The applicable Treasury Regulations state that an organization will be treated as a corporation if its corporate characteristics are such that the organization "more nearly resembles a corporation than a partnership." They go on to state that an unincorporated organization shall not be classified as a corporation unless such organization "has more corporate characteristics than noncorporate characteristics." The corporate characteristics to be considered in determining whether an organization will be characterized as a partnership or a corporation are (1) limited liability, (2) free transferability of interests, (3) continuity of life, and (4) centralized management.

The civil law systems offer a greater variety of corporate forms than do the Anglo-American, and some civil law entities having no close counterpart in U.S. law may present interesting characterization questions under the Treausry Regulations, which were developed to distinguish between the corporation and the partnership as they are known in U.S. law.

To illustrate a typical situation in which a characterization problem can arise, assume that a joint venture company is set up in a developing country with 55 percent of the equity owned by U.S. shareholders and the rest owned by a local investor. The company has been granted holiday and it is set up as a form of legal organization that corresponds to the SARL of French law. If that entity is characterized for U.S. tax purposes as a partnership, as it might well be, then deferral will be lost and the benefit of the foreign tax holiday will be eliminated because the entity will be taxed for U.S. purposes as a partnership and thus all of its income will be immediately subject to U.S. tax. Thus, the characterization problem is one that can result in cancellation of foreign tax holidays and thereby have a substantial adverse effect on after-tax profitability. Our tax treaties as yet do not do much in the area of trying to make the rules on characterization of entities consistent between the United States and the foreign countries concerned. This is one area in which it may well be that our tax treaties can make a broader contribution than they do now.

Thank you very much.

ROBERT COLE: Thank you, Dick. Richard Pugh has touched upon the basics, but as I said, the U.S. tax system reaches far into foreign countries. Dave Foster will deal with other basics, and some of the very important unusual uses of the tax system.

Remarks by David S. Foster

Exporting United States Tax Policy

My talk is entitled "Exporting United States Tax Policy," and I think that is a rather fun title to think about. I would like to think of my job at the Treasury as making tax policy and it is something like making a widget, I suppose. You can say we sit there in Washington and we fashion it and make it just the way we want and then we export it all over the world. I have never thought of it that way before, but I imagine there is a lot of truth in that and as I go through some various thoughts this afternoon, you can keep that in mind because it is fascinating, just how close what actually happens is to that analogy.

There are two basic types of tax policy, I think, and you can look at us exporting both of them. We have tax policy rules that are our ideas about how items ought to be taxed. I am thinking of it in the context of an income tax system. It is our ideas as to what constitutes income and in what years and what the rates should be. The second kind of tax policy is what particular activities should we encourage. Should we try to help capital intensive industries or labor intensive industries. Should we help doctors as opposed to lawyers, or what type of tax incentive should we have; should we urge people to insulate their houses through the tax system. That kind of rule we export too.

There is an extraterritorial effect whenever the United States law governs actions outside the United States. Classically, murder in the United States is a U.S. offense. Murder outside the United States is not. If we were to pass the law that made murder outside the United States a U.S. offense, we would have extraterritoriality. There are some questions in the area of what jurisdiction a country has to tax. If we were to tax, for instance, the French income of a Frenchman, we would step beyond the bounds of the international standard. We do not go that far. But we do go a long way in some very surprising ways. A few of those may raise some questions.

Taxation of Individuals

Let's consider first the way we tax individuals. We have said this a couple of times before. We tax our residents on worldwide income. This can be looked at as exporting U.S. tax policy and I will give some examples later on about how that happens. That is a normal international rule though, and no one objects. It is normal to tax your residents on worldwide income. We also tax the U.S. income of non-residents. This again is very normal. The surprising thing that we do is tax non-residents who are U.S. citizens on their worldwide income.

There are very few countries that do this. I have often meant to try to make an exhaustive list, but I never have. I have a list of four, however: the U.S., the Philippines, North Korea and Liberia. As you can see, the list does not include the major countries of the world.

The Philippines is somewhat explainable in that they adopted our Internal Revenue Code of 1939. They did backtract very substantially, however. I am not sure what the year was, but they now have a system where their non-resident citizens are taxed at graduated rates starting at one percent and going to three percent. So, although they tax their citizens on a worldwide basis, it has much less impact than it does with us. I think that can be said as well for Liberia and for North Korea. There are far more Americans outside of the United States than there are Liberians outside of Liberia, or North Koreans outside of North Korea.

Originally, there may have been some question about whether we have the power to do such a thing. The basic Supreme Court case of *Cook v. Tait*, (265 U.S. 47), in 1924, however, held that the United States has the power to tax the citizen resident abroad. The idea was that he must pay for the benefits of his citizenship. I guess the theory is that we have the Marines out there to save people whenever they get into trouble. We have some trouble enforcing this rule of taxing a citizen while he is abroad. I will not go into that in any detail. Joe Guttentag will talk about that later on.

Our taxation of citizens abroad has given me personally a great deal of trouble over the years in negotiating tax treaties. The basic tax treaty model has a provision in it that states that, notwithstanding anything else in this Convention, the United States reserves the right to tax its citizens as if this Convention were not in force. And there are certain exceptions where a few isolated treaty rules govern. When we put this provision in, when you are dealing with a country that has not negotiated with the United States before, they just cannot believe it. They first think the provision must be a joke. And then when they begin to realize that we are serious, they try to figure out what they have got to give us to make us retreat to a "sensible" position. They soon discover that we just are completely non-negotiable from our standpoint, and they finally either accept it or they go away. If they accept it, they seem nevertheless to be convinced that we are crazy.

Another major headache that this has caused me in the last several months relates to the proposed changes in the tax treatment of certain residents abroad.

At the moment, there are two basic exceptions to the rule that we tax our non-resident citizens on worldwide income—Sections 911 and 912 of the Internal Revenue Code. Section 911 exempts a portion of the foreign source earned income of private overseas citizens. Section 912 exempts the overseas benefits and allowances of U.S. government employees. Both sections are the subject of current study. Section 911 was amended very substantially in the Tax Reform Act of 1976. The effective date was to be January 1, 1976. It was retroactive. There was a storm of protest and that effective date has been put off by one year. The protest is continuing, however, and there is a move to go back to the way it used to be; there is a move to put the effective date off; and there are moves to completely change the system. There has also been a considerable discussion about changing section 912—covering the government employee—as well. To a lot of people it seems that the rules ought to be the same for private citizens and government employees. The majority of people that don't think that way are government employees.

Section 911 was enacted in 1924 as a stimulus to exports. There was no limit on the amount of earned income that could be excluded from tax. It now tends to be viewed, however, as an offset for disadvantages of living abroad. Foreign sales taxes are not deductible. If you are living in a country that speaks a foreign language, you will probably have substantially higher educational expenses. The cost of living is very high abroad. There are higher travel expenses. There are many cases where there is double taxation either when there is no treaty, or even after the effect of the treaty.

Section 912 for government employees was enacted in the early 1940s in order to avoid the appropriations process. It was felt that the pay should be increased for government employees, but there were not enough budgetary funds. I don't think that that is considered now to be an adequate justification for section 912, but the same justifications are given as for the private employee. The one major problem with the justification of additional expenses is that there is in fact an exemption for the entire housing allowance under section 912. The government will pay an employee's full housing costs abroad, and that is all tax exempt income. These two provisions can be looked at as the problems which are created by our system of taxing the U.S. citizens resident abroad.

Taxation of Corporations

Let me return next to the taxation of corporations. We tax corporations that are incorporated in the United States on their worldwide income. This is somewhat similar to taxation on the basis of citizenship. However, here we don't stand alone. A great number of countries around the world use a similar system. The major alternative is to tax corporations based on where their place of management is. This can be looked at as being somewhat analogous to taxing an individual on the basis of residence. But it is really quite different, because residence means where you really live, while place of management is somewhat artificial, as one can hold the board of directors' meetings pretty much wherever he wants.

Withholding Taxes

Another interesting extraterritorial problem in our law is that we impose withholding taxes on many payments which are made by foreigners. For instance, if a U.S. corporation is to pay a dividend to a nonresident alien, we would impose a 30 percent withholding tax on the dividend payment. A similar tax is imposed on a foreign corporation which is doing business in the United States if over half of its income is U.S. income. This strikes many countries as being rather strange. And it sometimes can be difficult to collect. We are asking their head office in Hong Kong to collect a withholding tax and pay it over to the United States Government.

We have similar withholding taxes on interest, and we have withholding taxes on rents and royalties for the use of property in the United States. That creates a particularly interesting problem in the shipping area where there are multiple sub-leases. If a ship calls at a U.S. port, in theory we are supposed to collect 30 percent of the rent at each tier. If you have enough tiers, the tax can go well beyond the amount of the total rent. This I do not think is a policy issue. It is basically a screw-up. I guess many of our extraterritorial effects can be viewed as a screw-up.

Diplomats and Ship Crews

I will say a word about diplomats and ship crews, because many countries tax their diplomats who are located abroad as if they were in their country, and they tax people who are on board ships that fly their flags as if they were in their country. We do not have that rule. We do, however, tax our citizens on world wide income, and most of our diplomats are U.S. citizens. This is one area at least where we have not reached out quite as far as others.

Neutrality

I would like to consider briefly the problem of neutrality. Dick Pugh has talked about that in connection with deferral. There are two ways of looking at neutrality. We tax U.S. income and foreign income differently and we have different ways in which we tax different kinds of income. Within the United States, we tax U.S. shipping income, for instance, differently from professional services income. The difference in the rules between U.S. and foreign income will, of course, have an effect on whether the United States people will want to invest in the United States or abroad. The difference in the rules between different sectors will push people into one industry versus another. This can sometimes have a reverse effect if you consider the two things together.

For instance, in a capital-intensive industry, we give very large incentives in the form of the investment credit and accelerated depreciation. We don't have similar incentives in service businesses. Now if you move to the foreign arena, you no longer have the investment credit on capital-intensive industries and you don't have the asset depreciation range method of depreciation. This changes the relative advantage. If you are going to go abroad in any event, our tax system will encourage the *service* business rather than the capital-intensive business, because the service business is not at as great a disadvantage when you are abroad as it is when you are in the United States.

In general, most of our rules tend to favor U.S. investment as opposed to foreign. One major exception is the rule that we do not tax foreign income until the dividends are paid to the United States—the deferral rule. It is possible to look at our general pro-U.S. investment rules, on the one hand, and our pro-foreign investment rule of deferral, on the other hand, as being rough offsets. I must underline, however, that the offset is extremely rough, and if you look at particular isolated cases, there is no effective offset.

One major special rule that we have is the DISC (Domestic International Sales Corporation) program. We have a special regime for export sales where you can get a deferral on a portion of your export income. Last November, a panel, actually four separate identical panels, set up under the GATT (General Agreement on Tariffs and Trade) treaty, held that DISC violates the GATT treaty. GATT provides that a country cannot have border tax adjustments for direct taxes (mainly income taxes), but border tax adjustments are all right for indirect taxes (such as sales taxes). GATT says, for instance, that if you are manufacturing goods in country A and exporting to country B, that it is all right to forgive sales taxes in country A, but it is not all right to forgive income taxes in country A. The panels held that in effect we are rebating income taxes under our DISC program. These panels also held illegal the export practices of Belgium, France, and The Netherlands, so we have a major dispute on our hands in the foreign arena.

RICHARD PUGH: Excuse me, David. Are you willing to make any rash predictions as to how the Administration is going to come out on the future of DISC and on the future of deferral?

DAVID S. FOSTER: Well on DISC, I think all indications are that the Administration will come out for its repeal. There has been a lot of talk along that line. I would not bet very much money on it, however, because you never know what is going to happen. There is a sizable group of people that think that DISC ought to be saved as a bargaining chip in the multilateral trade negotiations and in the GATT, and it is possible that towards the end that argument may win the day. In general, the Administration thinks that DISC is not a good program, but it is possible that they won't come out for its repeal.

On deferral, President Carter, early in his campaign, said that deferral should be ended. A little later on in his campaign, he said that it should be studied for a year and then a decision should be made as to whether deferral should be ended. In the television debates, he called again for deferral to be ended. It is being discussed within the Administration right now and so far as I know the President has not made up his mind. He will be making up his own mind on this issue. I think about all I can say is that there are both points of view within the Administration.

Bob has asked me to skip on to the antiboycott legislation, but before I do I would like to pass briefly over some of the other items in the outline.

Tax Sparing

With respect to tax sparing, let me just say that this is one major item of non-neutrality which the United States does not have in its laws, and is not willing to agree to under its treaties. The one exception is the possession tax credit under section 936 of the Internal Revenue Code. Many other countries give tax sparing by treaty, and this makes it much more difficult for us to negotiate treaties with developing countries.

Less-Developed Country Provisions

We used to have in our law special rules for computing the deemed paid foreign tax credit with respect to less developed countries and special rules for computing subpart F income when dividends from less developed countries were reinvested in less developed countries. These provisions are no longer part of our law, however.

Foreign Tax Credit

With respect to the foreign tax credit, I will generally defer to Dick Pugh. However, I would like to point out that our foreign tax credit has an effect on the tax systems of other countries. We give a foreign tax credit only for taxes which are imported on "income," within the U.S. concept of the term, and we give the credit up to our tax rate. This has the effect of encouraging other countries to impose taxes on income rather that to raise money in other ways, and to raise their rates up to the U.S. rate. This is a form of exporting U.S. tax policy. This can be looked at as a very desirable effect since it tends to cause more uniformity throughout the world.

Interest Equalization Tax

With respect to the interest equalization tax, which of course is no longer with us, let me just point out that the tax had the obvious purpose and effect of keeping United States companies from lending abroad. This can be looked at as an anti-extraterritorial effect.

Bribery

The area of foreign bribery is another area of extraterritorial effect which has been particularly controversial recently with the famous eleven questions of the Internal Revenue Service and with the new legislation contained in the Tax Reform Act of 1976.

Antiboycott Legislation

Let me turn now to the antiboycott legislation. The Tax Reform Act of 1976 provided that, if a taxpayer participates in or cooperates with an international boycott, he will lose his foreign tax credit, his DISC benefits, and his deferral benefits on the income that is related to his boycotting activities. The direct application of this law is on the taxpayer. It therefore can be said not to be extraterritorial. However, the indirect target of the legislation is quite clearly the boycotting countries. There is a hope to hurt those countries so that they will drop the boycott and the eventual hope, of course, is to help the countries which are being boycotted. I know of no precedent for such legislation, in the tax law at least. It is extraterritorial in the extreme in its intended effect. Its extraterritorial effect is very similar to the effect of a direct boycott itself.

The legislation also has an effect on third countries. The legislation applies to activities of U.S. taxpayers and to related foreign companies doing business in third countries. At least with respect to reporting, the legislation can also apply to the activities of foreign corporations which do business in the United States and related foreign companies. As an example of how it applies in the third country: If a United States corporation were to have a wholly-owned subsidiary in Canada which manufactured widgets, and sold them to Saudi Arabia, and in connection with that sale, agreed, for instance, not to hire Jews, the legislation would say that the Canadian tax paid by that subsidiary would not be creditable. The requirement for taking into account in full the activities of related foreign countries is that there be 50 percent control. However, ten percent control can be enough to trigger certain penalties. In particular, the loss of the foreign tax credit can result from mere 10 percent ownership. This is a very difficult practical problem, because the 10 percent owner may not even know whether his corporation is boycotting or not.

There are three penalties if you boycott. You lose the foreign tax credit, you lose your DISC benefits, and you lose deferral. The major issue on the foreign tax credit is whether the new legislation overrides our tax treaties. Many of our tax treaties, particularly the more recent ones, provide that the tax credit shall be available subject to the limitations of the U.S. law as it shall be amended from time to time without changing the general principle of the foreign tax credit article. The U.S. position is that the boycott legislation did not change the general principle of the foreign tax credit article. It is a penalty for bad behavior. It is not really a denial of double taxation relief. In fact, that is the position of the U.S. even with respect to older treaties, which do not have such language and just flatly require a credit to be allowed. For instance, a lot of the older treaties have language such as "subject to the provisions of the Internal Revenue Code as in existence November 23, 1944, there shall be allowed a foreign tax credit."

The reporting has been a particular problem because the statutory requirement for reporting is extremely sweeping. As a consequence, the Treasury has waived certain reporting requirements in the published guidelines. In particular, the answer to question A-14 of the guidelines provides that the activities of foreign parent and sister corporations need not be reported by United States corporations if the United States corporation either (1) has no deferral, DISC or foreign tax credit, (2) forfeits the benefits of those provisions, or (3) shows that it didn't boycott, and that its activities are separate.

There have been significant diplomatic protests against this law. Canada was the first to complain. Their complaints were primarily through the Department of External Affairs. Last week, I met in Ottawa with Canadian representatives negotiating a tax treaty. They asked for treaty protection against this provision. At the July OECD meeting, Germany raised the problem and stated that it was considering what measures to take. The Fiscal Affairs Committee of the OECD asked the United States to prepare a note on the problem to be considered at the next meeting in January. Two weeks ago, we received a diplomatic note from the Kingdom of the Netherlands stating that it is seriously concerned about this legislation. I will quote just one paragraph:

> The Netherlands Government has serious reservations about the extraterritorial consequences of a legal nature resulting from both the text of the laws involved and the regulations pursuant to it. In this connnection it is useful to recall that the recently approved Export Administration Act specifies exceptions for activities in connection with anti-boycotting laws in other countries, so providing for limitations of its extraterritorial scope.

The Export Administration Act, of course, takes a different approach from the Tax Reform Act. The Export Administration Act directly forbids boycotting instead of having tax penalties. In addition, there are significant exceptions in the Export Administration Act which are not found in the Tax Reform Act. There are two reasons for those exceptions. First, the Export Administration Act went through the legislative process in much more deliberate fashion. Second, the fact that the form of the Export Administration Act is a prohibition rather than tax penalties lends itself better to a more limited reach.

Unitary Tax at State Level

I have said before that it is normal to tax foreign income of residents. It is also normal to give double taxation relief by means of a foreign tax credit. In general, most United States states tax foreign income. However, they do not give a foreign tax credit. It is possible to justify this lack of generosity by taking into account an offsetting over-generosity in that the federal government allows a full tax credit for all foreign taxes, although only a deduction for state taxes. The practice of the states is still questionable, however.

There is current controversy concerning the unitary tax system of California and other states as applied to foreign income. Normally, most states tax only the entity doing business in the state. California and others tax the worldwide