxation), the sensible source rule for outbound transactions would be *to treat as foreign source whatever the relevant foreign country treats as domestic source for purposes of applying its foreign tax*. This poses some risk of excessive grabbing of income by the foreign jurisdiction to elevate the foreign tax credit limit, but as long as the tax is not a soak-up tax, the risk seems a tolerable one.

B. Abolish withholding taxation

The United States achieves very little in terms of revenue by imposing a 30% withholding tax on gross payments to foreigners. The reason for this is the myriad exemptions and reductions that restrict the application of this tax. Capital gains are not taxed because of the source rule. Interest is generally not taxed because of the portfolio interest exemption. Royalties are not taxed because of treaty-based reductions and treaty shopping.[11] The only remaining category is dividends, but even portfolio dividends are generally not taxed because of the availability of equity swaps (dividend equivalent payments on derivatives are sourced to the residence of the recipient). Thus, the withholding tax is generally limited to direct dividends received by corporate parents, a very unappealing source of income since the underlying income is taxed at the subsidiary level, at the parent level, and possibly also at the level of the parent's shareholders.

In an ideal world, this author would prefer to reimpose the withholding tax on deductible payments, such as royalties and interest, subject to treaty reductions, and to abandon withholding on dividends and capital gains where the underlying income was subject to tax.[12] In particular, this author would prefer abolishing the portfolio interest exemption as part of a coordinated effort by the OECD to reimpose a single layer of tax on interest flows, with rebates of tax available upon a showing that the income was declared in the country of residence. Such a coordinated effort, however, seems unlikely under present conditions, as the tide has turned against tax coordination efforts. In the meantime, this author would propose *abandoning the withholding tax altogether, with the whole superstructure of complex regulations that go with it*. It achieves far too little buck for the bang.[13]

The principal argument in support of the withholding tax is that it serves as an incentive for other countries to enter treaty negotiations with the United States. Its importance, however, is very doubtful under current conditions. The United States already has tax treaties with most OECD Member countries, which reduce the withholding tax rates significantly; thus, achieving further reductions is unlikely to be a major motivating factor in that case. The United States has relatively few treaties with non-OECD countries and is actively interested in negotiating more such treaties. Reducing U.S. withholding taxes, however, is unlikely to be a major motive for these countries either, because the United States is not a major target for investors from developing countries (and they are uninterested in encouraging outbound investment). Instead, they are more interested in the encouragement of U.S. investors that results from a tax treaty with the United States.

C. Adopt a default formula

Transfer pricing is a major source of transactional complexity. Outbound transfer pricing can be dealt with by abolishing deferral, but this seems unlikely at the moment and would not address inbound transfer pricing. Thus, it seems necessary to do something about transfer pricing and, more generally, the division of active income among source jurisdictions (that have the primary right to tax active income under the benefits principle).

The most significant development in transfer pricing in recent years is the rise of advance pricing agreements (APAs). In particular, the availability of the formulary methods to split the residual profit (which cannot be allocated using comparables since no comparables exist) in multilateral APAs, like the ones applicable to global trading, is a major step forward. APAs are complicated to negotiate, however, especially with multiple taxing jurisdictions, and there are many multinationals that refuse to enter the process despite the recent string of victories by the Internal Revenue Service (IRS) in the transfer pricing area.[14]

Thus, it seems advisable *to adopt a default formulary apportionment rule to apply to taxpayers who refuse to enter the APA program* either because of its cost or because litigation offers a better prospect of success. The formula should be simple to understand and to apply, and the three-factor state formula seems a good candidate.[15] The major drawback of this formula is that it ignores intangibles, but a good argument can be made that the residual profit from intangibles results from the relationship among the related entities and therefore cannot be allocated among them in any but an arbitrary way.[16] If taxpayers feel the formula is biased against them in some way, they will be free to enter negotiations for an APA.

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11. See *SDI Netherlands v. Commissioner*, 107 T.C. 161 (1996) (royalties paid to and by a "Dutch sandwich" company not subject to withholding).
12. This author would thus prefer abolishing I.R.C. § 897 (Foreign Investment in Real Property Tax Act or FIRPTA) – a useless, xenophobic section that achieves transactional complexity principally by requiring documentation of non-foreign status in every securities transaction where real estate is a significant source of value. It is not as if the underlying source of value added (i.e. the real estate) is likely to leave U.S. taxing jurisdiction.
13. At the very least, the United States should repeal I.R.C. § 884 (the branch profits tax) as an unnecessary effort to impose two levels of tax on inbound corporate investors. Of course, that would have the practical effect (in these days of limited liability companies (LLCs)) of eliminating the dividend withholding tax as well. I.R.C § 163(j) (the earning stripping rule), however, should be retained because it is needed to preserve the single U.S. source-based tax on active income.
14. See e.g. *DHL Corp.*, 76 T.C.M. 1122 (1998), *United Parcel Service*, 78 T.C.M. 262 (1999), *Compaq Computer*, 113 T.C. No. 17 (1999), and *The Limited, Inc.*, 113 T.C. No. 13 (1999), all transfer pricing cases won by the IRS. *United Parcel Service*, however, was reversed on appeal, 2001 U.S. App. LEXIS 13926 (11th Cir. 2001).
15. It clearly formed the basis for the formula used in the global trading APAs.
16. For a more elaborate statement of this proposal, see Avi-Yonah, Reuven S., "The Rise and Fall of Arm's Length: A Study in the Development of US International Taxation", 15 *Virginia Tax Review* 89 (1995).

The concern with the United States adopting a formula would be an increased risk of double taxation if other countries refuse to go along. It is not clear, however, that they would – even the OECD transfer pricing guidelines permit the use of formulas ("any other method") if all parties agree. The United States has pioneered many useful international tax rules, such as the foreign tax credit and controlled foreign corporation (CFC) legislation, and it can be a pioneer in this field as well.

D. Simplify the anti-deferral rules

The most significant simplification measure possible in the outbound area would be to abolish deferral altogether by looking through all CFCs, as proposed by Peroni, Fleming and Shay.[17] This is particularly appealing since, after check-the-box, deferral has become elective and ending deferral would eliminate outbound transfer pricing as well as many other sources of complexity.[18]

In the current political climate, however, abolishing deferral seems highly unlikely. Thus, the most sensible proposal is the one adopted by the Joint Committee on Taxation.[19] Under this proposal, *four out of the current six anti-deferral regimes would be eliminated*. The accumulated earnings tax, the foreign personal holding company (FPHC) regime and the foreign investment company regime would be abolished, and the personal holding company regime would not apply to foreign corporations. The only remaining regimes would be the passive foreign investment company (PFIC) regime and Subpart F, which apply to portfolio and controlling shareholders, respectively (and do not overlap). Sensibly, the Joint Committee did not attempt to invent a new regime that would be an amalgam of the PFIC and FPHC regimes, as was attempted by Dan Rostenkowski in the 1992 legislation.

It has been quite frustrating to operate under all six regimes since 1992, when they were almost eliminated. Hopefully, this time, the opportunity will not be missed, and the Joint Committee's recommendation will be adopted as soon as possible. The only question is whether some further simplification should be achieved within the PFIC regime, which is burdensome for small taxpayers. This author would prefer a de minimis rule for PFIC income (e.g. USD 10,000 per taxpayer, indexed for inflation) for cases in which the violation of horizontal equity is not egregious enough to justify imposing the PFIC regime.

E. Simplify Subpart F

The biggest missed opportunity in the Joint Committee Study is its failure to address Subpart F, primarily because of its political salience. As this author has written elsewhere, Subpart F as currently drafted is obsolete because it relies on an active/passive distinction that is unrelated to the underlying question whether the income has been taxed elsewhere and should therefore (under the benefits principle) be exempt from further U.S. tax. Instead, the United States should follow most other OECD countries by *applying Subpart F to cases where the income was not subject to an effective tax rate overseas that is at least 90% of the U.S. corporate rate*.[20] This "low-tax kick-in" is consistent with one of the recommendations of the recent Treasury Study of Subpart F and is unlikely to put U.S. multinationals at a competitive disadvantage given the CFC rules of our trading partners.[21]

F. Abandon the baskets

The principal rationale for the current basket system for the foreign tax credit (I.R.C. § 904(d)) is capital export neutrality (CEN). Absent some limitation on cross-crediting or averaging, taxpayers in an excess credit position have an incentive to derive income from low-tax countries rather than from the United States, thus violating CEN. This can be illustrated by the following example, in which a taxpayer invests first in a high-tax foreign country, Foreign Country A:

	Foreign Country A
taxable income	100
foreign tax	50
U.S. tentative tax	35
foreign tax credit limitation	35 (35% x 100)
foreign tax credit	(35)
net U.S. 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 is:

	Foreign Country A	United States
taxable income	100	100
foreign tax	50	0
U.S. tentative tax	35	35
foreign tax credit limitation	35 (35% x 100)	0
foreign tax credit	(35)	0
net U.S. 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 is:

	Foreign Country A	Foreign Country B
taxable income	100	100
foreign tax	50	0
U.S. tentative tax	35	35

17. See Peroni, Robert, J. Clifton Fleming and Steve Shay, "Getting Serious about Curtailing Deferral of U.S. Tax on Foreign Source Income", 52 *Southern Methodist Univ. Law Review* 455 (1999).
18. For a listing, see Avi-Yonah, Reuven S., "To End Deferral as We Know It: Simplification Potential of Check the Box", 74 *Tax Notes* 219 (1997).
19. Joint Committee Study, supra note 1, at 834.
20. See Avi-Yonah, Reuven S., "U.S. Notice 98-11 and the Logic of Subpart F: A Comparative Perspective", 98 *Tax Notes International* 1797 (8 June 1998).
21. See U.S. Department of the Treasury, "The Deferral of Income Earned Through U.S. Controlled Foreign Corporations: A Policy Study", 2001 *WTD* 1-45 (2001).

foreign tax credit limitation	70 (35% x 200)	70
foreign tax credit	(50)	0
net U.S. 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.

Consider, however, a taxpayer in excess limitation because the taxpayer invests first in Foreign Country B:

	Foreign Country B
taxable income	100
foreign tax	0
U.S. tentative tax	35
foreign tax credit limitation	35 (35% x 100)
foreign tax credit	0
net U.S. tax	35
total tax	35
after-tax income	65
excess limitation	35

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

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

If the taxpayer invests in Foreign Country A, the result is:

	Foreign Country B	Foreign Country A
taxable income	100	100
foreign tax	0	50
U.S. tentative tax	35	35
foreign tax credit limitation	70 (35% x 200)	70
foreign tax credit	0	(50)
net U.S. 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 tax revenues of the U.S. Treasury, which in the case of the U.S. investment are 70, but in the case of the Foreign Country A investment are only 20.

The general conclusion therefore is that the basket system is needed to protect CEN only for taxpayers in excess credit, but not for taxpayers at the limit or in excess limitation positions. Since most U.S. 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 tax rates at the expense of the U.S. Treasury. Having made that concession, however, it does not appear sensible 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 seem to be able to do today as well with much transactional complexity and planning.[22] Full crediting of foreign taxes imposed primarily on active income is consistent with CEN and with the single tax and benefit principles. Therefore, this author proposes *abolishing the baskets and permitting taxpayers to cross-credit freely*. This would eliminate a major source of transactional complexity.

IV. CONCLUSION

The foregoing six proposals, if adopted, would represent a major step forward in rationalizing and simplifying the U.S. international tax regime. The proposals need not be adopted as a package: any single proposal can stand on its own, although, as a political matter, it may be advisable to bundle them together (e.g. reforming Subpart F as a trade-off for abolishing the baskets).

These six proposals do not, of course, represent the only ways in which the U.S. international tax regime can be simplified. Each proposal, however, offers the potential for a significant reduction of *transactional* complexity, which, in terms of wasted effort and needless costs, is much more important than simplifying the statutory language or length of the I.R.C. This distinction can be illustrated by a recent proposal not supported by this author: to move the United States to a territorial (exemption) regime. Such a regime could certainly simplify the I.R.C. because all the anti-deferral rules and the foreign tax credit rules could be eliminated in one fell swoop. There would, however, be a significant added level of transactional complexity because of the increased need to monitor the source of income (since only U.S.-source income would be taxable for all taxpayers) and transfer pricing. Thus, it seems that this proposal does not offer a real chance for simplification. Simplification is worthwhile only if it can reduce the staggering amount of resources currently devoted to enforcing and complying with the U.S. international tax rules. Hopefully, this article makes useful suggestions in that direction.

22. The IRS and the courts, however, should continue to be vigilant in regard to crediting foreign taxes where the burden clearly does not fall on the taxpayer, as in the *Compaq* case (*Compaq Computer*, 113 T.C. 214 (1999)) and the examples described in Notice 98-5, 1998-3 I.R.B. 49. These precedents seem a sufficient deterrent to prevent abuse of a basketless regime.