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U.S. Notice 98-11 and the Logic of Subpart F: A Comparative Perspective

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Special Reports

U.S. Notice 98-11 and the Logic of Subpart F: A Comparative Perspective

by Reuven S. Avi-Yonah

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In this report, he argues that the dichotomy between active and passive income that underlies subpart F and Notice 98-11 is obsolete, and should be replaced with an explicit link to source tax rates, as most of our trading partners do in similar legislation.

The debate about Notice 98-11 and the temporary regulations implementing it seems to be an appropriate occasion for asking whether the policy mix underlying subpart F is still valid 36 years after its enactment.[1] (For the full text of Notice 98-11, see *Doc 98-2983 (6 pages)*.) Raising policy questions seems particularly appropriate since the administration has asked Congress to ratify its actions in this area through legislation, although Congress currently seems more inclined to overrule the temporary regulations.[2]

Subpart F was enacted in 1962 as a result of a compromise between the Kennedy administration, which proposed terminating deferral altogether, and Congress, which "recognized the need to maintain active American business operations abroad on an equal competitive footing with other operating businesses in the same country."[3] The legislative history explains that "[y]our committee's bill does not go as far as the president's recommendations. It does not eliminate tax deferral *in the case of operating businesses owned by Americans which are located in the economically developed countries of the world*."[4]

The floor debates, likewise, constantly emphasize the distinction between "manufacturing or similar operating company" activities, which were to continue benefiting from deferral, and "tax haven devices," for which deferral was to be eliminated.[5]

Thus, the assumption underlying subpart F was that a distinction could be drawn between two types of foreign operations: (a) active operating businesses, which

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[1]Notice 98-11, 1998-6 IRB 16; for the debate on the notice, *see, e.g.*, New York State Bar Association, "Notice 98-11: Tax Treatment of Hybrid Entities in the U.S.," *Tax Notes Int'l*, May 25, 1998, p. 1669, or *Doc 98-13191 (21 pages)* ("the NYSBA Report"); Cooper, Melcher, and Stretch, "Suddenly Saving Foreign Taxes Is Abusive? An Untenable Proposal," *Tax Notes Int'l*, Mar. 9, 1998, p. 779, or *Doc 98-8510 (8 pages)*; Gannon, Calianese *et al.*, "U.S. Subpart F, Hybrid Entities, and Other Little Things," *Tax Notes Int'l*, May 4, 1998, p. 1467, or *Doc 98-13237 (13 pages)*; Ganz and Strange, "Inclusion of Subpart F Income Under Hybrid Branch Regs — How the Regs Work," *Tax Notes Int'l*, Apr. 27, 1998, p. 1332, or *Doc 98-13280 (2 pages)*; Hariton, "Notice 98-11 Notwithstanding, What Should Be Done With Subpart F?," *Tax Notes Int'l*, Apr. 6, 1998, p. 1089, or *Doc 98-11437 (3 pages)*; Sheppard, "Sweet Tax Nothings: Rethinking U.S. Treasury's Foreign Policy," *Tax Notes Int'l*, Apr. 20, 1998, p. 1229, or *Doc 98-12099 (6 pages)*; Sheppard, "U.S. Cross Border Tax Arbitrage, 'Hybridity,' Mules, and Hinnies," *Tax Notes Int'l*, Feb. 23, 1998, p. 579, or *Doc 98-6196 (11 pages)*.

[2]"Prescribe Regulatory Directive to Address Tax Avoidance Through Use of Hybrids," p. 144 of the General Explanation of the Administration's Revenue Proposals (Feb. 2, 1998).

[3]S. Rep. No. 1881 at 83, 1962-3 C.B. 789; H.R. Rep. No. 1447, at 62, 1962-3 C.B. 461.

[4]*Ibid.* (Emphasis added.)

were typically located in "economically developed countries" and were therefore subject to significant positive foreign tax rates, and (b) investment yielding passive income and "base" companies, which (precisely because they did not involve "real" business activities) could be earned in jurisdictions offering low or zero tax rates. Deferral was to be allowed for the former category on competitive grounds because the foreign tax rate, while significant, may be lower than the U.S. rate and therefore a controlled foreign corporation (CFC) would be at a competitive disadvantage vis-à-vis a local competitor paying only the foreign tax.[6] Deferral was to be denied in the latter case because the combination of a low foreign tax and deferral gave U.S. multinationals too much of an incentive to invest abroad rather than at home.[7]

The fundamental problem raised by subpart F today is that this dichotomy, as envisaged by Congress in 1962, is no longer valid. Specifically, the assumption that active business operations (as opposed to passive income and base company operations) cannot be conducted in low-tax jurisdictions is incorrect. As of last year, there were 68 countries in the world that offered "production tax havens," i.e., special tax regimes that grant temporary or permanent tax holidays to foreign investors conducting active business operations therein.[8] From the point of view of these countries, the tax holiday is geared precisely toward active manufacturing operations, because those operations contribute to relieving unemployment and the employees gain valuable skills, which they can carry with them to other jobs. The main difference between such production tax havens and traditional tax havens is that the tax holidays are granted only to foreign investors; local companies and the local population are subject to significant tax burdens, which may even have to be raised to provide infrastructure and other services to the foreign investors. Most of these production tax havens were introduced since 1980, that is, long after the enactment of subpart F.

A specific example can perhaps clarify how U.S. multinationals benefit from production tax havens. Intel Corporation, a top-10 multinational, has major manufacturing facilities outside the United States in China, Ireland, Israel, Malaysia, the Philippines, and Puerto Rico.[9] All of these manufacturing facilities are located in countries that grant tax holidays, but because the activities therein are active business operations, they are not subject to subpart F and the income from these operations benefits from deferral.[10] The combination of deferral and cross-crediting for income in the general basket means that in most cases no U.S. tax is ever levied on this income, because even when it is eventually repatriated any residual U.S. tax is eliminated by cross-crediting foreign taxes paid by sales subsidiaries located in high-tax jurisdictions.[11]

The assumption that active business operations (as opposed to passive income and base company operations) cannot be conducted in low-tax jurisdictions is incorrect.

This situation was not envisaged by the drafters of subpart F. As the quotations above show, the underlying assumption was that active business operations could not be conducted in low-tax jurisdictions. Otherwise, the dichotomy between "tax haven operations" and "legitimate manufacturing or similar operating company" operations, which was emphasized so much in the legislative history, makes no sense.[12] This explains why there is a "high tax kick-out" provision in subpart F, because Congress was aware that some passive or holding company income may be subject to

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[5] *See* the quotations from the floor debates reproduced in the Appendix to the NYSBA Report.

[6] This argument assumes that taxes are typically shifted forward to consumers (and therefore the CFC would have higher prices than its local competitor), which seems questionable in light of the normal incidence analysis for the income tax (i.e., that it falls on capital or sometimes labor).

[7] This is sometimes labeled "capital export neutrality" or CEN. "Capital import neutrality" or CIN, as mentioned in Hariton and the NYSBA Report, refers to equal treatment of investors in the same country and therefore supports deferral. CEN relates to neutrality in the location of investment; CIN to neutrality in the location of savings, if one assumes that savings in the United States would be lower because its multinationals are subject to higher tax rates — a questionable assumption, as the capital gains debate has shown.

[8] Coopers & Lybrand, 1997 International Tax Summaries (1997). For a fuller discussion of this phenomenon, *see* Avi-Yonah, "International Taxation, Electronic Commerce, and the Problem of Tax Competition," 52 *Tax Law Rev.* (Spring 1997 issue, forthcoming).

[9] http://www.intel.com/intel/inteli/sites.htm.

[10] The ability to defer the income from such operations has been enhanced by the repeal of section 956A.

[11] This means that the United States is effectively granting tax sparing to such production tax havens, a situation that would have made Stanley Surrey (one of the architects of subpart F) extremely unhappy.

[12] Appendix to NYSBA Report.

high foreign taxes, but there is no "low tax kick-in."[13]

It is instructive to compare subpart F in this regard to similar provisions in the legislation of our major trading partners. Limitations on deferral or exemption of certain types of income of controlled foreign corporations (CFCs) were first introduced by the United States in 1962, but have since been adopted by all our major trading partners (including even countries that typically exempt foreign-source income).[14] Perhaps because such legislation was enacted later than subpart F (and thus the other countries could learn from our mistakes), our trading partners tend to link the deferral or exemption explicitly to the tax rate actually imposed on the income abroad (although some also link it to the type of income involved).

For example, Japan grants deferral only if the foreign operations are located in a jurisdiction that has an effective tax rate over 25 percent; otherwise, all income (active or passive) of a CFC is subject to current taxation. Sweden similarly allows deferral only if a foreign corporation is subject to tax in its resident state in a manner comparable to Swedish taxation; otherwise the entity is treated as a passthrough and all its income is taxed currently. The United Kingdom likewise eliminates deferral for corporations subject to a "lower level of taxation," defined as less than 75 percent of the taxes the corporation would have paid as a U.K. resident (although there are in this case significant exceptions for active business operations). Germany permits deferral if the effective tax rate abroad (ignoring operating losses and foreign tax credits) is 30 percent or more, although the rules apply only to passive income. Australia has the most recent set of rules, introduced in 1987. Its regime is based on a "white list" of countries that have significant effective tax rates, for which deferral is permitted, but even for countries on the list income derived from special regimes (such as tax holidays for foreign investors) may be excluded.[15]

Among exemption regimes, Australia and Canada exempt foreign-source dividends if the income was earned in countries where it is likely to have been subject to tax. The French exemption likewise is conditioned on the income being earned in a jurisdiction in which it is subject to an effective tax rate not significantly lower than the French rate, and Germany has a similar rule.[16] It should be noted, however, that some of those countries (for example, Germany) grant extensive tax-sparing credits in their treaties, so that the limitations apply only to treaty countries.

Our trading partners tend to link deferral or exemption explicitly to the tax rate actually imposed on income abroad.

It is interesting to reconsider Notice 98-11 against this background. The notice contains two examples of how active income of a CFC can escape foreign taxation while also avoiding subpart F inclusion. In both cases, the key is a hybrid entity treated as a branch under the check-the-box regulations but as a separate entity for foreign tax purposes. In Example 1 in the notice, the CFC borrows funds from a branch of its foreign parent incorporated in the same country as the CFC. The branch is located in a low-tax jurisdiction. For U.S. purposes, the interest paid by the CFC is considered paid to the holding company and therefore is not subject to subpart F because of the same-country exception.[17] For foreign purposes, the interest is considered paid to a separate entity and reduces the foreign tax on the CFC's active income, while not being subject to tax because paid to a low-tax jurisdiction.

The second example in the notice is even simpler: CFC borrows from its own branch, located in a low-tax jurisdiction. For U.S. purposes the loan is ignored because there can be no loan from the taxpayer to itself; for foreign purposes the branch is a separate entity and the interest is deductible in the CFC's jurisdiction and not subject to tax in the branch's jurisdiction. Thus, in both cases the high foreign tax rate on the CFC's income has been eliminated without triggering a subpart F inclusion.

What is not included in the notice is a third example. Suppose the CFC has simply been earning active income in a production tax haven. If the problem in examples 1 and 2 is reducing the foreign tax rate on active income, why should there be deferral in this example 3? Presumably, because Treasury felt that including such an example would exceed their authority to interpret subpart F, and

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[13] *See* section 954(b)(4) (high tax kick-out).

[14] The classic study is Arnold, *The Taxation of Controlled Foreign Corporations: An International Comparison* (Canadian Tax Foundation, 1986).

[15] Ault, *Comparative Income Taxation* (Kluwer, 1997), 413-422.

[16] *Ibid.*, 411-413.

[17] Section 954(c)(3).

is best left to Congress.[18] However, if the analysis above is correct and the purpose of subpart F, like that of the corresponding legislation of our trading partners, was to eliminate deferral for foreign income not subject to significant tax abroad, then this example is just as inconsistent with that purpose as examples 1 and 2.[19]

It thus seems that subpart F, as currently enacted, is obsolete and needs to be reformed. Short of terminating deferral altogether, the solution is to include a "low tax kick-in" similar to those of our trading partners, that is, subject to current tax income of CFCs (whether active or passive) that is not taxed currently at 90 percent of the section 11 rate.[20] Such a move would be consistent with the stated purpose of limiting deferral to U.S. operations in "economically developed countries" with significant tax rates, while eliminating it in the case of "tax havens," including production tax havens.

Objections to such legislation would be made in the name of competitiveness.[21] In particular, some of the CFC regimes of our trading partners (e.g., the United Kingdom) do not apply to active income earned in a low-tax jurisdiction (although some, like Japan, do). In addition, some of our trading partners (such as Germany) grant tax-sparing credits in their treaties. In those cases, a CFC of a U.S. multinational operating, for example, in Brazil would be subject to current U.S. tax on its income while a CFC of a German multinational in Brazil would not be subject to German tax under the Germany-Brazil tax treaty.

However, if this argument ever made sense, it is doubtful that it does now.[22] The OECD has recently come out in a major initiative designed to curb harmful tax competition, defined to include production tax havens. In addition, the OECD also came out against tax sparing, adopting the long-held U.S. position with the concurrence of Germany and other traditional tax-sparing advocates. In particular, the OECD recommends that any applicable limitations on deferral in CFC legislation be given preference over tax-sparing provisions, and that few, if any, new tax-sparing provisions be negotiated.[23] Thus, it seems likely that if we amend subpart F to include a low-tax kick-in, our major trading partners (and potential competitors) will follow our lead and not grant deferral or exemption to income earned in production tax havens.

In 1962, the United States led the world in limiting deferral to income subject to tax abroad. Unfortunately, the definition of subpart F income has failed to keep up with the rise of production tax havens, so that the United States now lags behind its trading partners in actually taxing income earned abroad in low-tax jurisdictions on a current basis. The United States should resume its leadership role in this area by restricting deferral to income that is subject to significant taxes abroad, as originally envisaged by the drafters of subpart F. ✦

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[18]Whether Treasury had authority for examples 1 and 2 is a thorny issue discussed at length in the NYSBA Report; on balance, I believe they do, because the transactions in those examples, defeat the purpose of subpart F in precisely the situation envisaged by its drafters (active income in a high-tax country converted to passive income in a low-tax one).

[19]One interesting question is why would the CFC's country in examples 1 and 2 acquiesce in such earnings stripping. Presumably the answer is that this is a back-door way of granting a tax holiday because politics preclude granting an explicit one (or lowering rates generally).

[20]I would also favor terminating deferral, especially now that it has become elective because of the check-the-box regulations. Such a move carries significant simplification benefits. *See* Avi-Yonah, "To End Deferral as We Know It: Simplification Potential of Check-the-Box," *Tax Notes Int'l*, Dec. 30, 1996, p. 2207, or *Doc 97-128 (12 pages)*.

[21]*See, e.g.*, Cooper *et al., supra*.

[22]As noted above, the argument assumes that taxes are passed on to consumers and therefore the higher tax rate faced by the U.S. CFC would make it charge higher prices than the German CFC facing a lower rate. The more likely result is some reduction in the U.S. parent's after-tax profit, but even this may not happen if cross-crediting is allowed, because then no residual U.S. tax will be due on the subpart F income thanks to available credits (as the discussion of Notice 98-5 has shown, most U.S. multinationals are currently in an excess limitation position). (For the full text of Notice 98-5, see *Doc 98-175 (16 pages)*.)

[23]Owens and Fensby, "Is There a Need to Reevaluate Tax Sparing?" *Tax Notes Int'l*, May 4, 1998, p. 1447, or *Doc 98-13979 (2 pages)*; *Tax Sparing: A Reconsideration* (OECD 1998).