REPORT #514

TAX SECTION

New York State Bar Association

Committee on the Foreign Activities
of
United States Taxpayers

COMMENTS
ON THE
FOREIGN TAX CREDIT REFORM PROPOSAL
IN THE
PRESIDENT'S TAX PROPOSALS
TO
TEE CONGRESS
FOR
FAIRNESS, GROWTH AND SIMPLICITY

December 30, 1985

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REPORT # 514

TAX SECTION

New York State Bar Association

LETTERS: The Honorable Dan Rostenkowski
cc: Robert J. Leonard, Esq.

J. Roger Mentz, Esq.
cc: Stephen E. Shay

The Honorable Bob Packwood
cc: John Colvin, Esq.

The Honorable David H. Brockway
cc: H. Patrick Oglesby

REPORT # 514

TAX SECTION

New York State Bar Association

January 13, 1986

The Honorable Dan Rostenkowski
2232 Rayburn House Office Building
Washington, D.C.

Dear Representative Rostenkowski:

Enclosed is a Report on the Foreign Tax Credit Reforms in the President's Tax Reform Proposals and the Tax Reform Act of 1985 as recently passed by the House of Representatives.

The Report recommends retention of the overall credit limitation, with adjustments through separate credit limitation baskets as needed to control abuses. It also supports continuation of the separate annual accounting pools for determining the earnings out of which a dividend is paid. If the multiple-year pool concept is adopted, however, the Report recommends a moving two-tier pool to minimize the number of prior years that may have to be examined when a distribution is made. Finally, the Report endorses the adoption of the Subpart F rules for computing earnings and profits for purposes of regular dividend distributions as well as for Subpart F inclusions.

Sincerely yours,

Dale S. Collinson

DSC :bd
Enclosure

cc: Robert J. Leonard, Esq.

REPORT #514

NEW YORK STATE BAR ASSOCIATION

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United States Taxpayers*

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December 30, 1985

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* This report was written by Peter A. Barnes, Wm. L. Burke, William G. Dakin, and Alan O. Dixler. The principal draftsman was Wm. L. Burke. Helpful comments were received from Dale S. Collinson, Alan W. Granwell, David A. Newman, David R. Tillinghast and Ralph O. Winger.

The tax revision submitted by the President to the Congress in May, 1985[1] proposed major revisions in the operation of the foreign tax credit limitation provisions. On September 26, 1985, Rep. Rostenkowski, Chairman of the House Ways and Means Committee, released a summary of tax reform options to be used by the Ways and Means Committee in its drafting sessions.[2] On December 17, 1985, the House of Representatives passed legislation which generally adopts the alternative position in the Staff Options Summary.[3]

This report comments on the reforms in the foreign tax credit provisions recommended in the Administration Proposal and on the related alternatives in the Staff Options Summary and the House Bill. More detailed comments on the House Bill will be made in a further report. Proposals relating to areas of international taxation other than the foreign tax credit limitation provisions will be considered separately by this Committee or by the Committee on United States Activities of Foreign Taxpayers.

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1 "The President's Tax Proposals to the Congress for Fairness, Growth and Simplicity" (May, 1985) (hereafter the "Administration Proposal".)

2 The summary was prepared by the staff of the Joint Committee on Taxation after consulting with members of the Ways and Means Committee. To distinguish it from the House Bill, the draft is hereafter referred to as the "Staff Options Summary."

3 H.R. 3838, 99th Cong., 1st Sess. ("Tax Reform Act of 1985") (herein the "House Bill")

Summary of Comments

The Committee opposes changing to a per country limitation for foreign tax credits from the overall limitation because the overall limitation is far simpler administratively and it appears questionable whether the per country limitation would provide any significant reduction in “abuse.” Instead, to the extent that specific abuses are perceived, the Committee favors dealing with the problem through appropriately defined separate credit limitation “baskets,” such as the expanded passive interest “basket” recommended in the Administration Proposal. If a per country limitation is adopted, the Committee believes that tracing of source of earnings through all tiers of foreign subsidiaries would be necessary to make the system effective, and in that event the current exclusion of foreing income tax credits for foreign taxes paid by fourth-tier and lower foreign subsidiaries should be eliminated.

The Committee also opposes changing to a multiple- year pool for calculating earnings and the related foreign tax computations necessary to determine the Section 902 “indirect” foreign tax credit carried by distributions from foreign subsidiaries. The Committee believes that no significant improvement in dealing with currently perceived problems will result from changing to multiple year pools. It believes, however, that such pools will raise serious additional technical problems, including the incompatibility with the general rule that distributions out of current year's earnings are taxable dividends even if there is an aggregate deficit in earnings, and problems of coordination with Subpart F. It will also impose administrative and auditing burdens that are not raised by the use of separate annual pools due to the potential need to establish earnings and profits for prior years even when relatively modest dividends are paid (a problem which will be particularly acute if the foreign corporation had no United States shareholders in some of the relevant prior years or the United States shareholder has such a small minority interest that it is not able to compel the foreign corporation to provide the necessary data). If separate-year pools are to be abandoned, the Committee recommends the adoption of two pools instead of a single pool, one consisting of a moving pool of accumulated profits and related foreign taxes covering a reasonable number of the immediately preceding years and the other pool covering the more remote years remaining.

The Committee supports the proposal to conform the rules for computing earnings for purposes of actual distributions from foreign corporations to those used with respect to subpart F deemed distributions It notes, however, that retention of the “leap frog” rules for direct inclusion of subpart F income will still result in different consequences between actual distributions and subpart F deemed distributions that could render it more difficult to achieve the effects desired from changes to a per country limitation or multiple-year earnings pools. If either the per country or the single pool proposals are adopted, consideration should be given to whether such direct inclusion rules should be retained.

If major reforms in the tax credit rules are adopted, the Committee also endorses the proposal to expand the excess credit carryover/carryback provisions, but it believes that the relief allowed should include expansion of the carryback period from 2 years to 3 or 4 years as has been done with carryback provisions in other contexts.

Tax Reform Proposals

The principal changes included in the Administration Proposal are the following:

- -- substitution of a "per country" foreign tax credit limitation for the current "overall" Limitation (including permitting taxpayers to elect to deduct or credit foreign income taxes on a per country basis),[4]
- -- expansion of the separate foreign tax credit limitation "basket" for passive interest income to include certain dividends and gains from the disposition of assets which generate passive income,
- -- revision of the rules relating to oil and gas extraction income,

4 Under the "per country" approach, the foreign tax credits allowable are computed separately by country with respect to the income, or relevant subgroups of income, treated as sourced in that country. Under the "overall" approach, the limitation is computed with respect to the aggregate income, or subgroup of income, treated as foreign sourced, without regard to country.

-- revision of the loss allocation rules so that losses from any country (including the United States) offset a pro rata portion of all income in all other countries (including the United States), and resourcing subsequent income from the loss jurisdiction in the same manner that the prior losses were allocated,

-- provision of rules with respect to the computation of the indirect foreign tax credit to accommodate a per country limitation, including sourcing dividend distributions to the countries from which earnings and profits are generated, maintaining the separate limitation character of passive income, allocating foreign income taxes to particular source countries, and allocating and apportioning expenses,

-- revision of the indirect foreign tax credit rules to substitute a single pool of all the distributing corporation's earnings and related foreign income taxes for the current rule of separate annual pools, and repeal of the rule treating distributions in the first 60 days of the taxable year as made from the prior year's earnings and profits,

-- establishment of a uniform set of rules for the computation of accumulated profits and related foreign income taxes for both regular distributions and Subpart F distributions, and

-- extension of the current excess foreign tax credit carryover period from 5 to 10 years

The Staff Options Summary and the House Bill include proposals which would:

-- reject the proposed per country limitation in favor of the overall limitation in current law,

-- replace the current separate limitation on interest income with a separate limitation on “low-tax income,” which generally would include income received either directly or through a foreign subsidiary that is defined in the code's anti-tax haven rules as foreign personal holding company income, insurance income, or foreign base company shipping income,

-- adopt the Administration's proposal to calculate accumulated profits and related foreign taxes on a single pool basis, rather than on a separate year-by-year basis as under current law, and

-- with respect to the treatment of losses in calculating foreign tax credits, generally follow current law, except that foreign source losses would be used first to reduce foreign source income subject to other separate limitations before being used to reduce domestic income; when income is later earned in the loss basket, it would be treated as income of the type previously offset by the loss.[5]

Per Country Limitation

Because the United States taxes the worldwide income of its citizens, residents, corporations and other United States persons, there is a potential for double taxation when income is earned abroad and is taxed also by another jurisdiction. To ameliorate this burden, almost from their inception the federal income tax laws have included provisions that have allowed, to at least some extent, a credit for foreign income taxes in computing federal income tax liability.

The history of the foreign tax credit limitation reflects a checkered and rather ambulatory past When the credit was first enacted in 1918, it was unlimited –- foreign income taxes could be credited against the taxpayer's total tax liability even though the amount of such taxes exceeded the effective United States rate on foreign source income Congress limited the credit in 1921, however, in an effort to ensure that the credit did not reduce the United States tax ensure that the credit did not reduce the United States tax

5 The Staff Options Summary also proposed changing the creditability of “in lieu of” taxes so as to limit the credit for a foreign levy imposed on interest paid to banks and other financial institutions to the amount of the general income tax of the levying country that would otherwise be imposed. Instead of this provision, the House Bill limits the creditable withholding taxes and “in lieu” gross income taxes on interest paid to banks, insurance companies and other financial institutions to the United States tax attributable to such income. Certain loans outstanding on November 16, 1985 to borrowers in 15 enumerated developing countries would be grandfathered through 1988.

on a taxpayer's United States source income From 1921 to 1932, an overall limitation was imposed. In 1932, an additional per country limitation was added, so that foreign taxes were creditable only to the lesser of the overall limitation or the per country limitation In 1954, Congress amended the law so that only the per country limitation applied From 1960 to 1975, taxpayers could elect to use a per country or the overall limitation; once having elected the overall limitation, however, the taxpayer was required to continue that limitation until the Service permitted a change back to the per country limitation.[6] Finally, in 1976, Congress repealed the per country limitation and since that time the overall limitation has been used alone. Thus, almost all permutations have now been tried (including the Administration's Proposal during the 1954-60 period.)[7]

Under present law the amount of foreign income tax which may be credited against United States income tax is limited by the ratio of foreign source taxable income to worldwide taxable income. Section 904(a).[8] The limitation is computed separately for each of six categories or “baskets” of income -- operating income

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6 Because of the changes made in the 1969 Tax Reform Act, taxpayers on the overall limitation at that time were given a one-time option to change back to the per country limitation commencing with their first tax year beginning after December 31, 1969.

7 There has not yet been a period (or any proposal) in which the limitation has been per country or overall, whichever was greater each year.

8 Unless otherwise indicated, all references to sections are to the Internal Revenue Code of 1954, as amended.

generally (other than oil and gas extraction income),[9] oil and gas extraction income, and the other four categories of income specified in Section 904(d)(l)(A-D) Excess foreign tax credits on foreign operating income other than oil and gas extraction income may not be used against United States tax on any other income described in Section 904(d)(l) Excess foreign tax credits on foreign oil and gas extraction income may not be used against United States tax on any other income Section 907(a) Similarly, foreign taxes paid on each other category of income described in section 904(d)(l) may be credited only against United states tax on that category of income Thus, averaging of tax rates in high tax and low tax countries is permitted but only within defined categories of income.

Under the Administration Proposal, the overall limitation would be replaced by a per country limitation. Such limitation would apply separately for each “basket” of income from that country In order to protect the integrity of the per country approach, in computing the indirect foreign tax credit, the dividend received by a United States corporation from a foreign corporation in which it has the requisite 10% ownership would be “traced” and the dividend apportioned to the underlying country of source and “basket” in relation to the

[9] Although foreign oil and gas extraction income is not technically in a separate basket under section 904(d)(l), section 907(a) operates to produce the same result for all practical purposes.

accumulated profits of the lower tier subsidiary out of which the dividend is paid.[10]

If the foreign corporation in turn had subsidiaries, the same apportionment rule would apply to dividends that it received from its subsidiary, and so on down a corporate chain to the lowest tier subsidiary (even, apparently, if the lowest subsidiary was fourth tier or lower so there is no foreign tax credit with respect to any income tax paid by it) However, under a proposed “de minimis” rule, if a foreign corporation receives less than 10% of its accumulated profits from outside its country of incorporation (the 10% limit apparently being calculated on an overall basis), it may elect to treat all of its accumulated profits as coming from sources within its country of incorporation Presumably, each year's profits will be considered separately for purposes of this de minimis rule.

Special rules would be provided to “source” certain tax payments equitably. Where a gross basis withholding tax is imposed on distributions from a lower tier corporation, the tax would be treated as paid to the same country as the country where the distribution is resourced; in all other cases, withholding taxes would be treated as paid to the country that imposes the tax. In the case of taxes on net income of a foreign

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10 The Administration Proposal does not state whether the same rules would apply to receipt of a dividend payment from another corporation if the recipient United States corporation does not have the requisite minimum stock ownership required for allowance of an indirect foreign tax credit, but protection of the integrity of the per country structure would appear to require the tracing in all cases.

corporation to which the 10% de minimis rule described above is not applicable, a portion of such taxes would be resourced within certain limits, in accordance with the source of the foreign corporation's accumulated profits (presumably determined, for this purpose, solely by reference to the accumulated profits of the specific year in question).

The Committee recommends that the present overall foreign tax credit limitation be retained because it is far simpler administratively and it appears questionable whether the more burdensome per country limitation would provide any significant reduction in “abuse.” The Committee questions the seriousness of any problem that now exists or that may be generated by the adoption of the rest of the Administration Proposal To the extent specific abuses are perceived, the Committee believes a better approach is to attack those problems through appropriately defined separate limitation “baskets,” such as the quasi-separate basket that was established in 1975 for oil and gas extraction income and the expansion of the “passive income” basket as proposed by the Administration.

The discussion in the Administration Proposal acknowledges that changing to a per country limitation will significantly increase recordkeeping requirements and administrative burdens both on taxpayers and on the IRS in auditing taxpayer compliance:

> "It is recognized that these appropriate results will be achieved only through imposition of significant new burdens on both taxpayers and the Internal Revenue Service Computation of a per country limitation with expanded separate baskets will introduce additional complexity into the already complicated limitation calculation. The per country limitation will make determinations regarding the source of subsidiary income, correct intercompany transfer pricing, and expense allocation involving exclusively foreign operations relevant to the foreign tax credit computation The recordkeeping burdens on taxpayers and auditing burdens on the IRS will be correspondingly increased."[11]

The discussion also reflects that while steps to simplify and ease the administrative burden will be considered, the drafters of the proposals were not able to identify steps which would significantly reduce the complexity and burdens created by the proposed changes.[12]

The Committee believes that the potential complexities and burdens from shifting to a per country system will indeed be formidable. Consider, for example, a United States corporation which has subsidiaries in three different countries, each deriving income from two different countries and each deriving income falling in the same two different baskets. If all of the earnings of all of the corporations are distributed each year, instead of making two credit limit calculations as would be required under current law, the United States corporation must make (and the Service must consider auditing) a total of 12 calculations. In addition, in computing such limits consideration must be given not

[11] Administration Proposal at 395.

[12] Ibid.

only to the questions of how to allocate specific expenses of each corporation and overhead expenses of the corporation and the overall group, but also to the questions of the proper charges for any transactions between the foreign corporations. Having done the foregoing, the United States corporation and the Service must then address additional issues, not posed by an overall limitation, relating to the amount of tax credits potentially available with respect to a particular source. One such issue would be what to do with income derived from an affiliate or subsidiary that does not increase the recipient's total foreign tax in its country of incorporation but changes the relative "mix" of the recipient corporation's foreign source income and potentially thereby the amount of "home country" tax allocated to a specific source.[13]

Even some of the specific rules suggested in the Administration Proposal to relieve compliance burdens do not necessarily foster simplicity. For example, the proposed 10% de minimis rule for not resourcing dividends presumably would be applied to each current year separately. But a taxpayer who relies on such a

[13] An example of a situation which could raise this issue would be a dividend to a parent corporation in a country (e.g., the Netherlands) which imposes no additional tax on the dividend from a subsidiary. Another example might be an intercompany lease where the rental receipts were sheltered in the recipient's country by more rapid depreciation than would be taken into account in computing accumulated profits for United States tax purposes. The degree of knowledge of foreign tax systems that taxpayers and, perhaps more importantly, IRS auditing agents may need to have and the depth of audit of foreign entities that may be necessary are obvious.

rule presumably will have to do sufficient recordkeeping to be able to determine compliance and then would have to preserve all the necessary records to substantiate compliance if challenged on audit.

In the face of the very significant increase in complexity and administrative burden that would be engendered, any proposal to change to a per country limitation should bear an especially heavy burden to show that there is an objectionable state of affairs existing or expected that is significant in magnitude and that can be expected to be controlled to a significant degree by the proposed changes.

The Committee questions the current magnitude of abuse and the extent to which it may be intensified by adoption of the Administration's Proposal. But it also believes that changing to the per country limitation is not likely to control abuse significantly in any event.

The Administration Proposal views the “averaging” of effective foreign tax rates as causing the United States Treasury to have to subsidize operations owned directly or indirectly by United States interests in countries imposing taxes at higher effective rates than the United States. It gives two reasons why “averaging” is undesirable. The first asserted reason is that averaging gives taxpayers an incentive to engage in manipulations, in the sense of doing something for tax purposes to increase the utilization of their available tax credits that they would not do in the absence of the tax considerations. There is a stated concern that such incentives will be increased by the rate reductions in the other parts of the Administration's Proposal.

The second asserted reason is that averaging allows some foreign countries to maintain higher tax rates on United States capital than they might otherwise maintain.

Whether and to what extent "averaging" should be viewed as a subsidy and the form and extent to which subsidies should be provided for foreign operations of United States businesses involve policy questions beyond the appropriate scope of these comments. The discussion which follows therefore focuses only on the reasons why substitution of a per country limitation for an overall limitation is not likely to enforce effectively whatever limits are desired for any such "subsidy."

The extent to which the overall limitation actually increases the burden on the United States Treasury from allowances of foreign tax credits appears open to question. When a taxpayer has net losses in a foreign country, the current overall limitation can be a more effective restriction on allowance of excess benefits than the per country proposal the Administration,[14] and does not appear that the overall limitation has prompted so far any

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[14] The principal reason that Congress repealed the per country limitation in 1976 was its belief that a per country calculation allowed a taxpayer with a loss in a particular foreign country to obtain a "double tax benefit." Because the limitation was computed separately for each foreign country, losses in any country did not reduce the amount of credit allowed for foreign taxes paid in other foreign countries from which income was derived. Instead the losses reduced U.S. taxes on U.S.-source income by decreasing the worldwide taxable income on which the U.S. tax was based.

(footnote continued)

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In addition, when the business operations in the loss country later became profitable, a credit was allowed for any taxes great shift of investment to low tax countries in order to "average down" effective foreign tax rate.[15] It is also

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paid in that country. Unless the foreign country had a mechanism for reducing taxes because of the previous loss, the taxpayer received a second benefit when it obtained a U.S. credit even though earlier losses in that country reduced U.S. tax liability on the U.S.-source income. The revenue projections accompanying the 1976 amendment indicated that mandating the overall limitation was expected to increase revenues in each of five subsequent budget periods. As part of the 1976 tax revisions; Congress also adopted a loss recovery rule. The additional revenue projected to be derived from that change was modest, however.

While the inclusion of a loss recovery rule such as that contained in the Administration Proposal can help to avoid the "double benefit" permitted by the law in effect prior to 1976, to the extent that there is a loss in a particular country and there is no subsequent profit from which that loss is recovered, an additional benefit potentially will still result. The foreign loss either reduces the tax on domestic income or it increases the effective foreign tax credit available by reducing the foreign source income without correspondingly reducing the amount of foreign taxes available for credit (if the reduced foreign source income does not generate an excess foreign tax credit which goes unused). Determining losses on a country-by-country basis instead of an overall foreign basis tends to increase the prospect that a loss (a) will arise and (b) will not be recovered subsequently.

15 It does not appear that tax havens such as New Hebrides, the Cayman Islands, the Bahamas or Cyprus are becoming industrial centers. Many business operations face the natural constraints of a need to be close to supplies of raw materials or skilled labor or close to the markets for their finished goods -- one is obliged to drill for oil, for example, where one finds it. Despite the availability of the overall limitation for almost 25 years, United States investment abroad is still very heavily concentrated in countries which have at least a high statutory tax rate. According to July 8, 1985 statistics from the U.S. Department of Commerce, Bureau of Economic Analysis, at the end of 1984 approximately 73% of total U.S. investment abroad (exclusive of banking and insurance and finance) was in countries with statutory rates equal to or greater than 46%. Approximately 87% was in countries with statutory rates equal to or greater than 33%. In terms of 1984 net capital outflows, approximately 53% went to countries with statutory rates equal to or higher than 46% and approximately 59% went to countries with statutory rates of 33% or more.

open to question whether adoption Administration's other tax reform proposals would significantly increase the incentive to establish operations in low tax countries. Although the proposals include a sharp reduction in the statutory tax rates, the Administration Proposal's change in the relevant effective tax rate is projected to be considerablymore modest.[16]

(Foot Note continued)
In some of the countries with high statutory rates, the effective tax rate may be significantly lower than the statutory rate (as in the United States). On the other hand, at least some of the investment in some low tax countries such as Hong Kong and Taiwan (and in other countries, such as Mexico and Spain with effective rates well below their statutory rates) may be due more to such natural business factors as low wage costs than to low enough taxes to permit absorption of excess foreign tax credits arising elsewhere.

There is reason to believe, therefore, that at present (a) excess foreign tax credits are not that significant or (b) they can be absorbed by generating other sources of lightly taxed income from the same country (or at least other “high” tax countries) or (c) the business constraints on establishing operations in low tax countries substantially restrict the feasibility of channeling investments solely (or even principally) to use excess credits.

16 The revenue projections included in the Administration Proposal indicate that before taking into account the change to the per country limitation and before taking into account the elimination of the investment tax credit and other business tax credits (which are only allowed after the foreign tax credit is allowed), the expected effect on total corporate taxes of the proposals would be as follows:

Corporate Income Tax Collections
(in billions)

	1986	1987	1988	1989	1990
Without Any Changes*	90.9	115.9	129.7	139.5	148.2
With All Changes Except Overall Limit	94.9	113.9	121.6	126.8	133.4
Increase (Decrease)	4	(2)	(8.1)	(12.7)	(14.8)
Percentage Change	4.4%	(1.7%)	(6.2%)	(9.1%)	(10%)

In itself, this would not appear to indicate a need for corporations with substantial foreign operations to dramatically improve after-tax returns on their existing foreign operations to protect their position and performance appearance in comparison to corporations more heavily concentrated in the domestic sector. Moreover, not all foreign earnings are repatriated (or at least are not repatriated currently). There is thus an incentive to minimize any excess foreign tax payment problem by reducing the foreign taxes paid rather than manipulating the foreign tax credit limitation to increase the creditable amount of foreign taxes. In its report on the Administration Proposal, the Joint Committee on Taxation noted that statistics compiled by the Service indicate that in 1980 the effective foreign tax rate on earnings of all United States controlled foreign corporations averaged approximately 30 percent, or slightly less than the reduced corporate tax rate proposed.[17]

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* Based on the projected figures for no tax reform changes plus addition of the projected increase in tax from elimination of the investment tax credit (to obtain a total estimated tax liability to which the foreign tax credit limitation would apply).

[17] Joint Committee on Taxation, “Tax Reform Proposals: Taxation of Foreign Income and Foreign Taxpayers,” July 18, 1985.

To the extent that undesirable averaging of effective rates is occurring under the current overall limitation (or would occur after enacting the other Administration proposals), the Committee doubts that changing to a per country limitation will improve the situation significantly. Since changing the basis of the limitation will not in itself change the degree to which particular taxpayers are willing to alter their business operations solely for tax purposes, the per country limitation can be expected to succeed only insofar as it reduces or makes more difficult opportunities for manipulation of effective foreign tax rates.

The Committee doubts that shifting to the per country limitation will significantly restrict such opportunities. First, as has already been noted, the current pattern of United States foreign investment suggests that United States taxpayers have not found it necessary or possible to reduce taxes by investing in countries with lower statutory rates. Consequently, even if a per country limitation would impose greater restrictions in principal, it is not clear that this would translate completely into a meaningful additional restriction.

Second, shifting to a per country limitation in itself does not foreclose tax planning using investment in low tax countries to effectively "average down" foreign tax rates. Given the considerable variety of tax systems in high tax countries, there undoubtedly will be opportunities to shift the principal place of taxation of some income without necessarily placing the real place of investment in a low tax country or changing the source of the income under United States tax rules. This is particularly likely to be the case with such transactions as intercompany leases or loans.[18] Policing the integrity of a per country system will therefore put considerable pressure on the United States source rules and separate tax credit "baskets," with potentially corresponding increases in the complexity of those rules.

Moreover, even with a per country limitation, opportunities are likely to arise for "averaging down" high taxes through structural planning. Consider, for example, a "high tax" country (such as the Netherlands) that taxes its corporations on worldwide net income but which does not impose further domestic tax on dividends from foreign subsidiaries, or a country (such as Germany) that uses the exemption method to avoid double taxation of a foreign (as to it) branch. If a subsidiary organized in such a country has too high an effective foreign tax rate, a home country tax allocation rule such as that put forth in the Administration Proposal would permit a taxpayer to "average down" its tax rate by routing an

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[18] Note that neither these examples nor any of the other examples in this report would appear to be subject to effective regulation by such provisions as the arm's length dealing standards in Section 482.

investment in a low tax country through that subsidiary rather than making the investment directly (or through a directly owned subsidiary). In such a case, all that would have been achieved by changing from an overall limitation to a per country limitation would be to force the United States taxpayer to make the same investment through the high tax country subsidiary that it otherwise would have made more directly. Policing a per country system to control the undesired effects thus is also likely to put considerable pressure on, and cause difficulty with, the rules for associating taxes imposed by a particular jurisdiction with the appropriately sourced income under United States tax rules.

Third, as already has been noted, a per country limitation raises additional problems of dealing with losses so as to prevent manipulation "averaging up" the effective rate of foreign tax credits carried by income sourced in other countries.

In light of the additional administrative burdens inherent in a per country limitation and the likelihood that a per country limitation will not prove significantly effective in controlling the perceived shortcoming in the current system, the Committee believes that it would be a mistake to shift from an overall limitation to a per country limitation. The cause of neither fairness nor simplicity would be served by such a wholesale change.

The foregoing analysis suggests that where problems arise in the operation of the limitation, the problem is likely to relate to a particular industry or type of income. Rather than change from the overall method, the Committee belives that a more effective approach is to focus on adjusting the “baskets” subject to separate overall limitations and the foreign loss recapture rules and on adjusting related provisions such as the source rules. Recent legislation has contained such adjustments and additions.[19] While all such rules rapidly introduce additional complexities, the complexity is targeted to the perceived abuse and will therefore tend to fall more heavily on those taxpayers best able to derive the excess benefits desired to be curtailed. Such an approach also offers the flexibility to observe first what changes in the pattern of international operations actually arise from any tax reforms enacted.

The Administration Proposal would make one such change. The “basket” of passive income subject to a separate limitation would be expanded to include dividends from stock interests of less than ten percent and gains from the disposition of assets that generate passive income (other than assets held for use in the ordinary course of business of the type involved in Corn Products Refining Co., 350 U.S. 46 (1955)). Interest, dividends and royalties received from subsidiaries or other affiliated corporations (presumably other corporations in which there is more than 10% overlapping ownership) would not be included in the passive limitation basket.

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[19] E.g., addition in 1975 of the separate basket for oil and gas extraction income; addition in 1984 of the resourcing rule in Section 904(d)(3) to protect the separate passive investment income basket from being circumvented and the special source rule in Section 956(b)(3) to put related party factoring income in the separate passive investment income basket.

The Committee supports the Administration Proposal to expand the passive income basket as an appropriate response to the concern about increased manipulation of the effective foreign tax rate. The appropriate subjects to consider including in the “passive income” basket, in the committee's view, are transactions of the type which (a) involve income that typically is lightly taxed and also (b) have a high likelihood of permitting a taxpayer to reduce the effective foreign tax rate by selectively choosing to increase foreign rather than domestic source income (as distinct from reducing total foreign taxes by shifting to a lower tax country some part of the foreign source income that could be expected to arise in the normal course of business). Portfolio stock investments and other similar discretionary investments not directly tied to the conduct of the foreign business of a taxpayer would satisfy both of the foregoing requirements. By contrast, interest, dividends and royalties from subsidiaries and interest on working capital balances or on loans to customers for purchases of the lender's products or services and other similar Corn Products type transactions would not satisfy the second requirement.[20]

[20] Similarly, the current exclusion from the passive income basket of royalties derived from property developed by the taxpayer is appropriate by reason of the second requirement not being satisfied. The decision to license such property for a royalty constitutes a decision as to how to exploit the taxpayer's business asset and does offer discretion to change the source of the resulting income as long as the source rule for royalties is where the property is used.

Royalties from licensing property not developed by the taxpayer may present a different situation, however. Even though there is a definite source rule for the income, there is a greater possibility that the transaction will represent a

(footnote continued)

The Administration Proposal indicates that further consideration will be given to establishing separate basket limitations for other types of “easily movable income that are generally taxed abroad on a gross withholding basis.” There may be other types of income, or more precisely, types of businesses which are typically lightly taxed and which have the characteristic of having at least some income that is highly moveable. The light taxation may be the result of being taxed on a gross withholding basis (e.g., leasing) or of exemption (e.g., shipping) or of special tax regimes (e.g., banking and insurance). While the source rules may not provide any discretion as to income from a particular transaction, such businesses may offer the opportunity for what are in reality passive discretionary-source financial investments that can be used to adjust effective foreign tax rates if they can be fully combined with other businesses for foreign tax credit limitation purposes. On the other hand, in some instances, such activities can be organized so as to be taxed abroad at a relatively high rate; if combined with a passive income basket, the effect could be to allow excess or high foreign taxes on such activities to “average up” the effective foreign tax rate on other incidental passive income.

(footnote continued from previous page)
“portfolio” type financial transaction involving discretionary investment made with a view to whether the income realized will be from the right foreign source. For such income, it seems appropriate to continue the practice under present law of including the income in the passive income basket unless the licensing activities constitute the active conduct of a trade or business within the meaning of Treas. Reg. $ l.9O4-4(b)(1).

The Committee believes that to the extent these types of activities present undesirable opportunities for rate averaging, a single separate limitation basket could be established for all such businesses apart from the separate passive income basket.

The Staff Options Summary also contains a proposal to expand the present “passive income” basket. The expanded basket would include insurance income, foreign base company income and the disfavored income used in the foreign personal holding company provisions (as in turn expanded to include gain on all passive income producing assets, income from commodities transactions other than hedging transactions, and generally all leasing and licensing transactions). It thus appears to mix in one basket items that the Committee believes, for the reasons just discussed, should be placed in two separate baskets if special restrictions were felt necessary.

The House Bill also expands the present passive income basket, but it also excludes “high-taxed” income from the basket and segregates banking and insurance income and shipping income into further separate baskets.

The intent of the foregoing comments is not necessarily to suggest that any of the enumerated types of income or activities should be the subject of a separate basket. Rather, it is to note that once separate baskets are established for passive investment income and any particular businesses that-are problems -- businesses that-are problems effective control in the case of either a per country or overall limitation -- any remaining potential for “abuse” would have to rest primarily with the incentive to relocate unrestricted business operations from the United States to a foreign site -- in effect a variation on the “runaway plant” debate of the 1970's. Given the non-tax restraints on such business relocations, a wholesale change to the per country limitation is not warranted.

Alternatively, if necessary, plant transfers from the United States that are motivated by a desire to make more effective use of excess foreign tax credits could be dealt with by establishing a separate basket for tax holiday income. The Committee does not favor creation of such a basket because of the technical and administrative problems that it would raise, but as a last resort it may be a preferable alternative to shifting to a general per country rule.[21]

If the per country limitation is adopted, one other change, required by fairness, should also be made in the foreign tax credit limitation rules. The deemed paid credit of Section 902 permits the crediting of taxes

[21] To avoid foreclosing non-tax motivated business development, such a provision probably would need to have motive or purpose as an operative element, with all of the difficulties that would raise. But among the other problems that would be posed by a “tax holiday” basket is the determination of when and for what period the requisite tax holiday exists and what ordering principal for distributions is to apply, when there are undistributed earnings before or after the tax holiday period. In some cases, the “holiday” may be obvious, such as the permanent tax relief offered by a tax haven or the 10-year tax relief period given to designated new business investments by Ireland, Singapore and various Caribbean islands. But any effective control would also need to deal with less obvious but equally significant incentives such as the immediate deduction for new investment in plant facilities afforded by the United Kingdom until recently. At a minimum, the necessary monitoring would require the Service to devote the necessary manpower resources to have an in-depth knowledge of the constantly changing tax laws of quite a number of foreign countries.

of foreign corporations only as remote as three foreign tiers from a United States corporate shareholder; this remoteness test is also applicable to deemed paid taxes pertaining to Section 951 inclusions See Sections 902(b) and 960(a). Thus, foreign tax credits will move up the chains in the above examples. However, unless the resourcing rule traces income below the third foreign tier, the taxpayer will be able to effect averaging of rates. This averaging can take place at any level below the level at which the tracing rules stop. Thus, in order to prevent averaging, tracing down all tiers of foreign corporations would be required. In fairness, if the taxpayer must compute earnings and profits and sources of income for foreign corporations more than three tiers away, then the three-tier limit on the deemed paid foreign tax credit should be removed so that credits will flow along with resourced income. This would not add an administrative burden to the Service because the examining agent would have had to audit all tiers of subsidiaries under the resourcing and tracing rules. Similarly, in the case of a section 1248 transaction, the obligation to trace down all of the tiers for income source should be coupled with the availability of a deemed paid credit which flows up from all levels.

Pooling of Accumulated Profits

Under current law, in computing the “deemed paid” or “indirect” foreign tax credit under Section 902 and Section 960, each year's accumulated profits (or earnings and profits) are maintained separately. Distributions are treated as being made from the most recent unexhausted yearly pool; deficits are carried back to prior years beginning with the most recent prior years, and any excess is carried forward to future years. An exception is made for actual distributions in the first 60 days of a taxable year; these are treated as being made out of the prior year's accumulated profits, if any.

The Administration proposes to treat distributions as coming from a pool of all of the distributing corporation's accumulated profits (in the case of actual distributions) or earnings and profits (in the case of Subpart F deemed dividends), rather than being related to profits from a particular year. The rule treating actual distributions made in the first 60 days of a taxable year as being made from the prior year's accumulated profits would be repealed. A dividend (actual or Subpart F) would be considered to bring with it a pro rata share of the accumulated foreign taxes paid by the subsidiary.

The pooling proposal would apply prospectively only. Future dividends would be treated as paid first out of the pool of all accumulated profits derived by the payor after the effective date. Dividends in excess of that pool would be treated as paid out of pre-effective date accumulated profits under the ordering principles of existing law.

The Administration's proposal appears to be intended, primarily, to remedy one ill and to prevent one abuse. The ill is the disparate treatment that year-by-year ordering can cause for a branch and for a foreign subsidiary.[22] The perceived abuse is the ability of taxpayers to engage in the so-called "rhythm method" of dividend distributions, under which a taxpayer takes out larger dividends in high tax years so that the taxpayer obtains use of a greater foreign tax credit than the average foreign taxes actually paid would allow.[23]

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22 The point can be illustrated by assuming a branch and a foreign subsidiary each having the following pre-tax income and foreign tax payments:

	Pre-Tax Income	Foreign Taxes
Year 1	100	-0-
Year 2	100	-0-
Year 3	100	45
Year 4	(200)	-0-

In the case of the branch, each year's income and taxes will be taken into account currently. Ultimately there will be a net of 100 of taxable income and a foreign tax credit of 46 to offset the U.S. tax on such income. In the case of the foreign subsidiary, however, this overall result can be achieved only if the subsidiary distributes a t least 54 during the period commencing after 60 days after year 2 and ending 60 days after the 'end of year 3. (Even then, there will be a timing difference on when the taxes are due and refunds are allowed.) If the subsidiary distributes all its income currently or within 60 days after the end of year 3, the result will be 300 in taxable income with only a foreign tax credit of 46 and a loss of 200 trapped in the subsidiary. Similarly, if the subsidiary makes no distribution until the end of year 4 and then distributes 54, since the year 4 loss carries back to eliminate the year 3 accumulated profits, the result will be 54 in taxable income and no foreign tax credits available to offset the U.S. tax liability

23 If, for example, in the example given in footnote 22, a distribution of 54 (which will gross-up to 100) is made at the end of year 3 and the loss in year 4 is only 100, a lesser burden will be obtained in the case of the subsidiary than in the case of the branch until such time as the other 100 in earnings of the subsidiary are distributed or deemed distributed.

There is no doubt that the ill exists and that the potential for abuse is also present. The Committee believes, however, that a single pool of earnings (or any system of multiple-year pools) will not solve either of the problems enumerated -- only change their occurrence at most – while vastly complicating compliance and audit burdens. If the separate annual pool system is to be abolished, then the Committee believes that there should be two separate earnings pools. One would be a moving pool covering a sufficient number of the most recent years to minimize the need to refer back to the second pool and to ameliorate potential abuse by averaging out foreign tax fluctuations. The second, which would cover all remaining prior years, then would need to be considered only if the subsidiary were to liquidate, be sold or make a truly extraordinary distribution.

The premise on which the single pool proposal rests is that the credits that become available should be neither more nor less than the “average” credit earned from foreign activity. The rationale for the single pool assumes that the current year's credit, at least in some years, will be greater than the historic average effective tax rate. It must also contemplate that, for some taxpayers, the current average effective tax rate will be higher than the expected future average, due to forseeable losses, declining profits, changes in the host country's tax rate, or some other reason.

Because the perceived problems in the annual pool approach are a consequence of timing differences, at least in part, the problems will not be solved entirely by shifting to one pool of earnings; one pool of earnings; in certain circumstances, a multipleyear pool may even aggravate the extent to which foreign tax credit planning will tend to distort business decisions on distribution policy. Consider the example given in footnote 22. If a single pool is in effect and the foreign subsidiary makes a distribution of 100 (including gross-up for tax credits) at the end of year 3 and no other distributions until the end of time (year 4), the result still will be a net United States tax liability of approximately 31 (46 minus a tax credit of roughly 15) whereas there would be no net United States tax liability in the case of the branch. The effect of using a single pool, therefore, may be to discourage repatriation of earnings to the United States if there is a prospect of a subsequent loss.[24]

Conversely, if year 3 were in fact year 1, and a distribution of 100 were made in year 1, there would still be a disproportionate allowance of foreign tax credits. This variation on the example suggests that in the case of a multiple-year pool, timing considerations can still extend not only to selecting the year of dividend inclusion but also to such issues as whether the taxpayer will make use of accelerated depreciation or other mechanisms for increasing or reducing taxable income (and thereby increasing or reducing taxes paid

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[24] On the other hand, in some cases the proposed loss recapture rules (and any other rule involving spreading of losses) can work a “distortion” in the other direction. If a company believes it is about to incur a loss, it may be advantageous to distribute all accumulated profits and obtain the related credits before the loss. Otherwise, under the proposed loss recapture rules, any opportunity to obtain any use of those credits could be substantially delayed, since future income will be resourced to the extent of the losses before the company can use any deemed paid credits.

and/or the effective foreign tax rate) in a particular year. A potential detrimental consequence of shifting to a single pool of earnings, therefore, can be an incentive to accelerate payment of foreign taxes disproportionately so as to take dividends in early years with high credits and then to delay taking any future dividends until the "average" credit in the pool increases. The point is illustrated more clearly by the following example:

Foreign Corporation A
(With Same Foreign Depreciation)

	Pre-Tax Income	Pre-Tax Income (U.S. Rules)	Foreign Taxes (22%)	Accum. Profits
Year 1	200	200	44	156
Year 2	200	200	44	156
Year 3	200	200	44	156
Year 4	300	300	66	234
Year 5	400	400	88	312
Year 6	400	400	88	312
Year 7	400	400	88	312
	2100	2100	462	1638

Foreign Corporation A
(With Slower Foreign Depreciation)

	Pre-Tax Income	Pre-Tax Income (U.S. Rules)	Foreign Taxes (22%)	Accum. Profits
Year 1	300	200	66	134
Year 2	300	200	66	134
Year 3	300	200	66	134
Year 4	300	200	66	234
Year 5	300	300	66	334
Year 6	300	400	66	334
Year 7	300	400	66	334
	2100	2100	462	1638

If A elects to use the same depreciation and to take a $100 dividend (including gross-up) anytime through year 3, his tax credit will be $22.00. By year 7, A will have paid a total of $462 in foreign tax. Assuming a 33% United States tax rate, however, A also will have paid $11.00 in additional United States tax if it receives no further dividends. If A knows that its parent United States shareholder wants to take a dividend in an early year, it may be better for A to elect to use slower foreign depreciation, which increases income and taxes in early years but results in higher depreciation (and lower reported foreign income) in later years. Using the slower depreciation, a $100 dividend from A anytime through year 3 would result in a tax credit of $33. By year 7, A'S foreign tax would still be the same, but A's United States taxes would have been reduced to nil.

The potential manipulation may be greatest in a start up case, but it could also still arise to some extent in existing operations whenever a timing difference results in a deduction arising earlier for United States tax purposes than for foreign tax law purposes. To illustrate further, suppose in the preceding example the same depreciation was used for both tax jurisdictions so that the pre-tax income was the same 300 in year 1 for United States and foreign tax purposes. Suppose also that the entire cumulative difference of 200 shown on the more rapid United States depreciation schedule in years 1 and 2 occurred instead a t the end of year 2 as the result of the United States allowing some extraordinary loss (e.g., a bad debt deduction) one year prior to the foreign tax law. Pre-Tax income under United States rules thus would be 100 in year 2 (300 less the 200 cumulative difference). If in year 2, A pays the same dividends as before, the result will be the same as in the preceding case of different depreciation rates.

Multiple-Year pooling is arguably an improvement over the present system in the sense that the timing “distortion” would be even greater under the annual pool approach if the amount of the dividend were limited to only the increase in accumulated profits arising in year 2 (as computed for United States tax purposes). But the magnitude of the adjustment is in f a c t arbitrary because the neutralization of the event which is the admitted source of the distortion -- the timing difference -- still is not reflected in any of the accounts being considered. The “proper” result will be achieved only if the earnings pool is “averaged” forward into the future as well as back. As the last example illustrates, not only are more or less taxes owed to the United States if dividends are paid in each of the first two years, but if less than the entire accumulated profits are distributed, even more or less United States taxes may be owed if disproporationate amounts are distributed each year than if a single pool approach is used and a single distribution is made at the end of year 2.

The above examples involve only the relatively simple case of a single foreign corporation. Most multinational corporations will have a number of foreign subsidiaries with attendant complexity and planning possibilities. Unless some anti-avoidance rules are included (which would be difficult to develop), the single pool of earnings approach is vulnerable to circumvention through structural planning steps such as (1) the use of multiple corporations conducting different parts of the overall enterprise with potentially different effective tax rates, or (2) appropriately timed mergers or divisions of business operations. Consider, for example, the following hypothetical:

	(Manufacturing with Depreciation Allowances)		(Sales Activity)	
	Pre-Tax Inc.	Foreign Tax	Pre-Tax Inc.	Foreign Tax
Year 1	100	-0-	100	50
Year 2	100	-0-	100	50
Year 3	100	-0-	100	50
Year 4	200	25	(300)	-0-

If the two operations are put in separate subsidiaries for at least years 1 and 2, a dividend can be paid from the sales operation which effectively brings with it a disproportionately higher tax credit than for the combined operation. Similarly, by judicious selection and timing of mergers, it may be possible to withdraw disproportionate amounts of foreign tax credits without long-term adverse detriments. In the preceding example, for instance, if distributions have not previously been made from the sales operation in years 1-3, the credits in the sales operation that otherwise would be lost as a result of the loss at the end of year 4 presumably can be recovered under either an annual pool or a single pool system by merging the sales and manufacturing operations.

If distributions have already been made from the sales operation in years 1-3, and the operations are merged after year 4, under a single pool system a distribution of another 200 (including gross-up) can be made to obtain the last foreign tax credit of 50;[25] by contrast, the annual pool approach discourages such planning because the sales operation loss in year 4 would offset the manufacturing income in years 4 and 3 when the operations are

One other point that the example suggests is that if a high profit/high tax company ("A") is about to be merged into a lower profit/low tax company ("B"), good planning may require A to give a distribution to its parent before the merger, in order to avoid diluting the value of the undistributed deemed paid credits. Although similar considerations are obviously relevant in combining the annual earnings pools under the current system, the magnitude and continuing importance of prior years under a single pool system must be expected to add pressure to take steps for tax purposes that would not be done if other business considerations governed.

With adoption of a single earnings pool, considerations with potentially similar influence on what is actually done can be expected to apply with respect to divisions or possible divisions of foreign subsidiaries. If a single company, AB, is divided under Section 355,

[25] Note also that in this particular example if the foreign country would not have imposed the tax on the manufacturing operation in year 4 if the manufacturing and sales operations had been combined, there has been an incentive to establish a structure that will actually increase the total foreign taxes paid.

the earnings and profits must be allocated between A and B in accordance with Section 312 and Treas. Reg. $1.312-10. This allocation will be made “in proportion to the fair market value of the business[es],” or, “[i]n a proper case, . . . in proportion to the net basis of the assets.” Treas. Reg. $1.312-10(a). Although fair market value depends in part on profitability (historic and, particularly, prospective), there is no reason to believe that either of these methods of allocation will divide the earnings and profits -- and thus the undistributed deemed paid foreign tax credits -- in a way that eliminates planning opportunities. (If the per country limitation is also adopted, even more potential planning opportunities must be expected when a subsidiary operating in two different countries is divided. In such a case, a rule must specify whether each country pool is to be allocated pro rata or in proportion to the portion of the business in each country that goes to each new corporation (under whichever of the fair market value or net basis tests is used)).

Varying fact patterns -- such as increasing or decreasing profits, greater or lesser use of available deductions, shifting corporate entities -- thus can substantially affect the availability of an indirect foreign tax credit. For a large multinational corporation with numerous subsidiaries, the various permutations available are likely to create many of the same planning opportunities that exist now.

Although the disparate foreign tax credit treatment sometimes accorded distributions from a branch and a subsidiary is a concern, it is not a major problem because taxpayers typically have substantial control over whether they wish to operate through a branch or a subsidiary- If the tax penalties of operating in one form or another are sufficiently great, the taxpayer frequently can change the corporate form it uses. There is no compelling need to switch to a pooling method for calculating the indirect foreign tax credit in order to remedy this problem.

On the other hand, the reform proposal would not stop the asserted manipulation of the rhythm method of dividend distributions. The proposal probably would reduce the ability of taxpayers to control the availability of indirect foreign tax credits, but it would not end the planning opportunities. The proposal's ability to significantly improve the extent to which foreign tax credits become available at an “average” rate should therefore be considered suspect.

Shifting to a single pool of earnings also creates a potential coordination problem with the dividend rules that does not arise with the current system of separate year pools. Neither the Administration Proposal nor the House Bill or the Staff Options Summary would change the rule that taxable dividends may be paid out of current earnings even when aggregate earnings show an overall deficit. Under an annual earnings scheme, if there are also foreign taxes paid on the current earnings (because, for example the foreign tax system does not allow carryovers), any foreign taxes will be carried by the dividend to provide a potential foreign tax credit. The effect of the reform proposals, however, presumably would be to deny any credit even though there would be a net taxable income inclusion to the United States shareholder that would not arise in the case of a branch.[26] The effect would be the type of inequity to the taxpayer that the Administration Proposal cites as a reason to change to the single pool. Eliminating the taxable income from the distribution would eliminate the inequity, but that would involve a major change in the fundamental scheme for determining when a taxable dividend arises. Creating a separate annual current earnings pool would provide an opportunity to obtain the foreign tax credit, but that would create exactly the type of opportunity for abusive use of the "rhythm" method for selecting earnings pools that the Administration Proposal is seeking to control. In the case of a prior loss, which is likely to be relatively frequent in light of the initial losses often incurred in start-up situations, the single earnings pool system (or any multiple-year pool system) thus has an inherent incompatibility with the rules for determining what constitutes a dividend.

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[26] Suppose, for example, the following situation.

	Pre-Tax Income	Foreign Taxes
Year 1	(100)	-0-
Year 2	100	50

In the case of a branch, there would be no net taxable income and an excess foreign tax credit of 50. In the case of a subsidiary, if there was a distribution of 50 in year 2, with annual earnings pools, there would be 100 in income, a foreign tax credit of 50 and a deferred foreign loss of 100. With a single earnings pool, there would still be 50 in income from the distribution but no foreign tax credit currently or subsequently and only a deferred foreign loss of 100.

Weighed against the questionable substantive improvement to be gained from substituting a single pool for the current annual pools, the clear administrative problems raised by a single pool appear overwhelming. If a single pool is adopted, any subsequent dividend distribution would require the taxpayer -- and the Service -- to review at least the entire earnings and profits (or accumulated profits) account for the period that has elapsed since a prior post-effective date distribution, whether that is one year or twenty years.[27] If the treatment of that previous distribution was not confirmed by a thorough audit, the Service may have the right (and may feel it necessary) to examine accounting records for periods prior to the previous distribution. Thus, although the current year-by-year ordering principle creates some instances in which extensive reviews of past years are necessary, a pooling principle would require extensive look-backs at least once and possibly more than once for every corporation that ever makes a distribution.[28]

The problem of an extended look-back is even more acute in the case of a foreign corporation newly

[27] To simplify recordkeeping, the Administration Proposal states that accumulated profits will be required to be calculated in the same manner as earnings and profits.

[28] One way to minimize the need to audit all prior years' earnings and profits calculations would be to allow a distribution to serve as prima facie evidence that the earnings and profits account (or accumulated profits account) was correct as of the date of that distribution. Such a rule, however, would put increased pressure on the Service to audit earnings and profits accounts every time there is a distribution, no matter how small. In the absence of such a rule, the earnings and profits account, in theory at least, would be subject to scrutiny at all times for all years until

acquired by a United States taxpayer. It is not only possible, but likely, that the foreign corporation will not have prepared - or maintained accounting records under United States tax accounting principles that would allow the taxpayer or the Service to apply the pooling principle to distributions. Moreover, when the United States taxpayer is a minority shareholder in the foreign corporation, the taxpayer may have no recourse to obtain the necessary records. Again, this problem can arise under the current system, but the risk of noncompliance (and inability to comply) increases exponentially as the recordkeeping burden multiplies.[29]

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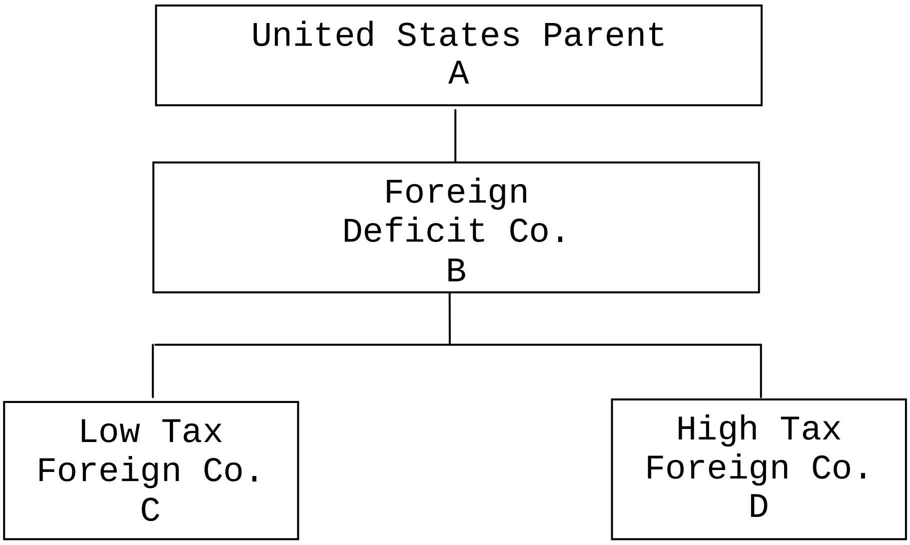
a judicially binding determination is received or the matter is settled through some type of closing agreement procedure.

[29] The House Bill appears to try to deal with this problem by providing that the multiple-year pool concept will be applied only beginning with years after 1985 in which the minimum ownership requirements for an indirect tax credit are met. While this may help to ameliorate the problem where there is no significant direct or indirect ownership, it does not help resolve the practical problems a 10 percent United States corporate shareholder may face in obtaining the necessary information once the shareholding has existed for several years.

Coordination with Subpart F

The Administration Proposal highlights the difference in operation between Section 301 and Section 951(a)(l)(A) and (B). Under the normal subchapter C rules, the recipient of a dividend from a foreign corporation is taxed on the amount distributed to the actual recipient. In contrast, a Section 951 inclusion is taxed directly to the indirect United States shareholder of the controlled foreign corporation regardless of how many intervening tiers of additional foreign corporations separate the United States shareholder from the controlled foreign corporation in question.

This “leap frog” feature of Section 951 inclusions can give rise to new tax planning possibilities if a per country foreign tax credit limitation is adopted. Consider the case of a United States parent corporation (“A”) with a foreign holding company (“B”) that has a deficit in accumulated profits. Assume B in turn owns two separate operating companies, one of which (“C”) has a very low effective tax rate while the other of which (“D”) has a relatively higher effective rate. If both C and D made distributions up the chain, and B in turn paid a dividend to A, the per country limitation would prevent the averaging of the foreign tax rates of C and D, assuming that each foreign corporation has income only from its own country of incorporation. A numerical example and an illustration may aid understanding:



B deficit[30]	--	(95)
C earnings	--	100
Country C taxes	--	4
D earnings	--	100
Country D taxes	--	35

Full distributions by C & D to B

B earnings	66
C taxes deemed paid by B	4
D taxes deemed paid by B	35

Full distribution by B to A

Cash Dividend	66
Section 78 gross-up	39
Total income	105

Tentative Tax @ 33% = = 34.65

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[30] Assume B pays no foreign taxes in this example

Foreign tax credit calculation

C source income $66 \times \frac{39.35}{66}$[31] + 4[32]	=	62.61	14.31
Tentative U.S. tax @ 33%	=	20.66	14.31
Credit	=	--	4
Net U.S. tax	=	16.66	10.31
D source income $66 \times \frac{26.65}{66}$ + 35[32]	=		63.65
Tentative U.S. tax @ 33%	=		20.34
Credit	=		20.34
U.S. tax	=	-0-	-0-

Total U.S. tax = 10.31. Unused country D taxes of 14.66

Now assume that, instead of the foregoing, C makes a full distribution to B followed by a full distribution by B to A. Meanwhile D makes an investment in United States property equal to all of its earnings. Significant averaging results:

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[31] Accumulated profits from C and D after application of loss pro rata.

[32] Gross-up for C taxes and D taxes, respectively, carried by traced-source dividend.

B deficit[33]	--	(95)
C earnings	--	100
Country C taxes	--	4
D earnings	--	100
Country D taxes	--	35

Full distributions by C to B

B earnings	1		
Country C Taxes	4		
Total income	5		
Tentative U.S. taxes @ 33%		=	1.65
Credit		=	1.65
Net U.S. tax			-0-

Investment in U.S. property by D

Section 951 inclusion	65		
Section 78 gross-up	35		
Total income	100		
Tentative U.S. tax @ 33%		=	33
Credit		=	33
Net U.S. tax			-0-

Total U.S. tax = -0-. Unused country C taxes of 2.35 and unused country D taxes of 2.

[33] Assume B pays no foreign taxes in this example.

When D pays an actual dividend to B, the Administration Proposal would effectively exclude that amount (and the related credit gross-up) and the attendant foreign tax from the accounts of B and similarly would not adjust the accounts of B when B made a further distribution to A.

By way of comparison, the result under the overall limitation under both the first and second set of facts is: total U.S. tax of 0, unused foreign taxes of 4.35. Thus, under the second set of facts the United States taxpayer is able to generate a result under the per-country limitation which closely resembles the result under the overall limitation.

The same results as the subpart F inclusion could be realized by appropriate timing of the dividends from C and D to B. But this would require a distribution first from C and then a distribution in a subsequent year from D to B. The timing and ordering would be critical.[34] "leap frog" rule of subpart F provides a way to circumvent such restraints. In so doing, however, it tends to undermine the effectiveness of the loss resourcing rule and thereby the effectiveness of the per country limitation by making it easier for taxpayers

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[34] If the dividend was received by D first and then the dividend from C was received in a subsequent year, an excess tax credit would arise with respect to country D and would be trapped in B because the deficit in earnings of B would be resourced to country D to the extent of the earnings from D.

to allocate the loss on a selective basis. Thus, if the per country limitation is adopted, consideration should also be given to eliminating the direct inclusion rules for deemed distributions under subpart F.

Other planning possibilities become available as well. For example, consider a situation where a Cayman Islands holding company is a first-tier subsidiary of a United States corporation. Assume that the Cayman Islands holding company has no income. Assume further that the Cayman Islands holding company owns several foreign operating companies which have various jurisdictions of incorporation and operation and are subject to various amounts of foreign taxation. None of the operating companies in this example has any subpart F income. Additionally, the United States corporation owns directly other first-tier foreign operating subsidiaries which have no subpart F income. For the sake of simplicity, assume, further, that all of the foreign operating companies pay taxes to, and have income only from, sources within the jurisdiction of incorporation.

If a first-tier foreign operating subsidiary pays a dividend to its United States parent, the income would be sourced to the country of incorporation. If an operating subsidiary of the Cayman Islands holding company paid a dividend to the Cayman Islands corporation, that would constitute subpart F income and a section 951 inclusion to the United States parent corporation which, under the Administration Proposal, would be resourced to the jurisdiction of incorporation of the operating subsidiary of the Cayman Islands corporation. If two operating subsidiaries of the Cayman

Islands holding company paid dividends, the consequent Section 951 inclusion would be resourced, ratably, to the two jurisdictions of incorporation of the operating companies.

If, however, some of the operating subsidiaries of the Cayman Islands holding company had earnings and profits deficits, then actual distributions to the Cayman Islands by the profitable subsidiaries might not trigger a Section 951 inclusion to the United States parent corporation under the chain deficit rules of Sections 952(c), 952(d), and Treas. Reg. § 1.952-1(c) and (d). If the Cayman Islands corporation then paid a cash dividend to the United States -- there being no chain deficit rule under subchapter C -- it would be resourced ratably to the jurisdiction of incorporation of the operating subsidiaries which had paid dividends to the Cayman Islands corporation. The United States shareholder thus is in a position to receive blended-source income (by obtaining a subchapter C dividend on investment in United Stat=s property from the Cayman Islands corporation) or pure-source income (by having an operating subsidiary of the Cayman Islands company make an investment in United States property, such as a loan to the United States shareholder).

An additional anomaly in the Administration Proposal is worthy of note. The resourcing of dividends rule suggested in the Proposal is based on 10 percent of earnings and profits. That is, if more than 10 percent of a foreign corporation's earnings and profits are derived from sources outside the country of its incorporation, then, for Section 904 purposes, a ratable amount of any dividend paid by such corporation will be resourced to the country or countries where the earnings and profits are derived. In contrast, the foreign base company income de minimis rule of Section 954(b)(3) turns on 10 percent of gross income of the controlled foreign corporation. That is, if less than 10 percent of the gross income of a controlled foreign corporation is foreign base company income, there is no Section 951 inclusion by its United States shareholders. It should be noted that, unlike gross income, earnings and profits is a net figure and likely to be considerably-smaller than gross income. As a result, dividends can be paid from lower tier foreign corporations to a higher tier foreign corporation and a certain degree of tax rate averaging can be achieved, provided that such dividends constitute less than 10 percent of the earnings and profits of the higher tier foreign corporation. In such a case, it is a virtual certainty that such dividends will not cause a Section 951 inclusion by the United States shareholder if such dividends are the only foreign base company income of the higher-tier foreign corporation by virtue of the 10 percent of gross income de minimis rule for foreign base company income.

The House Bill proposes to change the subpart F *de minimis* rule to 10 percent of earnings and profits.

Harmonization of Accumulated Profits and Earnings and Profits Computations

Currently, actual distributions not treated as distributions of previously taxed subpart F income are based on "accumulated profits" and deemed dividends are based on earnings and profits. The former are calculated under rules essentially the same as those used for calculation of earnings and profits for domestic corporations. The latter are calculated pursuant to regulations promulgated under Section 964(a): Section 964(a) requires that the rules be "substantially similar" to those used for calculation of earnings and profits of domestic corporations. Under the Section 964 Regulations, adjustments to conform foreign accounts to United States financial and tax accounting rules do not have to be made unless they are material and specific rules are provided for translating amounts stated in foreign currency. The amount computed for subpart F distribution purposes thus might be different, at least in theory, from the amount computed for actual distribution purposes.

The Administration Proposal and the House Bill both would require accumulated profits to be computed on the same basis as earnings and profits for subpart F purposes, thereby harmonizing the two concepts.

The Committee endorses this proposal and supports the use of the subpart F rules as the more modern and administratively sensible approach to deal with the practical difficulties and special problems of earnings computations in the international area.

Expansion of Excess Tax Credit Carryovers/Carrybacks

Under current law, excess foreign tax credits may be carried back 2 years and forward 5 years. The Administration Proposal would extend the carryforward period to 10 years; the House Bill would leave current law unchanged, but it also proposes to retain the overall limitation.

If the per country limitation is adopted, the likelihood of temperal mismatching may very well increase, and for the reasons already discussed changing to a single pool or multiple-year earnings pool may not provide adequate relief. If the per country limitation is adopted, the Committee supports expansion of the carryover/carryback period for excess credits.

The Committee believes, however, that extending only the carryforward period should not be based on “serious administrative difficulties” arising from an increased carryback period. While a foreign tax credit carryback claim may raise source and allocation issues not examined when prior years were audited, that problem already exists with respect to earlier years in relation to the present 2-year carryback.

Moreover, under current Service operating practices the earliest taxpayer year under active audit is frequently more than three years back in time. Since foreign tax credits are allowed before various other tax credits, a carryback could in turn raise the ancillary issue of a further carryback or carryover of such other credits, but that same result would arise in the case of a net operating loss producing a comparable reduction in tax liability in the earlier year. Consideration of further extension of the allowable carryback period therefore should not be excluded on technical grounds.