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Extraterritorial Effects of Foreign Tax Credit, Termination of Deferral and United States Tax Characterization

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with the business, is considered "effectively connected" unless there is a treaty. This is not the simplest area of the tax law and I hope President Carter is able to simplify it. As I mentioned, it is hard to justify some of these distinctions.

You ordinarily find that U.S. tax is imposed on the U.S. source income of the foreign person, as income is not ordinarily "effectively connected" unless it is U.S. source income. But there are certain categories of foreign source income which are treated as "effectively connected" and taxed by the United States. This is income which is earned by a U.S. office of a foreign person which we could perfectly well have called domestic source income. However, we had old source rules that we were reluctant to change. Instead of changing the source rules, we said that even though it is foreign source income, we will tax it if it meets certain tests.

It is important to note that in the case of business-type income, all normal deductions are available; the United States is most generous in allowing deductions to foreigners for expenses incurred overseas. The rates of tax are at the normal corporate rates. For foreign individuals, there is a problem in that if they are married, they cannot take advantage of the 50 percent maximum tax.

There are some other areas we are not going to discuss, so I thought I would just list them so we will have to keep them in mind. Indirect taxes which are basically state sales taxes. Social Security taxes have to be taken into account; foreigners come here for a short time, or Americans go abroad—U.S. and foreign Social Security taxes apply. We have estate taxes under the same situations, Americans abroad, foreigners here. Customs duties are obviously an international tax. Dave Foster is going to say a word about the *Zenith* case. So far I talked about the federal system in the United States. But most states of the United States have income taxes and other taxes which are generally far less accommodating to international transactions of U.S. persons than the federal system. However, the level is much lower and such taxes are deductible for federal purposes. Dave Foster is going to say a bit about the situation in California.

In conclusion, the cornerstone of our system is the foreign tax credit and the fact that we have a distinction between U.S. persons and foreign persons. Dick Pugh will now tell you about the foreign tax credit in more detail, and about how the distinction between domestic taxpayers and foreign taxpayers could be blurred under possible legislative proposals.

Remarks by Richard C. Pugh

Extraterritorial Effects of Foreign Tax Credit, Termination of Deferral and United States Tax Characterization

Thank you, Bob. I would like to touch on certain aspects of the foreign tax credit this afternoon, the proposed elimination of what we call deferral and, if time permits, certain characterizations that are used in the Internal Revenue Code in taxing foreign income. The existing and proposed provisions I want to comment on do not represent extraterritorial applications of U.S. legislative jurisdiction, as such. That is, they don't involve an attempt to subject non-U.S. persons to U.S. tax when they have no income from or contacts with the United States. But these provisions can have important consequences on the profitability of business operations that are conducted abroad by a U.S. company and so, to that extent, I think it is fair to say that they have some very significant extraterritorial implications.

Proposals to Repeal the Foreign Tax Credit

Most of you are aware that, over the last few years, some considerable support has been expressed for the view that we ought to repeal the foreign tax credit outright, in favor of simply granting a deduction for foreign income taxes. This was one of the features, you will recall, of the Burke-Hartke Bill supported strongly by the U.S. labor movement. Happily, I think now one can say that this proposal seems to have little or no current momentum. The Rostenkowski Task Force Report opposed elimination of the foreign tax credit. Corporations based in every major trading country in the world enjoy protection from double taxation internationally either by a foreign tax credit, or by an exemption from domestic tax for foreign-source income. Unilateral repeal by the United States of the foreign tax credit would have a devastating extraterritorial effect on the capacity of U.S. companies to compete abroad. The predictable result, I think, would be a sharp reduction in the volume of new U.S.-foreign investment and a probable withdrawal of a substantial amount of the existing foreign investment of U.S. companies.

Dave, perhaps you would like to comment on my generalization that the efforts to eliminate the foreign tax credit appear to have lost most of their zip.

DAVID S. FOSTER: Dick, I think you are probably correct. I don't think it has been seriously considered in connection with the current Carter tax reform package, now being put together. Elimination of the foreign tax credit has been considered by the Senate from time to time, but there does not seem to be any great movement in that direction right now.

ROBERT COLE: May I interrupt? One of the questions now apparently being considered is an accidental repeal of the foreign tax credit. Dave, would you like to explain that in a few sentences or should I?

DAVID FOSTER: You mean integration?

ROBERT COLE: Integration.

DAVID FOSTER: No, thank you.

ROBERT COLE: This is my concern, but it is a real problem and, therefore, we have to note it. A proposal to eliminate double taxation of corporate income is being considered, under which shareholders would be given a credit for part of the corporate tax paid by U.S. corporations. If the credit is based only on the U.S. corporate tax paid by the distributing corporation, then on distributed earnings the foreign tax credit would, in effect, be repealed. I hope that this is not going to happen. But the Administration has to come up with a solution if it proposes integration. I think there is a problem of an accidental tampering with the foreign tax credit which the Carter Administration has to take into account.

RICHARD PUGH: I hope we can count on the Tax Section and the International Law Section of the ABA to prevent that occurring, at least inadvertently.

DAVID FOSTER: Can I stick my two cents in here to say that I think that it is not quite accurate to say that it may happen *accidentally*. I think people are aware of the issue. In addition, I think it is worth pointing out that France, Germany, and the United Kingdom, have, in effect, repealed the foreign tax credit in connection with integration but that Canada has not.

RICHARD PUGH: Dave, would you explain that again, about the lack of a foreign tax credit in an integration system?

DAVID FOSTER: Well, if you have an integration system, it means that you give a credit to the shareholder for the tax imposed on the corporation. The problem arises when you have a corporation that has foreign income and, therefore, does not pay any domestic tax because of the foreign tax credit. The issue is do you then give credit at the shareholder level where foreign tax is paid at the corporate level? That is done in Canada, in fact, because Canada ignores the tax rate paid by the company itself.

WILLIAM COVENEY: Right, but it is not done in the United Kingdom, France, and Germany, in that they will impose a special tax in cases where there is no general domestic corporate tax paid. There is a special tax equal to the credit that they will give to the shareholders.

ROBERT COLE: I cannot resist. It is not three to one; it is three to two. Belgium has the Canadian System.

DAVID FOSTER: I am sorry, right.

RICHARD PUGH: One extraterritorial consequence of the foreign tax credit has a particular impact in the developing countries and I would like now to comment on that consequence. This is the possibility of cancelling the benefit of tax incentives adopted by developing countries, particularly tax holidays for desired investments, as the result of the operation of the foreign tax credit.

A very large number of developing countries have adopted special tax incentive regimes to encourage the inflow of foreign capital and technology. Prominant among these incentives are "tax holidays," under which the generally applicable income taxes on business income are reduced or more commonly eliminated altogether for an initial period of an investment. Commonly, the period runs from five to ten years. The corporate income tax is the tax most often forgiven under these incentive programs. But in some cases in order to encourage the inflow of needed technology, exemptions are also granted from the normally applicable withholding taxes on royalties or technical assistance fees, and sometimes withholding taxes on interest and dividends are also forgiven under these tax incentive programs. Under the usual foreign tax credit mechanism, however, the benefit of the exemption from foreign tax is cancelled when the income enjoying the tax holiday is remitted to the multinational company's home country. In effect, the taxes that are waived by the developing host country are paid, instead, to the Treasury of the multinational company's home country.

A distinction in this connection ought to be drawn between the waiver of taxes on corporate income of a subsidiary organized in a developing host country, on the one hand, and the waiver of withholding taxes normally imposed on royalties and technical service fees on the other.

Waiver of corporate income taxes by a developing country is normally not cancelled by taxes in the multinational's home country as long as the earnings of the foreign subsidiary are reinvested rather than distributed. Only upon distribution of the earnings as dividends or otherwise are the tax concessions in the developing country cancelled by taxes imposed on the shareholder by his home country. Thus, in the short term, the cancellation effect of the U.S. foreign tax credit creates an incentive to reinvest the earnings of a foreign subsidiary benefitting from a foreign tax holiday. Eventually, on repatriation of the earnings, the benefit of the tax holdiay is cancelled. In the case of waived taxes on royalties and technical assistance fees, however, the cancellation effect is automatic and immediate.

In order to prevent the frustration of tax concessions granted by developing countries, a large number of the principal capital- and technology-exporting countries of the world, with the notable exception of the United States, have adopted, either as a matter of domestic law or in their international double tax treaties with developing countries, the concept of a tax-sparing credit under which the taxes waived or spared by the developing country are treated as if they actually had been paid for purposes of computing foreign tax credits—so that the foreign tax waived is treated as a tax that offsets the domestic tax on the income from the developing country that would otherwise be imposed.

Countries utilizing the tax-sparing credit technique number at least fourteen, and prominent among them are Denmark, Finland, France, the Federal Republic of Germany, Italy, Japan, Norway, Sweden, and the United Kingdom. It has been reported that there are at least seventy-five double tax treaties that incorporate a tax-sparing credit. A number of other capital- and know-how-exporting countries, as Bob indicated, provide an exemption for foreign-source income, and this also, of course, avoids the problem of cancelling tax holidays that are granted in the developing country. Countries in this category include Canada, through its tax treaties, France, Switzerland, and the Netherlands.

The United States in the late 1950s and 1960 negotiated four tax treaties with tax-sparing credit provisions, but none of the tax-sparing credit provisions ever became effective. Tax-sparing credits were actively opposed by the Treasury until 1968 and support for the concept has not since been revived in the United States although its use by countries with which we compete has continued to increase.

Tax-sparing credits have been criticized on the ground that tax holidays are not sound fiscal policy for developing countries. However valid this comment may be, this criticism does seem somewhat gratuitous and somewhat arrogant in view of the very large number of developing countries that have concluded otherwise. They have determined that tax holidays do have a beneficial effect in attracting foreign capital.

A concept of international tax neutrality has often been cited in opposition to a tax-sparing credit. This neutrality is one under which the objective is to subject the income of a U.S. corporation from foreign sources and its income from domestic sources to the same total U.S. and foreign tax burden. This might be called domestic-market or capital-export neutrality. The focus is on equalizing the U.S. taxpayer's tax burden on U.S. and foreign income. A quite different concept of international tax neutrality could be called foreign-market or capital-import neutrality, under which the goal is to insure that a subsidiary corporation established in foreign country X by a multinational company is subject to the same income tax burden as other corporations established in country X, which are owned by nationals of that country or by nationals of the third country. Tax-sparing credits are compatible with foreign-market or capital-import neutrality, but not domestic-market or capital-export neutrality.

But analysis, it seems to me, of whether tax-sparing credits should be adopted by the United States is not much advanced by citing their compatibility with one form of tax neutrality or another. What must be evaluated is what the objectives are of our foreign economic policy in relation to the developing countries and to what extent, if at all, tax incentives should be enlisted in support of these objectives.

Recent amendments to the Internal Revenue Code have eliminated the potpourri of preexisting so-called tax incentives to investment in developing countries. In general, these incentives were ill-conceived, or ineffective, or both, and I don't believe that their repeal necessarily implies a rejection by Congress of the concept of providing effective tax incentives to encourage the flow of capital and technology to the developing countries.

In the context of the reexamination of the most basic features of the U.S. taxation of foreign income, which now appears to be in progress, I would submit that a thorough reexamination of our tax policy concerning investments in, and income from, developing countries ought to be undertaken.

The disparities in wealth and the resultant economic tensions between the countries of the North and the countries of the South—the haves and haves nots—continue to mount. I think a persuasive case can be made for encouraging private capital and private technology to make as great a contribution as possible to narrowing the gap; and it may well be that U.S. tax incentives can make a real contribution to encouraging the flow of private capital and technology to the developing countries. The other members of the OECD have concluded that a tax-sparing credit has a significant contribution to make. I am inclined to think that they are right and that the United States should emulate their example; but the most important thing is that we take a new look at our tax policy in this area and that we not be captives of the past and of question-begging notions of what kind of tax neutrality ought to be our goal.

I suspect that tax-sparing credits would not be as effective in inducing private capital and technology to flow to developing countries as other alternatives. Tax-sparing credits are tied to income flows on which the taxes are waived. Thus, the incentive they offer is less direct than investment credits or deductible reserves, both of which could be related directly to the amount of new investment that was sought to be encouraged. It is interesting, I think, that France, Germany, and Japan all have the concept of deductible reserves for certain investments in developing countries. They permit between 50 percent and 100 percent of a new investment to be set up in reserve that is deductible in year one, subject to later recapture if the investment proves to be profitable. You will recall that a couple of U.S. tax treaties with developing countries were negotiated back in the early 1960s with a special investment tax credit for certain new investment. These investments credit provisions, however, never became effective. And the Johnson Administration, I believe, proposed at one point a substantial investment credit to encourage the flow of private capital to the developing countries. If we decide that as a part of our foreign economic policy private investment in developing countries should be encouraged, let us examine the whole range of possibilities, even those that we previously rejected, in considering whether tax incentives are appropriate and, if they are, what incentives are likely to be the most effective.

Proposals to End Deferral

A general principle that is applied in all of the tax systems that I have had any contact with is that the income of a foreign corporation the stock of which is owned by domestic shareholders is not subject to domestic tax unless and until those earnings are distributed as a dividend or otherwise to the domestic shareholders. In the United States, this principle has come to be known as the deferral principle.* U.S. taxes on the earnings of a foreign corporation are deferred until those earnings are distributed to U.S. shareholders.

There are a number of exceptions to the deferral principle. The most important for our purposes are the special rules under which the undistributed foreign personal holding company income of a foreign personal holding company and the undistributed subpart F income of a controlled foreign corporation may be taxed as a constructive dividend to U.S. shareholders.

These special exceptions were made to the deferral principle to meet what we regarded as special tax avoidance problems associated with the use of foreign tax haven companies. But for the treatment of foreign personal holding company income of foreign personal holding companies as a constructive dividend to its U.S. shareholders, those shareholders could avoid current U.S. tax on their investment income by accumulating that income in a foreign corporation located in a tax haven. But for the similar treatment of the Subpart F income of controlled foreign corporations, certain types of income such as dividends, interest, rents, royalties, certain income from the rendering of services abroad and from international sales could be accumulated free of U.S. tax in a tax haven corporation and be used for additional investment abroad.

There appeared to be no jurisdictional basis under international law for imposing U.S. tax directly on the non-U.S.-source income of the foreign corporation set up in a tax haven. The foreign corporation, albeit a wholly-owned subsidiary of a U.S. corporation, was still regarded as a foreign person and as long as it had no U.S.-source income, the foreign corporation itself could not be subject to U.S. tax. Accordingly, the expedient was adopted of taxing, not the foreign corporation, but the U.S. shareholder as if he had received a dividend equal to his share of the foreign corporation's undistributed income falling into certain categories. Although this approach involved taxing the U.S. shareholder on a constructive distribution of income he did not actually receive, its constitutionality has been sustained and now appears beyond any reasonable question, at least insofar as controlled foreign corporations and foreign personal holding companies are concerned.

Treating the certain categories of undistributed income of a controlled foreign corporation as a constructive dividend, and thereby ending effectively

*Deferral tends to be a "loaded" term, which implies an unwarranted tax concession. This is ironical since it denotes the principle adopted by all of the major trading countries of the free world. In any event, the term's wide currency and convenience have resulted in its general use by proponents as well as opponents.

the deferral of U.S. tax, may have some important extraterritorial consequences. For example, suppose a U.S. manufacturing company established an international sales company in Bermuda and a Japanese competitor did the same. The income of the U.S. company's Bermuda sales company from foreign sales outside Bermuda of U.S. manufactured goods would, under subpart F, be immediately subject to the U.S. 48 percent corporate tax as constructive dividend.

ROBERT COLE: Could I interrupt you just a second? Could you, in three sentences, define a controlled foreign corporation, foreign personal holding company, and subpart F income, for those who are not familiar with these concepts?

RICHARD PUGH: A controlled foreign corporation, briefly, is a foreign corporation of which more than 50 percent of the total combined voting power is owned, directly, indirectly or constructively, by five or fewer than ten percent U.S. shareholders. A foreign personal holding company is a foreign corporation of which more than 50 percent in value of the stock is owned, directly, indirectly or constructively, by five or fewer individuals who are U.S. citizens or residents and at least 60 percent of the income of which constitutes passive-type income, such as dividends or royalties, and the like.

Subpart F income, which is the kind of income that is treated as a constructive dividend in the case of a controlled foreign corporation, has a number of components. The principal ones are items such as dividends, interest, royalties, rents, income from sales of goods produced outside the foreign company's country and sold outside that country and certain forms of personal service income. These types of income are included in the definition of subpart F income and this income can be treated as a constructive dividend distribution to U.S. shareholders under subpart F.

Getting back to my Bermuda sales company, the sales income of the U.S. company's Bermuda sales company would be what is called foreign base company sales income—one of the components of subpart F income—and would be taxed immediately in the United States as a constructive dividend. On the other hand, the income of the Japanese company's sales subsidiary would not be subject to current tax. This obviously has an extraterritorial effect in that the Japanese company is in a better overall position to compete in foreign markets than is the U.S. company as a result of this difference in taxation. This adverse extraterritorial effect on the competitiveness of the U.S. manufacturer can be justified in the context of dealing with the use of tax havens to avoid U.S. tax on export income. But, obviously, it would be preferable if all of the major trading competitors of the United States could be persuaded to penalize tax haven operations in a similar way since this would eliminate the competitive distortions which are present currently. So far, however, only two of the members of the OECD, Canada and the Federal Republic of Germany, have taken effective steps to restrict the use of foreign tax havens by domestic shareholders, the German approach being quite similar to our own subpart F.

The potential adverse extraterritorial effects of eliminating deferral become particularly significant when we evaluate the proposal that is now under consideration by the Administration—the proposal that the deferral of U.S. tax be eliminated on all types of income of controlled foreign corporations, not just subpart F income.

There have been a variety of proposals in recent years under which not only the subpart F income of controlled foreign corporations, but all income, including manufacturing income, all sorts of sales income, and all sorts of service income would be treated as a constructive dividend to the U.S. Persons owning, directly, indirectly, or constructively, at least 10% of the voting power of a controlled foreign corporation. Those supporting these proposals to end deferral altogether tend to stress the goal of domestic-market or capital-export neutrality—equalizing the income tax burden of U.S. taxpayers on both their foreign and their U.S.-source income.

At this point, I would like to commend to your reading an extremely interesting article written by David Foster and Gary Hufbauer on the problems of deferral. It is a very comprehensive piece of work and an extremely interesting one. It was published by the Treasury early this year in a volume dedicated to the late Nathan Gordon, who was formerly in charge of the tax treaty program. In this article, David points out that to achieve the objective of domestic-market neutrality completely, all of the U.S. tax benefits that apply to domestic income, such as the investment tax credit which now applies only to U.S., not foreign, property, the Asset Depreciation Range method of calculating depreciation deductions and the DISC benefits, would all have to be extended to foreign income as well. And, in addition, in cases in which foreign taxes exceeded U.S. taxes, the Treasury would have to grant to the taxpayer a cash refund or the taxpayer would have to be granted a foreign tax credit to permit recoupment of the excess of the foreign taxes over the U.S. taxes applicable. Furthermore, there would have to be an immediate utilization of foreign losses for U.S. tax purposes. Changes such as these that would really be required to reach what is referred to as pure domestic-market neutrality aren't usually proposed by those who support the ending of deferral. They may not be supported in part because they have very severe revenue implications. In David's article, it was pointed out that estimates made in 1976 indicated that, if pure domestic-market or capital-export neutrality were achieved, there would be a revenue loss of $1.2 billion.

ROBERT COLE: Dick, I think Dave's article has had an effect. I had an occasion to listen to one of the important academic tax reformers recently, and he said that after thinking about those points, especially investment credit and the ADR, he realized there would be no revenue gains from ending deferral, and tax reformers have really lost interest in that as a cause.

RICHARD PUGH: Not only there would be no revenue gain, but there would be a revenue loss.

The chief objection though, I think, to restricting or terminating deferral is that in any case in which the corporate tax rate of a foreign country is lower than the U.S. 48 percent rate, it would increase the tax burden on undistributed earnings of foreign corporations controlled by U.S. shareholders in ralation to the tax burden borne by foreign corporations in that country controlled by non-U.S. competitors. Therefore, it would impair the competitive position of U.S. corporations in foreign markets and in the U.S. market to the extent that foreign competitors are supplying the U.S. market from manufacturing subsidiaries located in low-tax countries. The adverse extraterritorial effect on after-tax return increases as the foreign tax rate falls below the U.S. rate and it is at its peak when the foreign subsidiary enjoys a foreign tax holiday.

Thus, the consequences of terminating deferral would be particularly adverse with respect to investments by U.S.-based multinationals in companies organized in less developed countries where tax holidays are common and where tax rates in general are lower than the U.S. rates. There would be an immediate cancellation of any tax exemption or any tax differential even with respect to the undistributed income of the foreign subsidiary. This would presumably result in considerable resentment in the developing countries and would certainly increase the need for a tax-sparing credit or some other relief.

It could also result in fiscal retaliation of the less developed countries. For example, they might enact what has been called a "sponge" tax, under which tax holidays would be terminated if the elimination of deferral would result in their cancellation through the operation of the U.S. foreign tax credit. Thus, the foreign tax would in effect be raised in order to soak up what would otherwise be the U.S. tax on the undistributed income of the company in the less developed country. Egypt is an example of a less developed country that permits tax relief for foreign investors only if the investor's home country does not tax the income of the Egyptian company, either when it is earned or when it is ultimately distributed. The less developed countries could also impose heavy withholding taxes on the constructive dividends that would be the mechanism for taxing undistributed income to U.S. shareholders.

WILLIAM CAVENEY: Dick, I should make a point about the Canadian tax system, because your discussion has been tied into the less developed countries, which are generally what comes to mind when you consider the "tax holidays." But when the Treasury Department's tax holiday legislative proposals were brought up about four years ago (and in the March, 1977, Rostenkowski Task Force Report), the definition of tax holiday included a country which had very rapid depreciation policies. In some situations you can read that as "Canada," because Canada is famous for its writeoff in only two years of manufacturing and processing plants and equipment. A company can build a $400 million plant, and write it off in two years—if it can otherwise absorb the deduction.

Thus, there is a lot of concern in Canada about its being defined as a tax holiday, if fast depreciation policies were to be exempted (in any anti-deferral legislation by the U.S.) for *only* less developed countries. In the past, the two-year writeoff was denied to companies that did not have a "degree of Canadian ownership" (i.e., 25 percent or more). The present law does not have such a discriminatory limitation, but the limitation requiring Canadian ownership could easily be reinstituted by simply changing the tax law, if the so-called deferral is eliminated by the United States.

RICHARD PUGH: I might cite yet another example of what the less developed countries might do in reaction to termination of deferral. They have the option always of not granting tax incentives, but granting other sorts of subsidies and cash grants as an alternative. This would encourage the inflow of capital without reducing their taxes in cases in which that reduction would be cancelled under the U.S. foreign tax credit.

To wrap this portion up, it seems to me that if the other major trading countries terminated deferral, that would be okay. This would eliminate the competitive distortions that would result from our going down the road alone in this direction. For the United States to take the solitary lead on this issue is fraught with risks to the long-term prospects of U.S. industry abroad, particularly in the less developed countries where the principal impact of terminating deferral would be felt.

In a 1974 survey of sixty-three countries, it was reported that twenty-six had corporate and dividend withholding taxes above the U.S. corporate rate. So there would not be any adverse effect to our investments in those countries as a result of eliminating deferral; but thirty-seven countries had tax rates lower than ours, and all but ten of these were developing countries. Obviously, that is where the elimination of deferral would really bite and I think could have serious long-term adverse implications.

I don't think we have time here to discuss the variety of proposals that fall short of complete elimination of deferral, but there are some interesting ones and I will just note them. You can see that some of them have much less adverse impact on the developing countries than others. These would include the proposal to require distribution of at least 50 percent of all kinds of the income of controlled foreign corporations. The 50 percent would either have to be actually distributed each year or would be deemed to be constructively distributed. Another proposal is that to the extent that earnings of a controlled foreign corporation are not needed in the business of that controlled foreign corporation, they would be deemed distributed as constructive dividends if they were not actually distributed. Another proposal is aimed, as Bill indicated, at tax holiday situations. Any case in which a controlled foreign corporation enjoyed a tax holiday, or exported a substantial portion of its output to the United States—that is the "run-away plant" situation—its income would be deemed distributed to the U.S. shareholder.

Finally, there are a variety of proposals that involve permitting deferral for a limited period of time, maybe five years. There would be no constructive distribution of the earnings of a controlled foreign corporation until the end of a period of five years or more during which those earnings could be accumulated.

Thus, it may be that if any form of deferral legislation is ultimately adopted, it will be something short of the complete elimination of deferral on the manufacturing and other income of controlled foreign corporations. As the debate progresses, I think it is of crucial importance to keep in mind the adverse impact that the elimination or the restriction of deferral may have on our position in the less-developed countries.

United States Tax Characterizations with Extraterritorial Effects

One technique that recurs at various points in the U.S. taxation of foreign income is the use of U.S. concepts in characterizing and quantifying foreign-source income, in characterizing foreign taxes for purposes of the foreign tax credit and in characterizing foreign legal entities. In each case, these characterizations can have important implications with respect to the after-tax profitability of a foreign investment.

I may have time later to get into some of the others, but for the moment, I think I will just consider the use of U.S. concepts in characterizing foreign taxes for purposes of deciding whether foreign taxes qualify as creditable taxes for purposes of the foreign tax credit. In order to qualify, they have to be income taxes or they have to be taxes in lieu of income taxes and we use our own concepts in determining whether a foreign tax so qualifies.

There are some interesting current issues pending, particularly in the mineral, oil and gas area. One arises in the context of the production-sharing agreements that have become common between U.S. oil companies and foreign government-owned oil companies in various countries where oil exploration and production is in process. For example, a ruling was issued by the Internal Revenue Service last year (Revenue Ruling 76-215) involving Pertamina and production-sharing arrangements in Indonesia. Under these arrangements, the foreign government, in this case the Indonesian Government, owns all of the oil and gas and an entity wholly-owned by that government, Pertamina, has the exclusive rights of exploration and development and has ultimate control over exploration and development and production. The U.S. company furnishes capital, technical, and managerial know-how and services in return for a share of production. The law of Indonesia provides that the government-owned oil company is to pay the government itself a percentage of the government-owned oil company's production share. And under Indonesian law, this payment by the foreign government-owned oil company to the foreign government constitutes the payment of all the tax liabilities of the U.S. oil company that is actually carrying out the exporation and development. In its ruling, the IRS held that the production share that is paid on behalf of the U.S. oil company by Pertamina to the Indonesian Government is not a foreign income tax, and, therefore, no foreign tax credit for the payment is available to the U.S. oil company concerned.

The reasons given were essentially two: First, since the foreign government already owns the oil and gas, there is no payment for or on behalf of the U.S. company, and, second, the payment is really not an income tax but a royalty.

Bob, I think you have had some contact with that problem.

ROBERT COLE: What is very interesting about the problem is that negotiations—three-way negotiations—are now in progress between the Internal Revenue Service, the U.S. oil companies, and the Government of Indonesia to try to revise the Indonesian law to meet the requirements of the Internal Revenue Service as to what constitutes an income tax under U.S. concepts.

RICHARD PUGH: I gather that characterization issues are also alive now with respect to payments made by certain U.S. oil companies that are operating in the Middle Eastern OPEC countries and with respect to the U.K. Petroleum Revenue Tax.

ROBERT COLE: Dave, would you like to say something about this problem in the case of the U.K? How is the definition of an income tax being handled?

DAVID FOSTER: The issue is whether the Petroleum Revenue Tax imposed by United Kingdom in the North Sea is a creditable income tax. The Internal Revenue Service took the informal position in a memo to Treasury two years ago that it was not, and the proposed treaty between the United States and the United Kingdom provides that it should be treated as an income tax for treaty purposes.

The way I said that sounds a little different from what really happened. The decision to make it creditable for treaty purposes was made before the time the

Service took its position. That is, just as a routine matter of renegotiating a treaty, it is normal to take a look at the taxes of the other country and specify which ones are creditable income taxes.

Richard Pugh: Just one final illustration of characterization problems. One that recurs with some frequency is the problem of characterizing foreign legal entities for U.S. tax purposes.

Important U.S. tax consequences may turn on whether an entity organized under foreign law will be characterized as a partnership or a corporation for U.S. tax purposes. The characterization is accomplished by using U.S. concepts and the result can be extraterritorial in the sense that the current after-tax return on investment may be affected importantly by the U.S. tax characterization.

For example, if a foreign legal entity is established, it may be taxed as a company in the foreign jurisdiction and yet may be characterized as a partnership for U.S. tax purposes. Such characterization implies immediate U.S. income tax on the income of the foreign enterprise, whether or not the income is remitted to the United States. With the exceptions noted above, if the foreign entity is characterized as a corporation for U.S. tax purposes, its undistributed earnings will not be subject to U.S. income tax. Loss of this deferral will have an impact on after-tax profitability whenever the foreign enterprise is subject to foreign corporate tax of less than 48 percent or is exempt from foreign corporate tax. There are, in addition, a number of special rules applicable to controlled foreign corporations that can come into play only if the foreign entity is classified for U.S. tax purposes as a corporation.

If the foreign legal entity is not characterized as a corporation for U.S. federal income tax purposes, tax deductions and losses of the entity can be taken currently as deductions for U.S. tax purposes. This may be particularly important when losses are expected during an initial start-up period. This factor, indeed, may make it desirable to inaugurate a foreign investment in an unincorporated business form and to convert to a business form characterized as a corporation for U.S. tax purposes after the period of initial losses is over and profitable operations commence. In addition, only if the foreign entity is treated as a partnership for U.S. tax purposes will the U.S. participant enjoy the U.S. tax benefits accorded to U.S. taxpayers in connection with mineral operations, such as percentage depletion with respect to solid minerals and deductibility of intagible drilling and development costs in oil or gas ventures and of exploration and development costs in solid mineral ventures. If the foreign business entity is treated as a corporation for U.S. tax purposes, it will be considered to be a foreign corporation which is not entitled to these benefits.