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COMMENT: A JAPANESE VIEW

*Yoshihiro Masui**

I. THE PROPOSAL

THREE assumptions underlie the present international tax rules with regard to income:¹

- (1) First assumption: Corporations are taxed as a distinct taxpayer, separate from shareholders.
- (2) Second assumption: It is possible to identify the residence of taxpayers.
- (3) Third assumption: It is possible to determine the source of income according to the separate enterprise principle and the arm's length standard.

The inevitable consequence of the first assumption is deferral. When a foreign corporation earns foreign source income, that income is not currently subject to U.S. taxation. Rather, the U.S. taxation will be deferred until the income is repatriated to the U.S. shareholders. The U.S. tax may also be deferred until the U.S. shareholders realize the gains by selling the stock.

Deferral is entrenched in the international tax rules throughout the Organization for Economic Co-Operation and Development (OECD) countries. No country has ever implemented a tax policy of completely discarding the first assumption. Legislative responses to deferral tend to be partial. For instance, the common pattern with regard to Controlled Foreign Corporation (CFC) legislation in OECD countries is that they are only applicable to those shareholders with substantial stock ownership. Moreover, they do not reach certain active income of the CFC. In an increasing number of countries, portfolio income derived through foreign investment funds is subject to tax on an accrual basis, but only in some targeted cases. The present practice in industrialized countries thus could be characterized as a selective limitation on deferral.

In sharp contrast to the status quo, Professors Robert J. Peroni, J. Clifton Fleming, Jr., and Stephen E. Shay (hereinafter "the authors") propose a complete reversal of the first assumption: eliminating deferral altogether. According to their plan, the foreign source income of foreign corporations will be taxed at the level of U.S. shareholders on an accrual

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1. See Tadao Okamura, *Iwanami Koza Gendai No Ho* 8 INT'L TAX'N, 294 (1997).

basis without exception. The authors argue forcefully on behalf of one side of what has been a long debate between the capital export neutrality (CEN) camp and the capital import neutrality camp (CIN).

II. WHY NOW?

The debate concerning the anti-deferral rules has a long history in international taxation. The present patchwork in many countries is a result of legislative struggles among competing views favoring or disfavoring deferral. The balance had been struck and compromise made. If so, why do we need to reconsider it now?

Several contemporary developments explain why the authors' proposal is topical, especially for the U.S. First, the U.S. adoption of the check-the-box regulations will mean that taxpayers may choose to end deferral when they like it. As a next step, it has become one of the conceivable policy options to abolish deferral on a mandatory basis. Second, the coordinated movements against harmful tax competition among OECD countries point to the need to strengthen anti-deferral regimes in each jurisdiction. Third, mark-to-market treatment has expanded steadily, starting with the financial sector. Mark-to-market means accrual, eliminating deferral. Fourth, electronic commerce makes it easier to manipulate the corporate residence for tax purposes. A high tax jurisdiction may wish to empower its anti-deferral rules to combat abuse. In short, the tax environment is changing.

On the other hand, it obviously requires many considerations before such a sweeping proposal is ever to be adopted. Among them, the authors have duly noted transition issues and income allocation issues.² In what follows, I will try to add three perspectives: (1) the weight of the present compromise; (2) the extent to which simplification will be achieved; and (3) the international repercussion.

III. UNNECESSARY COMPROMISE?

The authors reject the policy compromise embedded in the present anti-deferral of rules. Accordingly, they suggest the following criteria for the purpose of developing their proposal to end deferral:

- (a) An anti-deferral regime should be as simple as possible;
- (b) Active and passive income should be treated in the same manner;
- (c) An anti-deferral regime should reach all CFC income without exception; and
- (d) An anti-deferral regime need not be punitive.³

2. See Robert J. Peroni, *Getting Serious about Curtailing Deferral of U.S. Tax on Foreign Source Income*, 52 SMU L. REV. 455 (1999).

3. See *id.*

From their CEN perspective, deferral is viewed as an evil, active/passive nature of income, or of the character of income, and (c) reflects such policy judgment regardless of the criteria in (b).

With respect to criterion (a), the appeal to simplification should be weighed against other policy objectives. Every classification forces taxpayers and tax administrators to draw a fine line. Exceptions always complicate tax rules, and invite manipulation. But this is merely a matter of general statement. The genuine question for policymakers is whether a particular distinction is worth its cost.

To the authors, the present exceptions in the anti-deferral legislation lack any justifiable policy grounds and are not worth surviving. It is natural for them to emphasize the simplification potential of their proposal. To CIN contenders, however, the exemption of active income from the anti-deferral regime is at least necessary in order for a foreign corporation to compete on an equal footing in a foreign jurisdiction. They would gladly incur the complexity costs caused by the existence of various exclusions.

Thus, the above criteria in themselves reflect the authors' preference for the CEN doctrine. At this level, the controversy, or the relevance, of the CEN/CIN debate continues to be in a somewhat murky condition. The debate will continue without reaching an agreement.⁴

More realistically, would it be wise to discard the present compromise, which divides the boundaries between deferral and accrual? If an anti-deferral regime were to be viewed simply as an anti-avoidance measure, the present patchwork is not something that is excessively hard to live with.

The Japanese approach is best explained from these practical considerations. Unlike the U.S. transactional approach, Japanese legislation focuses on the location of the principal office of the foreign-controlled corporation. A decisive test in triggering taxation is the level of foreign tax. Its provisions are applicable only when the targeted jurisdiction has no corporate tax or when its effective corporate tax rate is 25% or less. The rule is even named the "anti-tax-haven system." When it applies, all of the undistributed income, passive or active, will be taxed currently to the Japanese shareholders. Exemption is granted for an active business, which has fixed assets in the jurisdiction. This is due to the deliberate policy decision to go after tax avoidance schemes, rather than eliminating deferral completely.

The authors will not be persuaded to embrace this type of practical conception. The Japanese approach is in direct conflict with their criteria (2) and (3). I would suggest, however, that the Japanese example offers a relatively straightforward, albeit unsophisticated, explanation for the selective limitation of deferral.

4. *See id.*

IV. NET SIMPLIFICATION?

Assuming that simplification is desirable, to what extent will the authors' plan simplify the present tax system?

Simplification should be measured in terms of the rule, transaction and compliance. First, in terms of rule complexity, the proposal would simplify the present U.S. anti-deferral rules because the authors will abolish the distinction between passive/active income and eliminate exclusions.⁵ This would result in fewer detailed rules and fewer definitional issues. On the other hand, it would be necessary to introduce additional rules with respect to income allocation and transition.

Second, taxpayers would face fewer difficulties when structuring transactions in some areas. For example, under the proposed regime, taxation will be neutral toward the decision to establish a subsidiary or a branch in a foreign jurisdiction. Moreover, the proposal would make it irrelevant for multinationals in determining whether to shift profits to their controlled foreign subsidiaries, thereby reducing the number of outbound transfer pricing disputes. The reduced transaction costs, nevertheless, will be offset by the increased transactional complexity in other areas. Under the proposed pass-through regime, taxpayers would start to arrange their affairs for tax minimization, while considering the effect of income allocation rules similar to Subchapter K. Instead of transfer pricing disputes, there would be increased pressures on the determination of profits attributable to a foreign pass-through entity for the purpose of foreign tax credit.

Third, compliance costs seem to increase for those taxpayers who will be compelled to obtain information, report their income currently, adjust their basis in the foreign subsidiary, and beware of the loss limitation rule. Under the present check-the-box regulations, taxpayers voluntarily elect to comply with the complex pass-through rules. The proposed regime forces mandatory accrued taxation on additional taxpayers. To that extent, those taxpayers would face increased compliance complexity. On the other hand, offsetting salutary effects would exist by repealing present distinctions and exclusions in multiple different anti-deferral provisions.

On the whole, it seems that the net simplification gain by the adoption of the proposal needs to be discounted, due to the offsetting effects examined above.

V. INTERNATIONAL REPERCUSSION

If the U.S. adopted the authors' proposal on a unilateral basis, what would be its international repercussions?

Capital importing countries might wish to adjust their corporate income tax rate to the same level as the U.S. rate. Suppose host country A currently imposes a 10% income tax. When the U.S. parent corporation

5. *See id.*

is taxed at 35%, without the application of anti-deferral legislation, its subsidiary in country A can retain its profits and take advantage of the local tax rate of 10%. After the introduction of the new proposal, deferral would be eliminated. The profits earned by the subsidiary would be taxed at the 35% U.S. rate. The host country's tax would be credited against the U.S. tax. Under this condition, it is to the advantage of country A to increase its tax rate to 35%. In this manner, country A can successfully soak up the revenue from the U.S. treasury without sacrificing the pockets of multinationals.

The reverse side is that country A has no incentive to raise income tax rates higher than the 35% U.S. rate. Some countries may even be tempted to reduce their originally high tax rate, say 50%, to conform to the U.S. rate of 35%. Only a few capital import countries would retain the original 50% rate, either because they would discover the existence of rent, or because their national economy is large enough to influence the international interest rate.

Another scenario also is possible. Host country A might wish to retain its original 10% rate if it can attract sufficient foreign capital from a third country that continues permitting deferral. Under this scenario, the U.S.-based multinationals might wish to change the location of their headquarters to the third country. The authors' extensive proposal seems to be proof against the dislocation of corporate residence, because it will ultimately tax the corporate profits at the hands of U.S. shareholders. But corporate ownership may easily be structured in a multiple chain. The proposal thus requires a far-reaching look-through rule, in order to currently tax the undistributed profits of a grand-grand-child corporation that is located abroad. To achieve this objective, information exchange would become vital among the U.S., the third country, and perhaps the host country.

The U.S. treaty partners will be interested in the issue if the proposal affects treaty provisions. In this regard, the proposal does not seem to violate the non-discrimination provision of the tax treaty. The proposed anti-deferral regime would apply to a shareholding only in foreign corporations. Assuming that the U.S. retains the current classical system of taxing domestic corporations, a U.S. shareholder will be treated differently according to the residence of the corporation in which she invests. If she invests in foreign corporations, she will be taxed on a pass-through basis. If she invests in domestic corporations, she will be subject to the classical system of corporate-shareholder taxation. This is a different treatment accorded to shareholders. Therefore, the proposal does not contradict Article 24, Paragraph 5, of the OECD Model Convention. Paragraph 5 aims at ensuring equal treatment for corporations residing in the same country. Paragraph 5 does not dictate a contracting state to subject foreign capital, in the hands of shareholders, to identical treatment to that applied to domestic capital.

On a global scale, it has become necessary to reexamine the underlying basic assumptions in international taxation. The challenge today is not solely directed at the separate taxation of foreign corporations from domestic shareholders, which is the main target of the authors' proposal. It is increasingly difficult to identify the residence of multinationals, as well as to determine the source of income according to the arm's length standard. As a final remark, I would like to stress the need to discuss these fundamental issues in an international forum.