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## The U.S. Treasury's Subpart F Report: Plus Ça Change, Plus C'est La Même Chose?

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# The U.S. Treasury's Subpart F Report: *Plus Ça Change, Plus C'est la Même Chose?*

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## I. INTRODUCTION

On 29 December 2000, the U.S. Treasury Department released its long-awaited study of Subpart F, entitled "The Deferral of Income Earned through U.S. Controlled Foreign Corporations" (hereafter "Treasury Study").<sup>1</sup> This study was commenced in the aftermath of the controversy that ensued from the issuance and subsequent withdrawal of Notice 98-11.<sup>2</sup> The study was originally expected to be issued in 1999 in response to the report published that year by the National Foreign Trade Council (hereafter "NFTC Report"), which advocated significant changes in Subpart F.<sup>3</sup> The Treasury Study's delayed issuance at the end of the Clinton Administration means that it only has (at best) persuasive force for the Bush Administration and Congress. However, even though the Treasury Study lacks the political authority it would have enjoyed had it been published a year earlier (or had Al Gore been elected), it is an impressive document (226 pages long) and well worth studying as we await the legislative outcome.

This article is divided into three parts. The first part summarizes the Treasury Study and highlights its main conclusions and recommendations, contrasting them with the almost diametrically opposed conclusions of the NFTC Report. The second part considers where U.S. tax policy in this area is likely to be headed and whether this direction is likely to be beneficial. The third part concludes.

## II. THE TREASURY STUDY

The Treasury Study is divided into eight chapters. After an Introduction that outlines the study's aims and structure come two chapters on the "original intent" of Subpart F, explaining what concerns led to its enactment in 1962. Then follow two chapters analysing Subpart F from an economic perspective, first in terms of its impact on welfare and then in terms of its impact on the competitiveness of U.S. multinationals. Chapters 5 and 6 address the questions whether Subpart F is achieving its policy goals in light of various techniques to avoid it and developments that undermine its application, such as the rising importance of services and of electronic commerce. Finally, Chapter 7 makes several alternative proposals for changes in Subpart F. Chapter 8 concludes.<sup>4</sup>

The first substantive chapter of the Treasury Study deals with the historical background to the original enactment of Subpart F in 1962. It explains the basic availability of deferral under the U.S. international income tax regime, which combines the separate accounting treatment of related corporations with a formalistic definition of which

corporations are considered to be U.S. residents (and hence subject to taxation on their worldwide income). Chapter 1 then surveys the various anti-deferral regimes adopted before 1962 and explains that none of them effectively applied to foreign subsidiaries (controlled foreign corporations or CFCs) of U.S.-based multinational enterprises (MNEs).<sup>5</sup> Finally, Chapter 1 considers the rising use of tax havens by U.S.-based MNEs in the 1950s and early 1960s. It argues that "the main thrust of the tax avoidance techniques which led to the enactment of subpart F was the 'deflection' of income to low-tax jurisdictions not only from the United States, but also from foreign high-tax developed countries where the principal value-adding activity took place".<sup>6</sup>

Chapter 2 of the Treasury Study discusses the legislative history and intent of Subpart F. The NFTC Report addressed the same issue and argued that, while the Kennedy administration proposal (to end deferral altogether for U.S.-controlled foreign corporations) was motivated primarily by capital export neutrality (CEN) concerns, Congress rejected that view in enacting the compromise that became Subpart F. "Attempting to force a strained interpretation of the legislation [Congress] did enact into an endorsement of capital export neutrality ... flagrantly disregards the historical record".<sup>7</sup> The Treasury Study rejects this view, and points out that Subpart F as

1. U.S. Department of the Treasury, Office of Tax Policy, "The Deferral of Income Earned Through U.S. Controlled Foreign Corporations: A Policy Study", 2001 WTD 1-45 (2 January 2001).

2. 1998-6 I.R.B. 18 (16 January 1998), withdrawn by Notice 98-35, 1998-27 I.R.B. 35. For an analysis of the debate on Notice 98-11, see e.g. Tillinghast, David R., "An Old-Timer's Comment on Subpart F", 98 *Tax Notes International* 61-24 (31 March 1998); Avi-Yonah, Reuven, "U.S. Notice 98-11 and the Logic of Subpart F: A Comparative Perspective", 98 *Tax Notes International* 1797 (8 June 1998).

3. National Foreign Trade Council, "The NFTC Foreign Income Project: International Tax Policy for the 21st Century, Part I: A Reconsideration of Subpart F" (25 March 1999). For a review, see Avi-Yonah, Reuven, "Tax Competition and Multinational Competitiveness: The New Balance of Subpart F", 18 *Tax Notes International* 1575 (19 April 1999).

4. There are also four appendices dealing with the development of U.S. anti-deferral regimes (App. A), a survey of economic studies on the international mobility of capital (App. B), the measurement of tax rates (App. C), and a survey of economic studies of income shifting by multinational enterprises (App. D).

5. Two of these regimes (the accumulated earnings tax and the personal holding company tax) were not intended to apply to foreign corporations, while the third, the foreign personal holding company regime, requires control by five or fewer U.S. individuals. In the author's view, these three regimes as well as the foreign investment company regime from 1962 are all obsolete and should be repealed (at least insofar as they apply to foreign corporations).

6. Treasury Study, text at footnote 45. This is a veiled reference to the debate around Notice 98-11, which revolved around practices that avoided the tax of other higher-tax countries (such as Germany), rather than U.S. tax.

7. NFTC Report, at 2-20.

enacted is perfectly compatible with an emphasis on CEN. That is because Congress assumed (correctly, for 1962) that active business income could largely be earned only in countries with tax rates similar to the United States, and therefore permitting deferral of U.S. tax on such income did not violate CEN.<sup>8</sup> Thus, “Congress was prepared to allow some tax disparity and to forego the minimal marginal tax it would have collected if deferral had been ended. Congress did not, however, endorse significant tax disparity”.<sup>9</sup> The Treasury Study concludes that, in enacting Subpart F, “Congress sought to end deferral for income obtained through [tax haven devices], without regard to whether those devices were used to avoid foreign tax or U.S. tax”.<sup>10</sup> In reaching the conclusion that the changes Congress made to the Kennedy Administration proposal “did not, as a practical matter, greatly weaken the capital export neutrality impact of subpart F”, the Treasury Study concurs with the assessment of insiders made shortly after enactment.<sup>11</sup> It thus seems that the Treasury Study is closer to historical reality than the NFTC Report, although it is unclear whether this legislative history should have any bearing on the discussion of whether and how Subpart F should be reformed 40 years later.

Chapter 3 of the Treasury Study is an important and innovative examination of Subpart F from the perspective of economic welfare. Several noted economists have recently questioned the continuing validity of CEN as a principal guideline for U.S. international tax policy.<sup>12</sup> The Treasury Study surveys the arguments of this literature and concludes that whether one takes the traditional maximization of global welfare or the narrower maximization of U.S. national welfare as the goal, CEN remains the best policy option:<sup>13</sup>

A careful review of the literature reveals that [CEN] is probably the best policy when the goal is to provide the greatest global economic output .... Similarly, with respect to national economic welfare, a careful review of the literature provides no convincing basis for rejecting the conclusions of the basic economic analysis that a country should tax income from outward foreign investment at a rate that is at least as high as the tax rate imposed on income from domestic investment.<sup>14</sup>

With regard to the specific Subpart F foreign-to-foreign related party rules (i.e. the base company sales and services rules and the rules on passive income from related parties), however, the Treasury Study sounds a more hesitant note. “The subpart F foreign-to-foreign related party rules do not necessarily improve global economic welfare” because they may just push investment from high-tax to low-tax foreign countries.<sup>15</sup> Moreover, these rules also do not necessarily improve U.S. national welfare in the short run because they would increase the revenues of foreign governments (and not of the United States). In the long run, however, “tightening these rules may cause U.S. companies to choose U.S. investment rather than foreign investment, which ... could produce a net national gain”.<sup>16</sup> In addition, the Treasury Study concludes that relaxing or repealing the foreign-to-foreign related party rules would likely lead to revenue losses for the United States. These conclusions are important because the principal legislative recommendation of the NFTC Report, which may be the basis of forthcoming legislation, is the repeal of the for-

ign-to-foreign related party rules in the name of enhancing the competitiveness of U.S.-based MNEs.

Chapter 4 of the Treasury Study addresses the thorny issue of the relationship between Subpart F and the competitiveness of U.S.-based MNEs. The argument that Subpart F impedes U.S.-based MNEs from competing with their foreign-based counterparts in the central thesis of the NFTC Report.<sup>17</sup> The Treasury Study responds that the assertion is not based on any data: “the available data simply does not provide a reliable basis for evaluating whether subpart F has affected competitiveness to any significant extent”.<sup>18</sup> This issue may in fact depend on which data is selected. For example, the NFTC Report emphasizes that, while in 1960 18 of the world’s 20 largest corporations ranked by sales were American, by 1996 the figure had fallen to eight.<sup>19</sup> The Treasury Study counters that, in July 2000, all of the world’s top five companies, 61 of the world’s top 100 companies and 484 of the world’s top 1,000 companies based on market value were American.<sup>20</sup> Moreover, despite the increased international competition highlighted by the NFTC Report, U.S. corporations’ share of worldwide profits rose from 36% in 1990 to 44% in 1998.<sup>21</sup> Of course, these figures may have been even higher absent Subpart F, but the Treasury Study concludes that this cannot be effectively proved. Moreover, the Treasury Study takes issue with the conclusion of the NFTC Report that Subpart F impedes competitiveness because it is tougher on U.S.-based MNEs than similar rules that apply to foreign-based MNEs.<sup>22</sup> The Treasury Study concludes that “foreign multinational corporations

8. In 1962, 80% of U.S. outbound foreign direct investments were into Canada and European countries, with tax rates as high or higher than the United States. See Avi-Yonah, *supra* note 2.

9. Treasury Study, Chapter 2, text at footnote 41. The exception was free world developing countries, for which deferral was granted for Cold War-related reasons.

10. *Id.*, Chapter 2, at III.

11. *Id.*, Chapter 2, text at footnote 1; see e.g. Ross, Stanford G., “Report on the U.S. Jurisdiction to Tax Foreign Income”, 496 *Studies on International Fiscal Law* 184, 212 (1964).

12. See Hines, James, “The Case against Deferral: A Deferential Reconsideration”, 52 *National Tax Journal* 385 (1999); Altshuler, Roseanne, “Recent Developments in the Debate on Deferral”, 87 *Tax Notes International* 255 (2000), and the works cited therein.

13. For an argument that national, rather than global, welfare should guide U.S. international tax policy, see Graetz, Michael, “2000 Tillinghast Lecture” (forthcoming in *Tax Law Review*). In the view of the present writer, this seems to take a rather short-sighted view of the relationship between global and national welfare. See Treasury Study, Chapter 3, text at footnote 3.

14. Treasury Study, Chapter 3, at I.

15. *Id.* This conclusion is reached because the base company rules do not reach low-taxed active income.

16. *Id.*

17. NFTC Report, at x: “the current structure of subpart F leans far too heavily in the direction of seeking to preserve an illusory neutrality, at the expense of imposing a real competitive disadvantage on U.S.-based companies.”

18. Treasury Study, Chapter 4, text at footnote 7.

19. NFTC Report, at xvi. This argument assumes that having U.S. rather than foreign-based MNEs dominate world markets is important to U.S. national welfare, which is not a universally-shared view. See Reich, Robert, *The Work of Nations* (1993).

20. Treasury Report, Chapter 4, text at footnote 6.

21. *Id.*, Chapter 4, text at footnote 7.

22. NFTC Report, at xiv: “In virtually every scenario considered ... the U.S. imposed the severest regime.” These “scenarios”, however, are purely hypothetical.

are subject to rules that are similar in effect to our subpart F rules".<sup>23</sup>

Chapter 5 of the Treasury Study surveys some current techniques for avoiding the rules of Subpart F, such as hybrid entity techniques (illustrated by Notice 98-11), contract manufacturing, commissionaire arrangements, and using dual resident corporations. The chapter concludes that "it may be possible to circumvent crucial provisions of subpart F" by such techniques.<sup>24</sup>

Chapter 6 of the Treasury Study discusses the challenges posed to Subpart F by recent tax and business developments. It points out that the adoption of the check-the-box entity classification rules in 1996, and in particular their extension to foreign "disregarded entities", have formed the basis for some of the avoidance techniques discussed in Chapter 5.<sup>25</sup> Chapter 6 notes that, as of March 2000, there were 7,875 elections made under the check-the-box regulations to disregard foreign entities that were treated as corporations in the host countries, whereas before these rules were adopted, there were at most a few hundred of these hybrids.<sup>26</sup> In addition, the Treasury Study points out that the rising importance of services (as illustrated by the enactment of an exception for financial services) and of electronic commerce also poses challenges to the structure of Subpart F, and in particular for the active/passive distinction which underlies it.<sup>27</sup>

Finally, Chapter 7 of the Treasury Study discusses options for changing and updating Subpart F, without making specific legislative recommendations. The chapter briefly outlines three alternative options for reform. The first option is the outright repeal of deferral, as proposed by the Kennedy Administration in 1961 (and by numerous commentators, including the present writer, since then).<sup>28</sup> This can be achieved either by simply expanding Subpart F to cover all income or by treating CFCs as branches or as domestic corporations.<sup>29</sup> The Treasury Study concludes that this option "would do the most to promote equity among U.S. taxpayers ... ending deferral would also be likely to have the most positive long-term effect on economic efficiency and welfare", as well as providing "considerable simplification".<sup>30</sup> While this option would "set the U.S. regime apart from the regimes of its major trading partners", it would not clash with such regimes because of the availability of a foreign tax credit.<sup>31</sup> The Treasury Study does not, however directly address the competitiveness implications of this proposal, which probably make it a political non-starter.

The second policy option discussed by the Treasury Study is similar to the first in that all the income of CFCs would be subject to Subpart F. Active income, however, would be included at a lower rate.<sup>32</sup> The Treasury Study concludes that this option would also have efficiency, equity and simplification advantages, but less so than the first option (and depending crucially on the rate, which is not specified).<sup>33</sup>

The final option discussed by the Treasury Study involves retaining Subpart F but repealing the foreign-to-foreign related party rules, which include the base company rules as well as passive income derived from related parties. Instead, the Treasury Study proposes that an effective tax

rate test be imposed on active income (while passive income from unrelated parties would be included as under present law). Under this test, active income of CFCs would enjoy deferral if subject to some unspecified minimal foreign tax rate, but otherwise would be currently taxed to the U.S. parent.<sup>34</sup> The Treasury Study states that the option offers efficiency and equity advantages that depend on the effective rate set, but that calculating the effective tax rate "could add complexity".<sup>35</sup> The Treasury Study concludes by summarizing its findings, stating that "[a]n anti-deferral regime [like subpart F] continues to be needed to prevent significant disparity between the rates of tax on U.S. and foreign income, thereby promoting efficiency, preserving the tax base and promoting equity".<sup>36</sup>

### III. THE FUTURE OF SUBPART F

Given the outcome of the recent U.S. election, the Treasury Study seems unlikely to have much impact. Instead, the Bush Administration and Congress seem more likely to be attentive to the NFTC Report. How attentive depends crucially on the attention paid to the lobbying efforts of U.S.-based MNEs, compared to the more diffuse voices of small business (which is more likely to be purely domestic and therefore less likely to benefit from the reduced taxation of foreign-source income).

The NFTC Report does not contain specific legislative recommendations, but its overall thrust is clear: "Changes in the international economic environment ... support a shift in the balance of U.S. international tax policy toward competitiveness and away from capital export neutrality. This could be accomplished by narrowing the scope of

23. Treasury Study, Chapter 4, at IV. This discussion assumes that MNE competitiveness, rather than for example the standard of living competitiveness of U.S. residents, should be the focus of U.S. tax policy, which seems a dubious proposition at best. See Joint Committee on Taxation, "Factors Affecting the International Competitiveness of the United States" (1991) (discussing various forms of competitiveness).

24. Treasury Study, Chapter 5, at III.

25. *Id.*, Chapter 6, at II.

26. *Id.*, Chapter 6, text at footnote 8.

27. *Id.*, Chapter 6, at III-IV. Nevertheless, in its proposed options, the Treasury continues to rely on this distinction.

28. See e.g. Peroni, Robert, J. Clifton Fleming and Stephen Shay, "Getting Serious about Curtailing Deferral of U.S. Tax on Foreign Source Income", and Avi-Yonah, Reuven, "Commentary", 52 *Southern Methodist Univ. Law Rev.* (1999), at 455 and 531, respectively.

29. Treasury Study, Chapter 7, at III.B.

30. *Id.*, Chapter 7, text at footnotes 11 and 12. For example, ending deferral would eliminate outbound transfer pricing issues. See Avi-Yonah, Reuven, "To End Deferral as We Know It: Simplification Potential of Check the Box", 74 *Tax Notes* 219 (1997).

31. Treasury Study, Chapter 7, text at footnotes 11-12.

32. A similar proposal was developed by Stuart Leblang. See Sheppard, Lee, "Rethinking U.S. Treasury's Subpart F Study", 2001 WTD 8-7 (8 January 2001).

33. Treasury Study, Chapter 7, at III.C.

34. A similar proposal was made by Avi-Yonah; see Avi-Yonah, *supra* note 2.

35. Treasury Study, Chapter 7, at III.D. Appendix C discusses the economic studies on the measurement of effective tax rate, suggesting that it can be done; a similar calculation is now required under the high-tax exception (Sec. 954(b)(4) of the U.S. Internal Revenue Code).

36. Treasury Study, Chapter 8, at II.

subpart F to portfolio income”.<sup>37</sup> Thus, the NFTC would presumably advocate repeal of the foreign-to-foreign related party rules without any replacement, leaving Subpart F to address only the passive income derived from unrelated parties (a small proportion of the foreign income of most U.S.-based MNEs).

This would be an unfortunate result from the efficiency and equity perspective developed in the Treasury Study. It may, however, enhance competitiveness. In the author’s view, the competitiveness issue should not be viewed from the narrow perspective adopted in both the NFTC Report and the Treasury Study. These studies focus on the competition in the market between U.S.-based and foreign-based MNEs, for which (as the Treasury Study points out) there is little data that supports the assertion that Subpart F puts U.S.-based MNEs at a competitive disadvantage. A better perspective would be to focus on the impact of Subpart F on two related issues: the likelihood that new MNEs will be formed in the United States and the takeover of U.S.-based MNEs by foreign-based MNEs. As for the former, the increased recent use of “inversion” transactions, in which a publicly held U.S.-based MNE reincorporates in a low-tax jurisdiction, suggests that there may indeed be a tax incentive to relocate new MNEs outside the United States.<sup>38</sup> As for the latter, there is considerable, albeit anecdotal, evidence that in some recent well-publicized takeovers of U.S.-based MNEs by foreign-based MNEs, the decision to form the new parent corporation overseas was in part motivated by tax considerations, primarily avoiding Subpart F.<sup>39</sup>

Nevertheless, restricting Subpart F to passive portfolio income because of such competitiveness issues at the expense of both efficiency and equity seems a bit unbalanced. This is so in particular because of an additional development that is not extensively discussed in either the NFTC Report or the Treasury Study. This development is the OECD’s harmful tax competition initiative, which is still advancing despite recent setbacks with respect to traditional offshore tax havens. In this regard, the key aspect of the OECD’s initiative is its determination to address the problem of harmful preferential tax regimes (in both OECD countries and non-OECD countries). Such regimes form the key to the use of tax disparities to avoid any current tax on active income, which is the focus of attention in the Treasury Study. In fact, the present writer has argued elsewhere that Subpart F is obsolete precisely because it assumes that active income can be earned only in high-tax countries, an assumption that was correct in 1962 but is no longer valid today, given the rise in preferential regimes (“production tax havens”).<sup>40</sup> The OECD’s harmful tax competition report recommends that the OECD countries tighten CFC rules (like Subpart F) to combat the avoidance potential inherent in preferential tax regimes. This, in turn, is the way to overcoming the (false) dichotomy

between efficiency and equity on one side (the Treasury Study) and competitiveness on the other (the NFTC Report): If the United States and its OECD allies could agree to simultaneously tighten CFC regimes, there would be no competitive disadvantage to anyone’s MNEs (since over 85% of MNEs are based in OECD countries).<sup>41</sup> The most plausible solution seems to be the concurrent adoption of an effective minimum tax rate, as in the third option discussed by the Treasury Study.<sup>42</sup>

If the United States were to adopt the conclusions of the NFTC Report, it would seem to be missing (in the name of competitiveness) a golden opportunity to use the OECD to overcome the competitiveness problem. The likely reaction of the other OECD countries would be to relax their own CFC rules, and a “race to the bottom” could ensue. This would be particularly ironic since the United States led the world in adopting the first CFC regime (Subpart F) unilaterally, and the other OECD countries followed in a “race to the top”.

### III. CONCLUSION

The Treasury Study is a significant contribution to the U.S. international tax policy literature. In particular, the economic chapters (Chapters 3 and 4) provide the best analysis to date of the continuing relevance of CEN and the lack of convincing arguments against it. In the current political climate, however, this is unlikely to be persuasive. It would be unfortunate if the United States were to gut Subpart F in the name of competitiveness at the very moment that the OECD’s harmful tax competition initiative provides an opportunity to update Subpart F without harming competitiveness.

37. NFTC Report, at xxi. If enacted, the proposal would cap a multi-year effort (since 1995) to roll back Subpart F, beginning with the repeal of Sec. 956A and continuing with the elimination of the CFC/PFIC (passive foreign investment company) overlap and the enactment of the financial services exception.

38. See Notice 94-46, 1994-1 C.B. 356, and the regulations thereunder (Reg. 1.367(a)-3). These rules do not seem to affect this trend because they impose only a shareholder-level toll charge, which does not deter new U.S. corporations from reincorporating elsewhere when the gain is relatively small.

39. See e.g. Daimler-Chrysler. See Staffaroni, Robert J., “Size Matters: Section 367(a) and the Acquisition of U.S. Corporations by Foreign Corporations”, 52 *Tax Lawyer* 523 (1999).

40. See Avi-Yonah, supra note 2.

41. There is, however, a question whether this would not lead to reincorporations or start-ups in non-OECD countries. Since these are poorer countries, encouraging their growth may not be a bad result but, if needed, a tentative resolution based on the market power of the rich countries could be developed. See Avi-Yonah, Reuven, “Globalization, Tax Competition and the Fiscal Crisis of the Welfare State”, 103 *Harvard Law Rev.* 1573 (2000).

42. Note, however, that the Treasury Study insists on maintaining an active-passive distinction that is arguably obsolete and, in any case, unnecessary if an overall effective tax rate test is adopted.