PRESENT LAW AND SELECTED POLICY ISSUES IN THE U.S. TAXATION OF CROSS-BORDER INCOME

Scheduled for a Public Hearing
Before the
SENATE COMMITTEE ON FINANCE
on March 17, 2015

Prepared by the Staff
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INTRODUCTION

The Senate Committee on Finance has scheduled a public hearing on March 17, 2015, titled "Building a Competitive U.S. International Tax System." This document,[1] prepared by the staff of the Joint Committee on Taxation, covers a number of topics related to the U.S. taxation of cross-border income. Part I of this document describes general international principles of taxation and how they are applied in the U.S.-tax system. Part II provides an overview of U.S. present law related to the taxation of cross-border income. Part III discusses selected issues that have been of particular interest to policymakers as they evaluate the U.S. international tax system: the competitiveness of the U.S. tax system; the economic distortions arising from deferral; the shifting of income and business operations away from the United States; the tax incentive to locate deductions in the United States; and inversions. Part IV contains background data on cross-border income flows and economic activity, including mergers and acquisitions.

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[1] This document may be cited as follows: Joint Committee on Taxation, *Present Law and Selected Policy Issues in the U.S. Taxation of Cross-Border Income* (JCX-51-15), March 16, 2015. This document can also be found on the Joint Committee on Taxation website at www.jct.gov.

I. INTERNATIONAL PRINCIPLES OF TAXATION

A. General Overview

A number of commonly accepted principles have developed to minimize the extent to which conflicts arise between countries as a result of extraterritorial or overlapping exercise of authority. International law generally recognizes the right of each sovereign nation to prescribe rules to regulate conduct with a sufficient nexus to the sovereign nation. The nexus may be between conduct and the territory of the nation or it may be between a person (whether natural or juridical) and the status of that person in the view of the sovereign nation.[2] Normative limitations based on the reasonableness of such regulatory action have developed. In addition, most legal systems respect limits on the extent to which extraterritorial measures can be given effect. The broad acceptance of such norms extends to cross-border trade and economic dealings.

These two broad bases of jurisdiction, *i.e.*, territoriality and nationality of the person whose conduct is regulated, have been refined and, in varying combinations, form the bases of most systems of income taxation. Exercise of taxing authority based on a person's status as a national, resident, or domiciliary of a jurisdiction reaches worldwide activities of such persons and is the broadest assertion of taxing authority. A more limited exercise of taxation occurs when taxation is imposed only to the extent that activities occur, or property is located, in the territory of the taxing jurisdiction. If a person conducts business or owns property in a jurisdiction, or if a transaction occurs in whole or in part in a jurisdiction, the resulting limited basis of taxation is a territorial application.

Regardless of which basis of taxation is used by a jurisdiction, the identification of its tax base depends upon establishing rules for determining whether the income falls within its authority to tax. The source of income and its related expenses are governed by source rules that specify the treatment of income derived from a broad range of activities. Those rules sometimes turn on residency, leading to another set of rules that determine how to identify which persons have sufficient contact with a jurisdiction to be considered resident. For individuals, the test may depend solely upon nationality, or a physical presence test, or some combination. For all other persons, determining residency may require more complex consideration of the level of activities within a jurisdiction. Such rules generally reflect a policy decision about the requisite level of activity within a geographic location that warrants assertion of taxing jurisdiction.

Mechanisms to eliminate double taxation have developed to address those situations in which the source and residency determinations of the respective jurisdictions result in duplicative assertion of taxing authority, as well as to permit limited mutual administrative assistance between jurisdictions.[3] For example, asymmetry between different standards adopted in two

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[2] American Law Institute, *Restatement (Third) of Foreign Relations Law of the United States*, secs. 402 and 403, (1987).

[3] Although U.S. courts extend comity to foreign judgments in some instances, they are not required to recognize or assist in enforcement of foreign judgments for collection of taxes, consistent with the common law "revenue rule" in *Holman v. Johnson*, 1 Cowp. 341, 98 Eng. Rep. 1120 (K.B.1775). American Law Institute,

countries for determining residency of persons, source of income, or other basis for taxation may result in income that is subject to taxation in both jurisdictions. When the rules of two or more countries overlap, potential double taxation is usually mitigated by operation of bilateral tax treaties or by legislative measures permitting credit for taxes paid to another jurisdiction.

In addition to bilateral treaties, countries work with multilateral organizations to develop common principles for adoption by its members and to identify emerging issues and possible solutions. The Organization for Economic and Cooperation and Development ("OECD"), in response to concerns raised by the G20 about base erosion and profit shifting and the desire to provide an internationally coordinated approach to such concerns, is conducting an ongoing project, which began with the release of a report on February 12, 2013, *Addressing Base Erosion and Profit Shifting*.[4] That report presents an overview of data and global business models, identifies the issues under study and provides timeframes in which it is issuing reports and delivering recommendations to the G20. The European Union and several of its member states have introduced proposals or enacted laws that deny tax benefits in arrangements in which companies might otherwise derive low-tax or zero-tax cross-border income.

Restatement (Third) of Foreign Relations Law of the United States, sec. 483, (1987). To the extent that the revenue rule is abrogated, it is done so in bilateral treaties, to ensure reciprocity.

[4] OECD Publishing, *Addressing Base Erosion and Profit Shifting*, 2013, available at http://dx.doi.org/10.1787/9789264192744-en ("BEPS Report").

B. International Principles as Applied in the U.S. System

The United States has adopted a Code that combines the worldwide taxation of all U.S. persons (U.S. citizens or resident aliens and domestic corporations)[5] on all income, whether derived in the United States or abroad, with territorial-based taxation of U.S.-source income of nonresident aliens and foreign entities, and limited deferral for foreign income earned by subsidiaries of U.S. companies. Under this system (sometimes described as the U.S. hybrid system), the application of the Code differs depending on whether the income arises from outbound investment or inbound investment. Outbound investment refers to the foreign activities of U.S. persons, while inbound investment is investment by foreign persons in U.S. assets or activities.

With respect to outbound activities, income earned directly by a U.S. person, including as a result of a domestic corporation's conduct of a foreign business itself (by means of direct sales, licensing or branch operations in the foreign jurisdiction) rather than through a separate foreign legal entity, or through a pass-through entity such as a partnership, is taxed on a current basis. However, active foreign business income earned by a domestic parent corporation indirectly through a foreign corporate subsidiary generally is not subject to U.S. tax until the income is distributed as a dividend to the domestic corporation. This taxpayer-favorable result is circumscribed by the anti-deferral regimes of the Code, described in Part II., below.

By contrast, nonresident aliens and foreign corporations are generally subject to U.S. tax only on their U.S.-source income. Thus, the source and type of income received by a foreign person generally determines whether there is any U.S. income tax liability, and the mechanism by which it is taxed (either by gross-basis withholding or on a net basis through tax return filing).

Category-by-category rules determine whether income has a U.S. source or a foreign source. For example, compensation for personal services generally is sourced based on where the services are performed, dividends and interest are, with limited exceptions, sourced based on the residence of the taxpayer making the payments, and royalties for the use of property generally are sourced based on where the property is used. These and other source rules are described in more detail below.

To mitigate double taxation of foreign-source income, the United States allows a credit for foreign income taxes paid. As a consequence, even though resident individuals and domestic corporations are subject to U.S. tax on all their income, both U.S. and foreign source, the source of income remains a critical factor to the extent that it determines the amount of credit available for foreign taxes paid. In addition to the statutory relief afforded by the credit, the network of bilateral treaties to which the United States is a party provides a system for elimination of double taxation and ensuring reciprocal treatment of taxpayers from treaty countries.

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[5] Sec. 7701(a)(30) defines U.S. person to include all U.S. citizens and residents as well as domestic entities such as partnerships, corporations, estates and certain trusts. Whether a noncitizen is a resident is determined under rules in section 7701(b).

Present law provides detailed rules for the allocation of deductible expenses between U.S.-source income and foreign-source income. These rules do not, however, affect the timing of the expense deduction. A domestic corporation generally is allowed a current deduction for its expenses (such as interest and administrative expenses) that support income that is derived through foreign subsidiaries and on which U.S. tax is deferred. The expense allocation rules apply to a domestic corporation principally for determining the corporation's foreign tax credit limitation. This limitation is computed by reference to the corporation's U.S. tax liability on its taxable foreign-source income in each of two principal limitation categories, commonly referred to as the "general basket" and the "passive basket." Consequently, the expense allocation rules primarily affect taxpayers that may not be able to fully use their foreign tax credits because of the foreign tax credit limitation.

U.S. tax law includes rules intended to prevent reduction of the U.S. tax base, whether through excessive borrowing in the United States, migration of the tax residence of domestic corporations from the United States to foreign jurisdictions through corporate inversion transactions or aggressive intercompany pricing practices with respect to intangible property.

II. PRESENT LAW

A. Principles Common to Inbound and Outbound Taxation

Although the U.S. tax rules differ depending on whether the activity in question is inbound or outbound, there are certain concepts that apply to both inbound and outbound investment. Such areas include the transfer pricing rules, entity classification, the rules for determination of source, and whether a corporation is foreign or domestic.

Transfer pricing

A basic U.S. tax principle applicable in dividing profits from transactions between related taxpayers is that the amount of profit allocated to each related taxpayer must be measured by reference to the amount of profit that a similarly situated taxpayer would realize in similar transactions with unrelated parties. The transfer pricing rules of section 482 and the accompanying Treasury regulations are intended to preserve the U.S. tax base by ensuring that taxpayers do not shift income properly attributable to the United States to a related foreign company through pricing that does not reflect an arm's-length result.[6] Similarly, the domestic laws of most U.S. trading partners include rules to limit income shifting through transfer pricing. The arm's-length standard is difficult to administer in situations in which no unrelated party market prices exist for transactions between related parties. When a foreign person with U.S. activities has transactions with related U.S. taxpayers, the amount of income attributable to U.S. activities is determined in part by the same transfer pricing rules of section 482 that apply when U.S. persons with foreign activities transact with related foreign taxpayers.

Section 482 authorizes the Secretary of the Treasury to allocate income, deductions, credits, or allowances among related business entities[7] when necessary to clearly reflect income or otherwise prevent tax avoidance, and comprehensive Treasury regulations under that section adopt the arm's-length standard as the method for determining whether allocations are appropriate.[8] The regulations generally attempt to identify the respective amounts of taxable income of the related parties that would have resulted if the parties had been unrelated parties dealing at arm's length. For income from intangible property, section 482 provides "in the case of any transfer (or license) of intangible property (within the meaning of section 936(h)(3)(B)), the income with respect to such transfer or license shall be commensurate with the income attributable to the intangible." By requiring inclusion in income of amounts commensurate with

[6] For a detailed description of the U.S. transfer pricing rules, see Joint Committee on Taxation, *Present Law and Background Related to Possible Income Shifting and Transfer Pricing* (JCX-37-10), July 20, 2010, pp. 18-50.

[7] The term "related" as used herein refers to relationships described in section 482, which refers to "two or more organizations, trades or businesses (whether or not incorporated, whether or not organized in the United States, and whether or not affiliated) owned or controlled directly or indirectly by the same interests."

[8] Section 1059A buttresses section 482 by limiting the extent to which costs used to determine custom valuation can also be used to determine basis in property imported from a related party. A taxpayer that imports property from a related party may not assign a value to the property for cost purposes that exceeds its customs value.

the income attributable to the intangible, Congress was responding to concerns regarding the effectiveness of the arm's-length standard with respect to intangible property—including, in particular, high-profit-potential intangibles.[9]

Entity classification

A business entity is generally eligible to choose how it is classified for Federal tax law purposes, under the "check-the-box" regulations adopted in 1997.[10] Those regulations simplified the entity classification process for both taxpayers and the Internal Revenue Service ("IRS"), by making the entity classification of unincorporated entities explicitly elective in most instances.[11] Whether an entity is eligible and the breadth of its choices depends upon whether it is a "per se corporation" and the number of beneficial owners.

Certain entities are treated as "per se corporations" for which an election is not permitted. Generally, these are domestic entities formed under a State corporation statute. A number of specific types of foreign business entities are identified in the regulations as per se corporations. These entities are generally corporations that are not closely held and the shares of which can be traded on a securities exchange.[12]

An eligible entity with two or more members may elect, however, to be classified as a corporation or a partnership. If an eligible entity fails to make an election, default rules apply. A domestic entity with multiple members is treated as a partnership. A foreign entity with multiple members is treated as a partnership, if at least one member does not have limited liability, but is treated as a corporation if all members have limited liability.

The regulations also provide explicitly that a single-member unincorporated entity may elect either to be treated as a corporation or to be disregarded (treated as not separate from its owner). A disregarded entity owned by an individual is treated in the same manner as a sole proprietorship. In the case of an entity owned by a corporation or partnership, the disregarded

[9] H.R. Rep. No. 99-426, p. 423.

[10] Treas. Reg. sec. 301.7701-1, *et seq*.

[11] The check-the-box regulations replaced Treas. Reg. sec. 301.7701-2, as in effect prior to 1997, under which the classification of unincorporated entities for Federal tax purposes was determined on the basis of a four characteristics indicative of status as a corporation: continuity of life, centralization of management, limited liability, and free transferability of interests. An entity that possessed three or more of these characteristics was treated as a corporation; if it possessed two or fewer, then it was treated as a partnership. Thus, to achieve characterization as a partnership under this system, taxpayers needed to arrange the governing instruments of an entity in such a way as to eliminate two of these corporate characteristics. The advent and proliferation of limited liability companies ("LLCs") under State laws allowed business owners to create customized entities that possessed a critical common feature—limited liability for investors—as well as other corporate characteristics the owners found desirable. As a consequence, classification was effectively elective for well-advised taxpayers.

[12] For domestic entities, the State corporation statute must describe the entity as a corporation, joint-stock company, or in similar terms. The regulations also treat insurance companies, organizations that conduct certain banking activities, organizations wholly owned by a State, and organizations that are taxable as corporations under other Code provisions as *per se* corporations.

entity is treated in the same manner as a branch or division. The default treatment for an eligible single-member domestic entity is as a disregarded entity. For an eligible single-member foreign entity, the default treatment depends upon whether the single-member entity has limited liability. If it does, the foreign entity is treated as a corporation; otherwise, its default treatment is that of a disregarded entity.

The regulations extended elective classification to foreign, as well as domestic, entities on the basis that the complexities and resources devoted to classification of domestic unincorporated business entities were mirrored in the foreign context. As a result, it is possible for an entity that operates across countries to elect into a hybrid status. "Hybrid entities" refers to entities that are treated as flow-through or disregarded entities for U.S. tax purposes but as corporations for foreign tax purposes; for "reverse hybrid entities," the opposite is true. The existence of hybrid and reverse hybrid entities can affect whether the taxpayer can use foreign tax credits attributable to deferred foreign-source income or income that is not taxable in the United States, as well as whether income is currently includible under subpart F.

Source of income rules

The rules for determining the source of certain types of income are specified in the Code and described briefly below. Various factors determine the source of income for U.S. tax purposes, including the status or nationality of the payor, the status or nationality of the recipient, the location of the recipient's activities that generate the income, and the location of the assets that generate the income. If a payor or recipient is an entity that is eligible to elect its classification for Federal tax purposes, its choice of whether to be recognized as legally separate from its owner in another jurisdiction can affect the determination of the source of the income and other tax attributes, if the hybrid entity is disregarded in one jurisdiction, but recognized in the other. To the extent that the source of income is not specified by statute, the Treasury Secretary may promulgate regulations that explain the appropriate treatment. However, many items of income are not explicitly addressed by either the Code or Treasury regulations, sometimes resulting in non-taxation of the income. On several occasions, courts have determined the source of such items by applying the rule for the type of income to which the disputed income is most closely analogous, based on all facts and circumstances.[13]

Interest

Interest is derived from U.S. sources if it is paid by the United States or any agency or instrumentality thereof, a State or any political subdivision thereof, or the District of Columbia. Interest is also from U.S. sources if it is paid by a resident or a domestic corporation on a bond, note, or other interest-bearing obligation.[14] Special rules apply to treat as foreign-source certain amounts paid on deposits with foreign commercial banking branches of U.S. corporations or partnerships and certain other amounts paid by foreign branches of domestic financial

[13] See, *e.g., Hunt v. Commissioner*, 90 T.C. 1289 (1988).

[14] Sec. 861(a)(1); Treas. Reg. sec. 1.861-2(a)(1).

institutions.[15] Interest paid by the U.S. branch of a foreign corporation is also treated as U.S.-source income.[16]

Dividends

Dividend income is generally sourced by reference to the payor's place of incorporation.[17] Thus, dividends paid by a domestic corporation are generally treated as entirely U.S.-source income. Similarly, dividends paid by a foreign corporation are generally treated as entirely foreign-source income. Under a special rule, dividends from certain foreign corporations that conduct U.S. businesses are treated in part as U.S.-source income.[18]

Rents and royalties

Rental income is sourced by reference to the location or place of use of the leased property.[19] The nationality or the country of residence of the lessor or lessee does not affect the source of rental income. Rental income from property located or used in the United States (or from any interest in such property) is U.S.-source income, regardless of whether the property is real or personal, intangible or tangible.

Royalties are sourced in the place of use of (or the place of privilege to use) the property for which the royalties are paid.[20] This source rule applies to royalties for the use of either tangible or intangible property, including patents, copyrights, secret processes, formulas, goodwill, trademarks, trade names, and franchises.

Income from sales of personal property

Subject to significant exceptions, income from the sale of personal property is sourced on the basis of the residence of the seller.[21] For this purpose, special definitions of the terms "U.S. resident" and "nonresident" are provided. A nonresident is defined as any person who is not a U.S. resident,[22] while the term "U.S. resident" comprises any juridical entity which is a U.S. person, all U.S. citizens, as well as any individual who is a U.S. resident without a tax home in a

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[15] Secs. 861(a)(1) and 862(a)(1). For purposes of certain reporting and withholding obligations the source rule in section 861(a)(1)(B) does not apply to interest paid by the foreign branch of a domestic financial institution. This results in the payment being treated as a withholdable payment. Sec. 1473(1)(C).

[16] Sec. 884(f)(1).

[17] Secs. 861(a)(2), 862(a)(2).

[18] Sec. 861(a)(2)(B).

[19] Sec. 861(a)(4).

[20] *Ibid.*

[21] Sec. 865(a).

[22] Sec. 865(g)(1)(B).

foreign country or a nonresident alien with a tax home in the United States.[23] As a result, nonresident includes any foreign corporation.[24]

Several special rules apply. For example, income from the sale of inventory property is generally sourced to the place of sale, which is determined by where title to the property passes.[25] However, if the sale is by a nonresident and is attributable to an office or other fixed place of business in the United States, the sale is treated as U.S.-source without regard to the place of sale, unless it is sold for use, disposition, or consumption outside the United States and a foreign office materially participates in the sale.[26] Income from the sale of inventory property that a taxpayer produces (in whole or in part) in the United States and sells outside the United States, or that a taxpayer produces (in whole or in part) outside the United States and sells in the United States is treated as partly U.S.-source and partly foreign-source.[27]

In determining the source of gain or loss from the sale or exchange of an interest in a foreign partnership, the IRS applies the asset-use test and business activities test at the partnership level to determine whether there is a U.S. business and, if so, the extent to which income derived is effectively connected with that U.S. business. To the extent that there is unrealized gain attributable to partnership assets that are effectively connected with the U.S. business, the foreign person's gain or loss from the sale or exchange of a partnership interest is effectively connected gain or loss to the extent of the partner's distributive share of such unrealized gain or loss. Similarly, to the extent that the partner's distributive share of unrealized gain is attributable to a permanent establishment of the partnership under an applicable treaty provision, it may be subject to U.S. tax under a treaty.[28]

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[23] Sec. 865(g)(1)(A).

[24] Sec. 865(g).

[25] Secs. 865(b), 861(a)(6), 862(a)(6); Treas. Reg. sec. 1.861-7(c).

[26] Sec. 865(e)(2).

[27] Sec. 863(b). A taxpayer may elect one of three methods for allocating and apportioning income as U.S.- or foreign-source: (1) 50-50 method under which 50 percent of the income from the sale of inventory property in such a situation is attributable to the production activities and 50 percent to the sales activities, with the income sourced based on the location of those activities; (2) IFP method under which, in certain circumstances, an independent factory price ("IFP") may be established by the taxpayer to determine income from production activities; (3) books and records method under which, with advance permission, the taxpayer may use books of account to detail the allocation of receipts and expenditures between production and sales activities. Treas. Reg. sec. 1.863-3(b), (c). If production activity occurs only within the United States, or only within foreign countries, then all income is sourced to where the production activity occurs; when production activities occur in both the United States and one or more foreign countries, the income attributable to production activities must be split between U.S. and foreign sources. Treas. Reg. sec. 1.863-3(c)(1). The sales activity is generally sourced based on where title to the property passes. Treas. Reg. secs. 1.863-3(c)(2), 1.861-7(c).

[28] Rev. Rul. 91-32, 1991-1 C.B. 107.

Gain on the sale of depreciable property is divided between U.S.-source and foreign-source in the same ratio that the depreciation was previously deductible for U.S. tax purposes.[29] Payments received on sales of intangible property are sourced in the same manner as royalties to the extent the payments are contingent on the productivity, use, or disposition of the intangible property.[30]

Personal services income

Compensation for labor or personal services is generally sourced to the place-of-performance. Thus, compensation for labor or personal services performed in the United States generally is treated as U.S.-source income, subject to an exception for amounts that meet certain de minimis criteria.[31] Compensation for services performed both within and without the United States is allocated between U.S.-and foreign-source.[32]

Insurance income

Underwriting income from issuing insurance or annuity contracts generally is treated as U.S.-source income if the contract involves property in, liability arising out of an activity in, or the lives or health of residents of, the United States.[33]

Transportation income

Generally, income from furnishing transportation that begins and ends in the United States is U.S.-source income.[34] Fifty percent of other income attributable to transportation that begins or ends in the United States is treated as U.S.-source income.

Income from space or ocean activities or international communications

In the case of a foreign person, generally no income from a space or ocean activity or from international communications is treated as U.S.-source income.[35] With respect to the latter, an exception is provided if the foreign person maintains an office or other fixed place of business in the United States, in which case the international communications income attributable to such

[29] Sec. 865(c).

[30] Sec. 865(d).

[31] Sec. 861(a)(3). Gross income of a nonresident alien individual, who is present in the United States as a member of the regular crew of a foreign vessel, from the performance of personal services in connection with the international operation of a ship is generally treated as foreign-source income.

[32] Treas. Reg. sec. 1.861-4(b).

[33] Sec. 861(a)(7).

[34] Sec. 863(c).

[35] Sec. 863(d).

fixed place of business is treated as U.S.-source income.[36] For U.S. persons, all income from space or ocean activities and 50 percent of international communications is treated as U.S.-source income.

Amounts received with respect to guarantees of indebtedness

Amounts received, directly or indirectly, from a noncorporate resident or from a domestic corporation for the provision of a guarantee of indebtedness of such person are income from U.S. sources.[37] This includes payments that are made indirectly for the provision of a guarantee. For example, U.S.-source income under this rule includes a guarantee fee paid by a foreign bank to a foreign corporation for the foreign corporation's guarantee of indebtedness owed to the bank by the foreign corporation's domestic subsidiary, where the cost of the guarantee fee is passed on to the domestic subsidiary through, for instance, additional interest charged on the indebtedness. In this situation, the domestic subsidiary has paid the guarantee fee as an economic matter through higher interest costs, and the additional interest payments made by the subsidiary are treated as indirect payments of the guarantee fee and, therefore, as U.S.-source.

Such U.S.-source income also includes amounts received from a foreign person, whether directly or indirectly, for the provision of a guarantee of indebtedness of that foreign person if the payments received are connected with income of such person that is effectively connected with the conduct of a U.S. trade or business. Amounts received from a foreign person, whether directly or indirectly, for the provision of a guarantee of that person's debt, are treated as foreign-source income if they are not from sources within the United States under section 861(a)(9).

Corporate residence

The U.S. tax treatment of a multinational corporate group depends significantly on whether the parent corporation of the group is domestic or foreign. For purposes of U.S. tax law, a corporation is treated as domestic if it is incorporated under the laws of the United States or of any State.[38] All other corporations (that is, those incorporated under the laws of foreign countries) are treated as foreign.[39] Thus, place of incorporation determines whether a corporation is treated as domestic or foreign for purposes of U.S. tax law, irrespective of substantive factors that might be thought to bear on a corporation's residence, considerations

[36] Sec. 863(e).

[37] Sec. 861(a)(9). This provision effects a legislative override of the opinion in *Container Corp. v. Commissioner*, 134 T.C. 122 (February 17, 2010), aff'd 2011 WL1664358, 107 A.F.T.R.2d 2011-1831 (5th Cir. May 2, 2011), in which the Tax Court held that fees paid by a domestic corporation to its foreign parent with respect to guarantees issued by the parent for the debts of the domestic corporation were more closely analogous to compensation for services than to interest, and determined that the source of the fees should be determined by reference to the residence of the foreign parent-guarantor. As a result, the income was treated as income from foreign sources.

[38] Sec. 7701(a)(4).

[39] Sec. 7701(a)(5).

such as the location of the corporation's management activities, employees, business assets, operations, or revenue sources; the exchange or exchanges on which the corporation's stock is traded; or the country or countries of residence of the corporation's owners. Only domestic corporations are subject to U.S. tax on a worldwide basis. Foreign corporations are taxed only on income that has a sufficient connection with the United States.

To the extent the U.S. tax rules impose a greater burden on a domestic multinational corporation than on a similarly situated foreign multinational corporation, the domestic multinational company may have an incentive to undertake a restructuring, merger, or acquisition that has the consequence of replacing the domestic parent company of the multinational group with a foreign parent company. This sort of transaction, in which a foreign corporation replaces a domestic corporation as the parent company of a multinational group, has been commonly referred to as an inversion. Subject to the Code's anti-inversion rules (described below) and other provisions related to, for example, outbound transfers of stock and property, the deductibility of related party interest payments, and a foreign subsidiary's investment in U.S. property, an inversion transaction might be motivated by various tax considerations, including the removal of a group's foreign operations from the U.S. taxing jurisdiction and the potential for reduction of U.S. tax on U.S.-source income through, for example, large payments of deductible interest or royalties from a U.S. subsidiary to the new foreign parent company.

Until enactment of the American Jobs Creation Act of 2004 ("AJCA"),[40] the Code included no rules specifically addressed to inversion transactions. Consequently, until AJCA a domestic corporation could re-domicile in another country with insignificant or no adverse U.S. tax consequences to the corporation or its shareholders even if nothing related to the ownership, management, or operations of the corporation changed in connection with the re-domiciliation.[41]

AJCA included provisions intended to curtail inversion transactions. Among other things, the general anti-inversion rules (the "toll charge rules") provide that during the 10-year period following the inversion transaction corporate-level gain recognized in connection with the

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[40] Pub. L. No. 108-357.

[41] Shareholders of the re-domiciled parent company who were U.S. persons generally would be subject to U.S. tax on the appreciation in the value of their stock of the U.S. company unless a number of conditions were satisfied, including that U.S. persons who were shareholders of the U.S. company received 50 percent or less of the total voting power and total value of the stock of the new foreign parent company in the transaction. See section 367(a)(1); Treas. Reg. sec. 1.367(a)-3(c)(1). The IRS promulgated these greater-than-50-percent rles after becoming aware of tax-motivated inversion transactions, including the publicly traded Helen of Troy cosmetic company's re-domiciliation in Bermuda. See Notice 94-46, 1994-1 C.B. 356 (April 18, 1994); T.D. 8638 (December 26, 1995). Shareholder taxation under section 367 as a result of inversion transactions remains largely the same after enactment of AJCA.

If an inversion transaction was effectuated by means of an asset acquisition, corporate-level gain generally would have been recognized under section 367(a).

For a fuller description of the possible tax consequences of a reincorporation transaction before AJCA, see Joint Committee on Taxation, *Background and Description of Present-Law Rules and Proposals Relating to Corporate Inversion Transactions* (JCX-52-02), June 5, 2002, p. 4.

inversion generally may not be offset by tax attributes such as net operating losses or foreign tax credits. These sanctions generally apply to a transaction in which, pursuant to a plan or a series of related transactions: (1) a domestic corporation becomes a subsidiary of a foreign-incorporated entity or otherwise transfers substantially all of its properties to such an entity in a transaction completed after March 4, 2003; (2) the former shareholders of the domestic corporation hold (by reason of the stock they had held in the domestic corporation) at least 60 percent but less than 80 percent (by vote or value) of the stock of the foreign-incorporated entity after the transaction (this stock often being referred to as "stock held by reason of"); and (3) the foreign-incorporated entity, considered together with all companies connected to it by a chain of greater than 50 percent ownership (that is, the "expanded affiliated group"), does not have substantial business activities in the entity's country of incorporation, compared to the total worldwide business activities of the expanded affiliated group.[42]

If a transaction otherwise satisfies the requirements for applicability of the anti-inversion rules and the former shareholders of the domestic corporation hold (by reason of the stock they had held in the domestic corporation) at least 80 percent (by vote or value) of the stock of the foreign-incorporated entity after the transaction, the anti-inversion rules entirely deny the tax benefits of the inversion transaction by deeming the new top-tier foreign corporation to be a domestic corporation for all Federal tax purposes.[43]

Similar rules apply if a foreign corporation acquires substantially all of the properties constituting a trade or business of a domestic partnership.[44]

The Treasury Department has promulgated detailed guidance under section 7874. Most recently, the IRS and Treasury Department issued a notice intended to address avoidance of section 7874 and to restrict or eliminate certain tax benefits facilitated by inversion transactions.[45]

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[42] Section 7874(a). AJCA also imposes an excise tax on certain stock compensation of some executives of companies that undertake inversion transactions. Section 4985.

[43] Sec. 7874(b).

[44] Sec. 7874(a)(2)(B)(i).

[45] Notice 2014-52, 2014 I.R.B. LEXIS 576 (Sept. 22, 2014). Among other things, the notice describes regulations that the Treasury Department and IRS intend to issue (1) addressing some taxpayer planning to keep the percentage of the new foreign parent company stock that is held by former owners of the inverted domestic parent company (by reason of owning stock of the domestic parent) below the 80 or 60 percent threshold; (2) restricting the tax-free post-inversion use of untaxed foreign subsidiary earnings to make loans to or stock purchases from certain foreign affiliates, and (3) preventing taxpayers from avoiding U.S. taxation of pre-inversion earnings of foreign subsidiaries by engaging in post-inversion transactions that would end the controlled foreign corporation status of those subsidiaries.

B. U.S. Tax Rules Applicable to Nonresident Aliens and Foreign Corporations (Inbound)

Nonresident aliens and foreign corporations are generally subject to U.S. tax only on their U.S.-source income. Thus, the source and type of income received by a foreign person generally determines whether there is any U.S. income tax liability and the mechanism by which it is taxed. The U.S. tax rules for U.S. activities of foreign taxpayers apply differently to two broad types of income: U.S.-source income that is "fixed or determinable annual or periodical gains, profits, and income" ("FDAP income") or income that is "effectively connected with the conduct of a trade or business within the United States" ("ECI"). FDAP income generally is subject to a 30-percent gross-basis withholding tax, while ECI is generally subject to the same U.S. tax rules that apply to business income derived by U.S. persons. That is, deductions are permitted in determining taxable ECI, which is then taxed at the same rates applicable to U.S. persons. Much FDAP income and similar income is, however, exempt from withholding tax or is subject to a reduced rate of tax under the Code[46] or a bilateral income tax treaty.[47]

1. Gross-basis taxation of U.S.-source income

Non-business income received by foreign persons from U.S. sources is generally subject to tax on a gross basis at a rate of 30 percent, which is collected by withholding at the source of the payment. As explained below, the categories of income subject to the 30-percent tax and the categories for which withholding is required are generally coextensive, with the result that determining the withholding tax liability determines the substantive liability.

The income of non-resident aliens or foreign corporations that is subject to tax at a rate of 30-percent includes FDAP income that is not effectively connected with the conduct of a U.S. trade or business.[48] The items enumerated in defining FDAP income are illustrative; the common characteristic of types of FDAP income is that taxes with respect to the income may be readily computed and collected at the source, in contrast to the administrative difficulty involved in determining the seller's basis and resulting gain from sales of property.[49] The words "annual or periodical" are "merely generally descriptive" of the payments that could be within the

[46] *E.g.*, the portfolio interest exception in section 871(h) (discussed below).

[47] The United States has set forth its negotiating position on withholding rates and other provisions in the United States Model Income Tax Convention of November 15, 2006 (the "U.S. Model Treaty"). Because each treaty reflects considerations unique to the relationship between the two treaty countries, treaty withholding tax rates on each category of income are not uniform across treaties.

[48] Secs. 871(a), 881. If the FDAP income is also ECI, it is taxed on a net basis, at graduated rates.

[49] *Commissioner v. Wodehouse,* 337 U.S. 369, 388-89 (1949). After reviewing legislative history of the Revenue Act of 1936, the Supreme Court noted that Congress expressly intended to limit taxes on nonresident aliens to taxes that could be readily collectible, *i.e.*, subject to withholding, in response to "a theoretical system impractical of administration in a great number of cases. H.R. Rep. No. 2475, 74th Cong., 2d Sess. 9-10 (1936)." In doing so, the Court rejected P.G. Wodehouse's arguments that an advance royalty payment was not within the purview of the statutory definition of FDAP income.

purview of the statute and do not preclude application of the withholding tax to one-time, lump sum payments to nonresident aliens.[50]

Types of FDAP income

FDAP income encompasses a broad range of types of gross income, but has limited application to gains on sales of property, including market discount on bonds and option premiums.[51] Capital gains received by nonresident aliens present in the United States for fewer than 183 days are generally treated as foreign source and are thus not subject to U.S. tax, unless the gains are effectively connected with a U.S. trade or business; capital gains received by nonresident aliens present in the United States for 183 days or more[52] that are treated as U.S.-source are subject to gross-basis taxation.[53] In contrast, U.S-source gains from the sale or exchange of intangibles are subject to tax, and subject to withholding if they are contingent upon productivity of the property sold and are not effectively connected with a U.S. trade or business.[54]

Interest on bank deposits may qualify for exemption on two grounds, depending on where the underlying principal is held on deposit. Interest paid with respect to deposits with domestic banks and savings and loan associations, and certain amounts held by insurance companies, are U.S. source but are not subject to the U.S. withholding tax when paid to a foreign person, unless the interest is effectively connected with a U.S. trade or business of the recipient.[55] Interest on deposits with foreign branches of domestic banks and domestic savings and loan associations is not treated as U.S.-source income and is thus exempt from U.S. withholding tax (regardless of whether the recipient is a U.S. or foreign person).[56] Similarly, interest and original issue discount on certain short-term obligations is also exempt from U.S. withholding tax when paid to

[50] *Commissioner v. Wodehouse*, 337 U.S. 369, 393 (1949).

[51] Although technically insurance premiums paid to a foreign insurer or reinsurer are FDAP income, they are exempt from withholding under Treas. Reg. sec. 1.1441-2(a)(7) if the insurance contract is subject to the excise tax under section 4371. Treas. Reg. sec. 1.1441-2(b)(1)(i), -2(b)(2).

[52] For purposes of this rule, whether a person is considered a resident in the United States is determined by application of the rules under section 7701(b).

[53] Sec. 871(a)(2). In addition, certain capital gains from sales of U.S. real property interests are subject to tax as effectively connected income (or in some instances as dividend income) under the Foreign Investment in Real Property Tax Act of 1980, discussed *infra* at part II.B.3.

[54] Secs. 871(a)(1)(D), 881(a)(4).

[55] Secs. 871(i)(2)(A), 881(d); Treas. Reg. sec. 1.1441-1(b)(4)(ii).

[56] Sec. 861(a)(1)(B); Treas. Reg. sec. 1.1441-1(b)(4)(iii).

a foreign person.[57] Additionally, there is generally no information reporting required with respect to payments of such amounts.[58]

Although FDAP income includes U.S.-source portfolio interest, such interest is specifically exempt from the 30 percent withholding tax. Portfolio interest is any interest (including original issue discount) that is paid on an obligation that is in registered form and for which the beneficial owner has provided to the U.S. withholding agent a statement certifying that the beneficial owner is not a U.S. person.[59] For obligations issued before March 19, 2012, portfolio interest also includes interest paid on an obligation that is not in registered form, provided that the obligation is shown to be targeted to foreign investors under the conditions sufficient to establish deductibility of the payment of such interest.[60] Portfolio interest, however, does not include interest received by a 10-percent shareholder,[61] certain contingent interest,[62] interest received by a controlled foreign corporation from a related person,[63] or interest received by a bank on an extension of credit made pursuant to a loan agreement entered into in the ordinary course of its trade or business.[64]

Imposition of gross-basis tax and reporting by U.S. withholding agents

The 30-percent tax on FDAP income is generally collected by means of withholding.[65] Withholding on FDAP payments to foreign payees is required unless the withholding agent,[66]

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[57] Secs. 871(g)(1)(B), 881(a)(3); Treas. Reg. sec. 1.1441-1(b)(4)(iv).

[58] Treas. Reg. sec. 1.1461-1(c)(2)(ii)(A), (B). Regulations require a bank to report interest if the recipient is a nonresident alien who resides in a country with which the United States has a satisfactory exchange of information program under a bilateral agreement and the deposit is maintained at an office in the United States. Treas. Reg. secs. 1.6049-4(b)(5) and 1.6049-8. The IRS has published a list of the 84 countries whose residents are subject to the reporting requirements, and a list of countries with respect to which the reported information will be automatically exchanged naming 18 countries. Rev. Proc. 2014-64, I.R. B. 2014-53 (December 29, 2014), available at http://www.irs.gov/pub/irs-irbs/irb14-53.pdf.

[59] Sec. 871(h)(2).

[60] Sec. 163(f)(2)(B). The exception to the registration requirements for foreign targeted securities was repealed in 2010, effective for obligations issued two years after enactment, thus narrowing the portfolio interest exemption for obligations issued after March 18, 2012. See Hiring Incentives to Restore Employment Law of 2010, Pub. L. No. 111-147, sec. 502(b).

[61] Sec. 871(h)(3).

[62] Sec. 871(h)(4).

[63] Sec. 881(c)(3)(C).

[64] Sec. 881(c)(3)(A).

[65] Secs. 1441, 1442.

[66] Withholding agent is defined broadly to include any U.S. or foreign person that has the control, receipt, custody, disposal, or payment of an item of income of a foreign person subject to withholding. Treas. Reg. sec. 1.1441-7(a).

i.e., the person making the payment to the foreign person receiving the income, can establish that the beneficial owner of the amount is eligible for an exemption from withholding or a reduced rate of withholding under an income tax treaty.[67] The principal statutory exemptions from the 30-percent withholding tax apply to interest on bank deposits, and portfolio interest, described above.[68]

In many instances, the income subject to withholding is the only income of the foreign recipient that is subject to any U.S. tax. No U.S. Federal income tax return from the foreign recipient is required with respect to the income from which tax was withheld, if the recipient has no ECI income and the withholding is sufficient to satisfy the recipient's liability. Accordingly, although the 30-percent gross-basis tax is a withholding tax, it is also generally the final tax liability of the foreign recipient (unless the foreign recipients files for a refund).

A withholding agent that makes payments of U.S.-source amounts to a foreign person is required to report and pay over any amounts of U.S. tax withheld. The reports are due to be filed with the IRS by March 15 of the calendar year following the year in which the payment is made. Two types of reports are required: (1) a summary of the total U.S.-source income paid and withholding tax withheld on foreign persons for the year and (2) a report to both the IRS and the foreign person of that person's U.S.-source income that is subject to reporting.[69] The nonresident withholding rules apply broadly to any financial institution or other payor, including foreign financial institutions.[70]

To the extent that the withholding agent deducts and withholds an amount, the withheld tax is credited to the recipient of the income.[71] If the agent withholds more than is required, and results in an overpayment of tax, the excess may be refunded to the recipient of the income upon filing of a timely claim for refund.

Excise tax on foreign reinsurance premiums

An excise tax applies to premiums paid to foreign insurers and reinsurers covering U.S. risks.[72] The excise tax is imposed on a gross basis at the rate of one percent on reinsurance and life insurance premiums, and at the rate of four percent on property and casualty insurance

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[67] Secs. 871, 881, 1441, 1442; Treas. Reg. sec. 1.1441-1(b).

[68] A reduced rate of withholding of 14 percent applies to certain scholarships and fellowships paid to individuals temporarily present in the United States. Sec. 1441(b). In addition to statutory exemptions, the 30-percent withholding tax with respect to interest, dividends or royalties may be reduced or eliminated by a tax treaty between the United States and the country in which the recipient of income otherwise subject to withholding is resident.

[69] Treas. Reg. sec. 1.1461-1(b), (c).

[70] See Treas. Reg. sec. 1.1441-7(a) (definition of withholding agent includes foreign persons).

[71] Sec. 1462.

[72] Secs. 4371-4374.

premiums. The excise tax does not apply to premiums that are effectively connected with the conduct of a U.S. trade or business or that are exempted from the excise tax under an applicable income tax treaty. The excise tax paid by one party cannot be credited if, for example, the risk is reinsured with a second party in a transaction that is also subject to the excise tax.

Many U.S. tax treaties provide an exemption from the excise tax, including the treaties with Germany, Japan, Switzerland, and the United Kingdom.[73] To prevent persons from inappropriately obtaining the benefits of exemption from the excise tax, the treaties generally include an anti-conduit rule. The most common anti-conduit rule provides that the treaty exemption applies to the excise tax only to the extent that the risks covered by the premiums are not reinsured with a person not entitled to the benefits of the treaty (or any other treaty that provides exemption from the excise tax).[74]

2. Net-basis taxation of U.S.-source income

Income from a U.S. business

The United States taxes on a net basis the income of foreign persons that is "effectively connected" with the conduct of a trade or business in the United States.[75] Any gross income derived by the foreign person that is not effectively connected with the person's U.S. business is not taken into account in determining the rates of U.S. tax applicable to the person's income from the business.[76]

U.S. trade or business

A foreign person is subject to U.S. tax on a net basis if the person is engaged in a U.S. trade or business. Partners in a partnership and beneficiaries of an estate or trust are treated as engaged in the conduct of a trade or business within the United States if the partnership, estate, or trust is so engaged.[77]

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[73] Generally, when a foreign person qualifies for benefits under such a treaty, the United States is not permitted to collect the insurance premiums excise tax from that person.

[74] In Rev. Rul. 2008-15, 2008-1 C.B. 633, the IRS provided guidance to the effect that the excise tax is imposed separately on each reinsurance policy covering a U.S. risk. Thus, if a U.S. insurer or reinsurer reinsures a U.S. risk with a foreign reinsurer, and that foreign reinsurer in turn reinsures the risk with a second foreign reinsurer, the excise tax applies to both the premium to the first foreign reinsurer and the premium to the second foreign reinsurer. In addition, if the first foreign reinsurer is resident in a jurisdiction with a tax treaty containing an excise tax exemption, the revenue ruling provides that the excise tax still applies to both payments to the extent that the transaction violates an anti-conduit rule in the applicable tax treaty. Even if no violation of an anti-conduit rule occurs, under the revenue ruling, the excise tax still applies to the premiums paid to the second foreign reinsurer, unless the second foreign reinsurer is itself entitled to an excise tax exemption.

[75] Secs. 871(b), 882.

[76] Secs. 871(b)(2), 882(a)(2).

[77] Sec. 875.

The question whether a foreign person is engaged in a U.S. trade or business is factual and has generated much case law. Basic issues include whether the activity constitutes business rather than investing, whether sufficient activities in connection with the business are conducted in the United States, and whether the relationship between the foreign person and persons performing functions in the United States in respect of the business is sufficient to attribute those functions to the foreign person.

The trade or business rules differ from one activity to another. The term "trade or business within the United States" expressly includes the performance of personal services within the United States.[78] If, however, a nonresident alien individual performs personal services for a foreign employer, and the individual's total compensation for the services and period in the United States are minimal ($3,000 or less in total compensation and 90 days or fewer of physical presence in a year), the individual is not considered to be engaged in a U.S. trade or business.[79] Detailed rules govern whether trading in stocks or securities or commodities constitutes the conduct of a U.S. trade or business.[80] A foreign person who trades in stock or securities or commodities in the United States through an independent agent generally is not treated as engaged in a U.S. trade or business if the foreign person does not have an office or other fixed place of business in the United States through which trades are carried out. A foreign person who trades stock or securities or commodities for the person's own account also generally is not considered to be engaged in a U.S. business so long as the foreign person is not a dealer in stock or securities or commodities.

For eligible foreign persons, U.S. bilateral income tax treaties restrict the application of net-basis U.S. taxation. Under each treaty, the United States is permitted to tax business profits only to the extent those profits are attributable to a U.S. permanent establishment of the foreign person. The threshold level of activities that constitute a permanent establishment is generally higher than the threshold level of activities that constitute a U.S. trade or business. For example, a permanent establishment typically requires the maintenance of a fixed place of business over a significant period of time.

Effectively connected income

A foreign person that is engaged in the conduct of a trade or business within the United States is subject to U.S. net-basis taxation on the income that is "effectively connected" with the business. Specific statutory rules govern whether income is ECI.[81]

In the case of U.S.-source capital gain and U.S.-source income of a type that would be subject to gross basis U.S. taxation, the factors taken into account in determining whether the

[78] Sec. 864(b).

[79] Sec. 864(b)(1).

[80] Sec. 864(b)(2).

[81] Sec. 864(c).

income is ECI include whether the income is derived from assets used in or held for use in the conduct of the U.S. trade or business and whether the activities of the trade or business were a material factor in the realization of the amount (the "asset use" and "business activities" tests).[82] Under the asset use and business activities tests, due regard is given to whether the income, gain, or asset was accounted for through the U.S. trade or business. All other U.S.-source income is treated as ECI.[83]

A foreign person who is engaged in a U.S. trade or business may have limited categories of foreign-source income that are considered to be ECI.[84] Foreign-source income not included in one of these categories (described next) generally is exempt from U.S. tax.

A foreign person's foreign-source income generally is considered to be ECI only if the person has an office or other fixed place of business within the United States to which the income is attributable and the income is in one of the following categories: (1) rents or royalties for the use of patents, copyrights, secret processes or formulas, good will, trade-marks, trade brands, franchises, or other like intangible properties derived in the active conduct of the trade or business; (2) interest or dividends derived in the active conduct of a banking, financing, or similar business within the United States or received by a corporation the principal business of which is trading in stocks or securities for its own account; or (3) income derived from the sale or exchange (outside the United States), through the U.S. office or fixed place of business, of inventory or property held by the foreign person primarily for sale to customers in the ordinary course of the trade or business, unless the sale or exchange is for use, consumption, or disposition outside the United States and an office or other fixed place of business of the foreign person in a foreign country participated materially in the sale or exchange.[85] Foreign-source dividends, interest, and royalties are not treated as ECI if the items are paid by a foreign corporation more than 50 percent (by vote) of which is owned directly, indirectly, or constructively by the recipient of the income.[86]

In determining whether a foreign person has a U.S. office or other fixed place of business, the office or other fixed place of business of an agent generally is disregarded. The place of business of an agent other than an independent agent acting in the ordinary course of business is not disregarded, however, if the agent either has the authority (regularly exercised) to negotiate and conclude contracts in the name of the foreign person or has a stock of merchandise from which he regularly fills orders on behalf of the foreign person.[87] If a foreign person has a

[82] Sec. 864(c)(2).

[83] Sec. 864(c)(3).

[84] This income is subject to net-basis U.S. taxation after allowance of a credit for any foreign income tax imposed on the income. Sec. 906.

[85] Sec. 864(c)(4)(B).

[86] Sec. 864(c)(4)(D)(i).

[87] Sec. 864(c)(5)(A).

U.S. office or fixed place of business, income, gain, deduction, or loss is not considered attributable to the office unless the office was a material factor in the production of the income, gain, deduction, or loss and the office regularly carries on activities of the type from which the income, gain, deduction, or loss was derived.[88]

Special rules apply in determining the ECI of an insurance company. The foreign-source income of a foreign corporation that is subject to tax under the insurance company provisions of the Code is treated as ECI if the income is attributable to its United States business.[89]

Income, gain, deduction, or loss for a particular year generally is not treated as ECI if the foreign person is not engaged in a U.S. trade or business in that year.[90] If, however, income or gain taken into account for a taxable year is attributable to the sale or exchange of property, the performance of services, or any other transaction that occurred in a prior taxable year, the determination whether the income or gain is taxable on a net basis is made as if the income were taken into account in the earlier year and without regard to the requirement that the taxpayer be engaged in a trade or business within the United States during the later taxable year.[91] If any property ceases to be used or held for use in connection with the conduct of a U.S. trade or business and the property is disposed of within 10 years after the cessation, the determination whether any income or gain attributable to the disposition of the property is taxable on a net basis is made as if the disposition occurred immediately before the property ceased to be used or held for use in connection with the conduct of a U.S. trade or business and without regard to the requirement that the taxpayer be engaged in a U.S. business during the taxable year for which the income or gain is taken into account.[92]

Allowance of deductions

Taxable ECI is computed by taking into account deductions associated with gross ECI. For this purpose, the apportionment and allocation of deductions is addressed in detailed regulations. The regulations applicable to deductions other than interest expense set forth general guidelines for allocating deductions among classes of income and apportioning deductions between ECI and non-ECI. In some circumstances, deductions may be allocated on the basis of units sold, gross sales or receipts, costs of goods sold, profits contributed, expenses incurred, assets used, salaries paid, space used, time spent, or gross income received. More specific guidelines are provided for the allocation and apportionment of research and experimental expenditures, legal and accounting fees, income taxes, losses on dispositions of property, and net operating losses. Detailed regulations under section 861 address the allocation

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[88] Sec. 864(c)(5)(B).

[89] Sec. 864(c)(4)(C).

[90] Sec. 864(c)(1)(B).

[91] Sec. 864(c)(6).

[92] Sec. 864(c)(7).

and apportionment of interest deductions. In general, interest is allocated and apportioned based on assets rather than income.

3. Special rules

FIRPTA

The Foreign Investment in Real Property Tax Act of 1980 ("FIRPTA")[93] generally treats a foreign person's gain or loss from the disposition of a U.S. real property interest ("USRPI") as ECI and, therefore, as taxable at the income tax rates applicable to U.S. persons, including the rates for net capital gain. A foreign person subject to tax on this income is required to file a U.S. tax return under the normal rules relating to receipt of ECI.[94] In the case of a foreign corporation, the gain from the disposition of a USRPI may also be subject to the branch profits tax at a 30-percent rate (or lower treaty rate).

The payor of income that FIRPTA treats as ECI ("FIRPTA income") is generally required to withhold U.S. tax from the payment. Withholding is generally 10 percent of the sales price, in the case of a direct sale by the foreign person of a USRPI, and 35 percent of the amount of a distribution to a foreign person of proceeds attributable to such sales from an entity such as a partnership, real estate investment trust ("REIT") or regulated investment company ("RIC").[95] The foreign person can request a refund with its U.S. tax return, if appropriate, based on that person's total ECI and deductions (if any) for the taxable year.

Branch profits taxes

A domestic corporation owned by foreign persons is subject to U.S. income tax on its net income. The earnings of the domestic corporation are subject to a second tax, this time at the shareholder level, when dividends are paid. As described previously, when the shareholders are foreign, the second-level tax is imposed at a flat rate and collected by withholding. Unless the portfolio interest exemption or another exemption applies, interest payments made by a domestic corporation to foreign creditors are likewise subject to U.S. withholding tax. To approximate these second-level withholding taxes imposed on payments made by domestic subsidiaries to their foreign parent corporations, the United States taxes a foreign corporation that is engaged in a U.S. trade or business through a U.S. branch on amounts of U.S. earnings and profits that are shifted out of, or amounts of interest that are deducted by, the U.S. branch of the foreign

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[93] Pub. L. No. 96-499. The rules governing the imposition and collection of tax under FIRPTA are contained in a series of provisions enacted in 1980 and subsequently amended. See secs. 897, 1445, 6039C, 6652(f).

[94] Sec. 897(a). In addition, section 6039C authorizes regulations that would require a return reporting foreign direct investments in U.S. real property interests. No such regulations have been issued, however.

[95] Sec. 1445 and Treasury regulations thereunder. The Treasury Department is authorized to issue regulations that reduce the 35-percent withholding on distributions to 20-percent withholding during the time that the maximum income tax rate on dividends and capital gains of U.S. persons is 20 percent.

corporation. These branch taxes may be reduced or eliminated under an applicable income tax treaty.[96]

Under the branch profits tax, the United States imposes a tax of 30 percent on a foreign corporation's "dividend equivalent amount."[97] The dividend equivalent amount generally is the earnings and profits of a U.S. branch of a foreign corporation attributable to its ECI.[98] Limited categories of earnings and profits attributable to a foreign corporation's ECI are excluded in calculating the dividend equivalent amount.[99]

In arriving at the dividend equivalent amount, a branch's effectively connected earnings and profits are adjusted to reflect changes in a branch's U.S. net equity (that is, the excess of the branch's assets over its liabilities, taking into account only amounts treated as connected with its U.S. trade or business).[100] The first adjustment reduces the dividend equivalent amount to the extent the branch's earnings are reinvested in trade or business assets in the United States (or reduce U.S. trade or business liabilities). The second adjustment increases the dividend equivalent amount to the extent prior reinvested earnings are considered remitted to the home office of the foreign corporation.

Interest paid by a U.S. trade or business of a foreign corporation generally is treated as if paid by a domestic corporation and therefore is subject to U.S. 30-percent withholding tax (if the interest is paid to a foreign person and a Code or treaty exemption or reduction would not be available if the interest were actually paid by a domestic corporation).[101] Certain "excess interest" of a U.S. trade or business of a foreign corporation is treated as if paid by a U.S. corporation to a foreign parent and, therefore, is subject to U.S. 30-percent withholding tax.[102] For this purpose, excess interest is the excess of the interest expense of the foreign corporation apportioned to the U.S. trade or business over the amount of interest paid by the trade or business.

Earnings stripping

Taxpayers are limited in their ability to reduce the U.S. tax on the income derived from their U.S. operations through certain earnings stripping transactions involving interest payments.

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[96] See Treas. Reg. sec. 1.884-1(g), -5.

[97] Sec. 884(a).

[98] Sec. 884(b).

[99] See sec. 884(d)(2) (excluding, for example, earnings and profits attributable to gain from the sale of U.S. real property interests described in section 897 (discussed below)).

[100] Sec. 884(b).

[101] Sec. 884(f)(1)(A).

[102] Sec. 884(f)(1)(B).

If the payor's debt-to-equity ratio exceeds 1.5 to 1 (a debt-to-equity ratio of 1.5 to 1 or less is considered a "safe harbor"), a deduction for disqualified interest paid or accrued by the payor in a taxable year is generally disallowed to the extent of the payor's excess interest expense.[103] Disqualified interest includes interest paid or accrued to related parties when no Federal income tax is imposed with respect to such interest;[104] to unrelated parties in certain instances in which a related party guarantees the debt ("guaranteed debt"); or to a REIT by a taxable REIT subsidiary of that REIT. Excess interest expense is the amount by which the payor's net interest expense (that is, the excess of interest paid or accrued over interest income) exceeds 50 percent of its adjusted taxable income (generally taxable income computed without regard to deductions for net interest expense, net operating losses, domestic production activities under section 199, depreciation, amortization, and depletion). Interest amounts disallowed under these rules can be carried forward indefinitely and are allowed as a deduction to the extent of excess limitation in a subsequent tax year. In addition, any excess limitation (that is, the excess, if any, of 50 percent of the adjusted taxable income of the payor over the payor's net interest expense) can be carried forward three years.

[103] Sec. 163(j).

[104] If a tax treaty reduces the rate of tax on interest paid or accrued by the taxpayer, the interest is treated as interest on which no Federal income tax is imposed to the extent of the same proportion of such interest as the rate of tax imposed without regard to the treaty, reduced by the rate of tax imposed under the treaty, bears to the rate of tax imposed without regard to the treaty. Sec. 163(j)(5)(B).

C. U.S. Tax Rules Applicable to Foreign Activities of U.S. Persons (Outbound)

1. In general

The United States has a worldwide tax system under which U.S. citizens, resident individuals, and domestic corporations generally are taxed on all income, whether derived in the United States or abroad. The U.S. does not impose an income tax on foreign corporations on income earned from foreign operations, whether or not some or all its shareholders are U.S. persons. Income earned by a domestic parent corporation from foreign operations conducted by foreign corporate subsidiaries generally is subject to U.S. tax when the income is distributed as a dividend to the domestic parent corporation. Until that repatriation, the U.S. tax on the income generally is deferred. U.S. shareholders of foreign corporations are taxed by the U.S. when the foreign corporation distributes its earnings as dividends or when a U.S. shareholder sells it stock at a gain. Thus, the U.S. tax on foreign earnings of foreign corporations is "deferred" until distributed to a U.S. shareholder or a U.S. shareholder recognizes gain on its stock.

However, certain anti-deferral regimes may cause the domestic parent corporation to be taxed on a current basis in the United States on certain categories of passive or highly mobile income earned by its foreign corporate subsidiaries, regardless of whether the income has been distributed as a dividend to the domestic parent corporation. The main anti-deferral regimes in this context are the CFC rules of subpart F[105] and the PFIC rules.[106] A foreign tax credit generally is available to offset, in whole or in part, the U.S. tax owed on foreign-source income, whether the income is earned directly by the domestic corporation, repatriated as an actual dividend, or included in the domestic parent corporation's income under one of the anti-deferral regimes.[107]

2. Anti-deferral regimes

<u>Subpart F</u>

Subpart F,[108] applicable to CFCs and their shareholders, is the main anti-deferral regime of relevance to a U.S.-based multinational corporate group. A CFC generally is defined as any foreign corporation if U.S. persons own (directly, indirectly, or constructively) more than 50 percent of the corporation's stock (measured by vote or value), taking into account only those U.S. persons that own at least 10 percent of the stock (measured by vote only).[109] Under the subpart F rules, the United States generally taxes the 10-percent U.S. shareholders of a CFC on

[105] Secs. 951-964.

[106] Secs. 1291-1298.

[107] Secs. 901, 902, 960, 1293(f).

[108] Secs. 951-964.

[109] Secs. 951(b), 957, 958.

their pro rata shares of certain income of the CFC (referred to as "subpart F income"), without regard to whether the income is distributed to the shareholders.[110] In effect, the United States treats the 10-percent U.S. shareholders of a CFC as having received a current distribution of the corporation's subpart F income.

With exceptions described below, subpart F income generally includes passive income and other income that is readily movable from one taxing jurisdiction to another. Subpart F income consists of foreign base company income,[111] insurance income,[112] and certain income relating to international boycotts and other violations of public policy.[113]

Foreign base company income consists of foreign personal holding company income, which includes passive income such as dividends, interest, rents, and royalties, and a number of categories of income from business operations, including foreign base company sales income, foreign base company services income, and foreign base company oil-related income.[114]

Insurance income subject to current inclusion under the subpart F rules includes any income of a CFC attributable to the issuing or reinsuring of any insurance or annuity contract in connection with risks located in a country other than the CFC's country of organization. Subpart F insurance income also includes income attributable to an insurance contract in connection with risks located within the CFC's country of organization, as the result of an arrangement under which another corporation receives a substantially equal amount of consideration for insurance of other country risks.

In the case of insurance, a temporary exception from foreign personal holding company income applies for certain income of a qualifying insurance company with respect to risks located within the CFC's country of creation or organization. Temporary exceptions from insurance income and from foreign personal holding company income also apply for certain income of a qualifying branch of a qualifying insurance company with respect to risks located within the home country of the branch, provided certain requirements are met under each of the exceptions. Further, additional temporary exceptions from insurance income and from foreign personal holding company income apply for certain income of certain CFCs or branches with respect to risks located in a country other than the United States, provided that the requirements for these exceptions are met. In the case of a life insurance or annuity contract, reserves for such contracts are determined under rules specific to the temporary exceptions. Present law also permits a taxpayer in certain circumstances, subject to approval by the IRS through the ruling process or in published guidance, to establish that the reserve of a life insurance company for life insurance and annuity contracts is the amount taken into account in determining the foreign

[110] Sec. 951(a).

[111] Sec. 954.

[112] Sec. 953.

[113] Sec. 952(a)(3)-(5).

[114] Sec. 954.

statement reserve for the contract (reduced by catastrophe, equalization, or deficiency reserve or any similar reserve). IRS approval is to be based on whether the method, the interest rate, the mortality and morbidity assumptions, and any other factors taken into account in determining foreign statement reserves (taken together or separately) provide an appropriate means of measuring income for Federal income tax purposes.

Special rules apply under subpart F with respect to related person insurance income.[115] Enacted in 1986, these rules address the concern that "the related person insurance income of many offshore 'captive' insurance companies avoided current taxation under the subpart F rules of prior law because, for example, the company's U.S. ownership was relatively dispersed."[116] For purposes of these rules, the U.S. ownership threshold for CFC status is reduced to 25 percent or more. Any U.S. person who owns or is considered to own any stock in a CFC, whatever the degree of ownership, is treated as a U.S. shareholder of such corporation for purposes of this 25-percent U.S. ownership threshold and exposed to current tax on the corporation's related person insurance income. Related person insurance income is defined for this purpose to mean any insurance income attributable to a policy of insurance or reinsurance with respect to which the primary insured is either a U.S. shareholder (within the meaning of the provision) in the foreign corporation receiving the income or a person related to such a shareholder.

Investments in U.S. property

The 10-percent U.S. shareholders of a CFC also are required to include currently in income for U.S. tax purposes their pro rata shares of the corporation's untaxed earnings invested in certain items of U.S. property.[117] This U.S. property generally includes tangible property located in the United States, stock of a U.S. corporation, an obligation of a U.S. person, and certain intangible assets, such as patents and copyrights, acquired or developed by the CFC for use in the United States.[118] There are specific exceptions to the general definition of U.S. property, including for bank deposits, certain export property, and certain trade or business obligations.[119] The inclusion rule for investment of earnings in U.S. property is intended to prevent taxpayers from avoiding U.S. tax on dividend repatriations by repatriating CFC earnings through non-dividend payments, such as loans to U.S. persons.

Subpart F exceptions

A provision colloquially referred to as the "CFC look-through" rule and applicable for taxable years beginning after 2005 and before 2015, excludes from foreign personal holding

[115] Sec. 953(c).

[116] Joint Committee on Taxation, *General Explanation of the Tax Reform Act of 1986* (JCS-10-87), May 4, 1987, p. 968.

[117] Secs. 951(a)(1)(B), 956.

[118] Sec. 956(c)(1).

[119] Sec. 956(c)(2).

company income dividends, interest, rents, and royalties received or accrued by one CFC from a related CFC (with relation based on control) to the extent attributable or properly allocable to non-subpart-F income of the payor.[120] The exclusion has been extended most recently to apply for taxable years of the foreign corporation beginning before 2015.[121]

There is also an exclusion from subpart F income for certain income of a CFC that is derived in the active conduct of banking or financing business ("active financing income").[122] The exception from subpart F for active financing income now applies to taxable years of foreign corporations starting before January 1, 2015 (and to taxable years of 10-percent U.S. shareholders with or within which those corporate taxable years end). With respect to income derived in the active conduct of a banking, financing, or similar business, a CFC is required to be predominantly engaged in such business and to conduct substantial activity with respect to such business in order to qualify for the active financing exceptions. In addition, certain nexus requirements apply, which provide that income derived by a CFC or a qualified business unit ("QBU") of a CFC from transactions with customers is eligible for the exceptions if, among other things, substantially all of the activities in connection with such transactions are conducted directly by the CFC or QBU in its home country, and such income is treated as earned by the CFC or QBU in its home country for purposes of such country's tax laws. Moreover, the exceptions apply to income derived from certain cross border transactions, provided that certain requirements are met.

In the case of a securities dealer, the temporary exception from foreign personal holding company income applies to certain income. The income covered by the exception is any interest or dividend (or certain equivalent amounts) from any transaction, including a hedging transaction or a transaction consisting of a deposit of collateral or margin, entered into in the ordinary course of the dealer's trade or business as a dealer in securities within the meaning of section 475. In the case of a QBU of the dealer, the income is required to be attributable to activities of the QBU in the country of incorporation, or to a QBU in the country in which the QBU both maintains its principal office and conducts substantial business activity. A coordination rule provides that this exception generally takes precedence over the exception for income of a banking, financing or similar business, in the case of a securities dealer.

Income is treated as active financing income only if, among other requirements, it is derived by a CFC or by a qualified business unit of that CFC. Certain activities conducted by persons related to the CFC or its qualified business unit are treated as conducted directly by the CFC or qualified business unit.[123] An activity qualifies under this rule if the activity is

[120] Sec. 954(c)(6).

[121] Sec. 954(c)(6)(C). Tax Increase Prevention Act of 2014, Pub. L. No. 113-295, sec. 135(a).

[122] Congress has extended the application of section 954(h) several times, most recently in 2014. Sec. 954(h). Tax Increase Prevention Act of 2014, Pub. L. No. 113-295; American Taxpayer Relief Act of 2012, Pub. L. No. 112-240, sec. 322(b); Pub. L. No. 111-312, sec. 750(a), 2010; Pub. L. No. 110-343, div. C, sec. 303(b), 2008; Pub. L. No. 109-222, sec. 103(a)(2), 2006; Pub. L. No. 107-147, sec. 614, 2002; Pub. L. No. 106-170, sec. 503, 1999; Pub. L. No. 105-277, 1998.

[123] Sec. 954(h)(3)(E).

performed by employees of the related person and if the related person is an eligible CFC, the home country of which is the same as the home country of the related CFC or qualified business unit; the activity is performed in the home country of the related person; and the related person receives arm's-length compensation that is treated as earned in the home country. Income from an activity qualifying under this rule is excepted from subpart F income so long as the other active financing requirements are satisfied.

Other exclusions from foreign personal holding company income include exceptions for dividends and interest received by a CFC from a related corporation organized and operating in the same foreign country in which the CFC is organized and for rents and royalties received by a CFC from a related corporation for the use of property within the country in which the CFC is organized.[124] These exclusions do not apply to the extent the payments reduce the subpart F income of the payor. There is an exception from foreign base company income and insurance income for any item of income received by a CFC if the taxpayer establishes that the income was subject to an effective foreign income tax rate greater than 90 percent of the maximum U.S. corporate income tax rate (that is, more than 90 percent of 35 percent, or 31.5 percent).[125]

Exclusion of previously taxed earnings and profits

A 10-percent U.S. shareholder of a CFC may exclude from its income actual distributions of earnings and profits from the CFC that were previously included in the 10-percent U.S. shareholder's income under subpart F.[126] Any income inclusion (under section 956) resulting from investments in U.S. property may also be excluded from the 10-percent U.S. shareholder's income when such earnings are ultimately distributed.[127] Ordering rules provide that distributions from a CFC are treated as coming first out of earnings and profits of the CFC that have been previously taxed under subpart F, then out of other earnings and profits.[128]

Basis adjustments

In general, a 10-percent U.S. shareholder of a CFC receives a basis increase with respect to its stock in the CFC equal to the amount of the CFC's earnings that are included in the 10-percent U.S. shareholder's income under subpart F.[129] Similarly, a 10-percent U.S. shareholder of a CFC generally reduces its basis in the CFC's stock in an amount equal to any

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124 Sec. 954(c)(3).

125 Sec. 954(b)(4).

126 Sec. 959(a)(1).

127 Sec. 959(a)(2).

128 Sec. 959(c).

129 Sec. 961(a).

distributions that the 10-percent U.S. shareholder receives from the CFC that are excluded from its income as previously taxed under subpart F.[130]

Passive foreign investment companies

The Tax Reform Act of 1986[131] established the PFIC anti-deferral regime. A PFIC is generally defined as any foreign corporation if 75 percent or more of its gross income for the taxable year consists of passive income, or 50 percent or more of its assets consists of assets that produce, or are held for the production of, passive income.[132] Alternative sets of income inclusion rules apply to U.S. persons that are shareholders in a PFIC, regardless of their percentage ownership in the company. One set of rules applies to PFICs that are qualified electing funds, under which electing U.S. shareholders currently include in gross income their respective shares of the company's earnings, with a separate election to defer payment of tax, subject to an interest charge, on income not currently received.[133] A second set of rules applies to PFICs that are not qualified electing funds, under which U.S. shareholders pay tax on certain income or gain realized through the company, plus an interest charge that is attributable to the value of deferral.[134] A third set of rules applies to PFIC stock that is marketable, under which electing U.S. shareholders currently take into account as income (or loss) the difference between the fair market value of the stock as of the close of the taxable year and their adjusted basis in such stock (subject to certain limitations), often referred to as "marking to market."[135]

Other anti-deferral rules

The subpart F and PFIC rules are not the only anti-deferral regimes. Other rules that impose current U.S. taxation on income earned through corporations include the accumulated earnings tax rules[136] and the personal holding company rules.

Rules for coordination among the anti-deferral regimes are provided to prevent U.S. persons from being subject to U.S. tax on the same item of income under multiple regimes. For example, a corporation generally is not treated as a PFIC with respect to a particular shareholder if the corporation is also a CFC and the shareholder is a 10-percent U.S. shareholder. Thus, subpart F is allowed to trump the PFIC rules.

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[130] Sec. 961(b).

[131] Pub. L. No. 99-514.

[132] Sec. 1297.

[133] Secs. 1293-1295.

[134] Sec. 1291.

[135] Sec. 1296.

[136] Secs. 531-537.

3. Foreign tax credit

Subject to certain limitations, U.S. citizens, resident individuals, and domestic corporations are allowed to claim credit for foreign income taxes they pay. A domestic corporation that owns at least 10 percent of the voting stock of a foreign corporation is allowed a "deemed-paid" credit for foreign income taxes paid by the foreign corporation that the domestic corporation is deemed to have paid when the related income is distributed as a dividend or is included in the domestic corporation's income under the anti-deferral rules.[137]

The foreign tax credit generally is limited to a taxpayer's U.S. tax liability on its foreign-source taxable income (as determined under U.S. tax accounting principles). This limit is intended to ensure that the credit serves its purpose of mitigating double taxation of foreign-source income without offsetting U.S. tax on U.S.-source income.[138] The limit is computed by multiplying a taxpayer's total U.S. tax liability for the year by the ratio of the taxpayer's foreign-source taxable income for the year to the taxpayer's total taxable income for the year. If the total amount of foreign income taxes paid and deemed paid for the year exceeds the taxpayer's foreign tax credit limitation for the year, the taxpayer may carry back the excess foreign taxes to the previous year or carry forward the excess taxes to one of the succeeding 10 years.[139]

The computation of the foreign tax credit limitation requires a taxpayer to determine the amount of its taxable income from foreign sources in each limitation category (described below) by allocating and apportioning deductions between U.S.-source gross income, on the one hand, and foreign-source gross income in each limitation category, on the other. In general, deductions are allocated and apportioned to the gross income to which the deductions factually relate.[140] However, subject to certain exceptions, deductions for interest expense and research and experimental expenses are apportioned based on taxpayer ratios.[141] In the case of interest expense, this ratio is the ratio of the corporation's foreign or domestic (as applicable) assets to its worldwide assets. In the case of research and experimental expenses, the apportionment ratio is based on either sales or gross income. All members of an affiliated group of corporations generally are treated as a single corporation for purposes of determining the apportionment ratios.[142]

The term "affiliated group" is determined generally by reference to the rules for determining whether corporations are eligible to file consolidated returns.[143] These rules exclude

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[137] Secs. 901, 902, 960, 1291(g).

[138] Secs. 901, 904.

[139] Sec. 904(c).

[140] Treas. Reg. sec. 1.861-8(b), Temp. Treas. Reg. sec. 1.861-8T(c).

[141] Temp. Treas. Reg. sec. 1.861-9T, Treas. Reg. sec. 1.861-17.

[142] Sec. 864(e)(1), (6); Temp. Treas. Reg. sec. 1.861-14T(e)(2).

[143] Secs. 864(e)(5), 1504.

foreign corporations from an affiliated group.[144] AJCA modified the interest expense allocation rules for taxable years beginning after December 31, 2008.[145] The effective date of the modified rules has been delayed to January 1, 2021.[146] The new rules permit a U.S. affiliated group to apportion the interest expense of the members of the U.S. affiliated group on a worldwide-group basis (that is, as if all domestic and foreign affiliates are a single corporation). A result of this rule is that interest expense of foreign members of a U.S. affiliated group is taken into account in determining whether a portion of the interest expense of the domestic members of the group must be allocated to foreign-source income. An allocation to foreign-source income generally is required only if, in broad terms, the domestic members of the group are more highly leveraged than is the entire worldwide group. The new rules are generally expected to reduce the amount of the U.S. group's interest expense that is allocated to foreign-source income.

The foreign tax credit limitation is applied separately to passive category income and to general category income.[147] Passive category income includes passive income, such as portfolio interest and dividend income, and certain specified types of income. General category income includes all other income. Passive income is treated as general category income if it is earned by a qualifying financial services entity. Passive income is also treated as general category income if it is highly taxed (that is, if the foreign tax rate is determined to exceed the highest rate of tax specified in Code section 1 or 11, as applicable). Dividends (and subpart F inclusions), interest, rents, and royalties received by a 10-percent U.S. shareholder from a CFC are assigned to a separate limitation category by reference to the category of income out of which the dividends or other payments were made.[148] Dividends received by a 10-percent corporate shareholder of a foreign corporation that is not a CFC are also categorized on a look-through basis.[149]

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[144] Sec. 1504(b)(3).

[145] AJCA sec. 401.

[146] Hiring Incentives to Restore Employment Act, Pub. L. No. 111-147, sec. 551(a).

[147] Sec. 904(d). AJCA generally reduced the number of income categories from nine to two, effective for tax years beginning in 2006. Before AJCA, the foreign tax credit limitation was applied separately to the following categories of income: (1) passive income, (2) high withholding tax interest, (3) financial services income, (4) shipping income, (5) certain dividends received from noncontrolled section 902 foreign corporations (also known as "10/50 companies"), (6) certain dividends from a domestic international sales corporation or former domestic international sales corporation, (7) taxable income attributable to certain foreign trade income, (8) certain distributions from a foreign sales corporation or former foreign sales corporation, and (9) any other income not described in items (1) through (8) (so-called "general basket" income). A number of other provisions of the Code, including several enacted in 2010 as part of Pub. L. No. 111-226, create additional separate categories in specific circumstances or limit the availability of the foreign tax credit in other ways. See, *e.g.*, secs. 865(h), 901(j), 904(d)(6), 904(h)(10).

[148] Sec. 904(d)(3). The subpart F rules applicable to CFCs and their 10-percent U.S. shareholders are described below.

[149] Sec. 904(d)(4).

In addition to the foreign tax credit limitation just described, a taxpayer's ability to claim a foreign tax credit may be further limited by a matching rule that prevents the separation of creditable foreign taxes from the associated foreign income. Under this rule, a foreign tax generally is not taken into account for U.S. tax purposes, and thus no foreign tax credit is available with respect to that foreign tax, until the taxable year in which the related income is taken into account for U.S. tax purposes.[150]

[150] Sec. 909.

III. POLICY ISSUES

A. Competitiveness

1. Economic benefits of competitiveness

__Overview__

U.S. policymakers are often concerned with promoting economic growth and the general economic well-being of the U.S. population, both of which are influenced significantly by the level of investment and employment in the United States. The meaning of "competitiveness" in U.S. tax policy discussions is broad, but generally reflects these policy concerns. The competitiveness of the U.S. tax system refers in large part to how effectively it promotes domestic investment and employment, and U.S. economic growth in general.

Domestic investment and employment arises from a number of sources, including the activities of U.S. multinationals and other U.S. businesses as well as foreign multinationals. In turn, their investment decisions in the United States may be based on a number of factors, including: the quality of the U.S. workforce and the cost of labor; their expected sales growth both in the United States and abroad (*i.e.*, the demand for their goods and services); the location of both their customers and their input suppliers; taxes; and the economic benefits of locating activities in particular areas, such as a geographic region (*e.g.*, Silicon Valley), because, for example, of existing research networks and proximity to universities.

In the cross-border context, concerns about the competitiveness of the U.S. tax system have centered on policy objectives that include: (1) fostering the growth of U.S. multinationals abroad, (2) encouraging domestic investment by U.S. and foreign businesses, and (3) promoting U.S. ownership, as opposed to foreign ownership, of U.S. and foreign assets. These particular policy objectives may be important to policymakers for a number of economic reasons, described below.

__Fostering the growth of U.S. multinationals abroad__

When U.S. multinationals grow overseas, as measured by increased sales abroad, that may lead to greater domestic investment and employment.[151] For example, a company may increase employment at a manufacturing plant, or build new facilities, if sales of its U.S.-made goods increase abroad. Likewise, an opportunity to expand into a new foreign market may increase the resources that a company puts into its U.S.-based marketing and management activities as it aims to gain a foothold in that market. To the extent that a U.S. company relies on its domestic operations to service foreign markets, increased sales overseas should increase domestic investment and employment. In addition, an increase in earnings may increase the value of the U.S. company, the benefits of which could accrue primarily to U.S. shareholders given the documented "home bias" in portfolio investments (*i.e.*, the disproportionate share of

[151] This particular claim concerns sales and is distinct from the claim that foreign investment and employment is a substitute for, or complement to, domestic investment and employment.

local equities that investors hold in their portfolio relative to what theories of the benefits of international diversification would predict).[152]

However, if growth of U.S. sales abroad is accompanied by increased foreign investment and employment, that may result in lower U.S. investment and employment. For example, a company may decide to move its U.S.-based manufacturing and marketing operations overseas, which reduces domestic investment and employment. However, it may also be the case that foreign investment and employment complements domestic investment and employment. For example, the successful expansion of a company's overseas operations may provide the company with funds to make more domestic investments and increase its domestic workforce.

The evidence on whether foreign investment and employment complements, or substitutes for, domestic investment and employment has been inconclusive. One study finds that expansion of a company's domestic economic activity is associated with expansion in the activity of its foreign affiliates.[153] However, this can occur if a company develops a new product and expands its sales force both in the United States and overseas.[154] In this case, domestic investment and employment growth coincides with, but is not caused by, foreign investment and employment growth. Another study finds that, on average, increases in domestic employment by U.S. multinationals are associated with increases in employment of their foreign affiliates.[155] However, this result holds only for affiliates in high-income countries. For affiliates in low-income countries, where labor costs may be lower than in the United States, the authors found that foreign employment growth is associated with reductions in U.S. employment.

<u>Encouraging domestic investment by U.S. foreign businesses</u>

Higher levels of domestic investment by U.S. and foreign businesses may contribute to U.S. economic growth and job creation. For example, when a U.S. business makes a new investment, such as constructing a new factory or research facility, it may need to hire workers as part of the investment. The investments they make may also increase the productivity of the operations of the U.S. business which may promote overall economic growth in the United States and potentially raise wages (to the extent that workers' wages rise as their productivity rises). These same economic effects are not restricted to domestic investments by U.S. businesses and could be brought about by domestic investments made by foreign businesses.

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[152] For a review of the literature on home bias in portfolio holdings, see Nicolas Coeurdacier and Hélène Rey, "Home Bias in Open Economy Financial Macroeconomics," *Journal of Economic Literature*, vol. 51, no. 1, March 2013, pp. 63-115.

[153] Mihir A. Desai, C. Fritz Foley, and James R. Hines Jr., "Domestic Effects of the Foreign Activities of U.S. Multinationals," *American Economic Journal: Economic Policy*, vol. 1, no. 1, February 2009, pp. 181-203.

[154] The authors of the study recognize this problem and attempt to correct for it in their analysis.

[155] Ann E. Harrison, Margaret S. McMillan, and Clair Null, "U.S. Multinational Activity Abroad and U.S. Jobs: Substitutes or Complements," *Industrial Relations*, vol. 46, no. 2, April 2007, pp. 347-365.

Promoting U.S. ownership of U.S. and foreign assets

Some policymakers may prefer that ownership of U.S. and foreign assets is held by U.S. persons instead of foreign persons. With regards to foreign assets, U.S. ownership may confer a number of benefits on the U.S. economy. Foreign assets may serve as a platform for overseas expansion and growth, potentially increasing domestic employment and investment. In addition, when a U.S. company acquires a foreign company, it may also be acquiring intangibles (such as intellectual property and managerial know-how) that may complement its existing U.S. operations and enhance their effectiveness. Moreover, income generated from the asset will be part of the U.S. income tax base rather than the income tax base of another country.

Relative to situations involving U.S. ownership of a foreign asset, it is less clear how, as a general matter, U.S. ownership of a U.S. asset benefits the U.S. economy more than foreign ownership of a U.S. asset.

For example, when a foreign company acquires a U.S. company, the headquarters operations of the U.S. company may move outside the United States. This may result in direct employment losses in the United States as well as some of the local economic benefits that accompany headquarters operations, including involvement in philanthropic activities.[156]

When a foreign company starts a new venture in the United States by making new investments ("greenfield investments") instead of acquiring an existing company, that may benefit the U.S. economy by increasing employment and investment. This positive economic impact may come at the expense of U.S. businesses, though. For example, the foreign company's U.S. venture may be competing directly with a U.S. company for control of a market for a particular product. If the foreign company's U.S. venture succeeds in controlling the market at the expense of its U.S.-based competitor because its products are more attractive and the company is managed more efficiently, for example, net investment and employment in the United States may still increase. However, what could have been a U.S.-headquartered company controlling a market segment is now a foreign-headquartered company. If policymakers are concerned about this scenario, though, that concern may be in conflict with the goal of encouraging U.S. investment by foreign corporations.

The U.S. economic impact in the second hypothetical example—where a foreign person makes a new investment in the United States—contrasts with that of the first hypothetical example, where a foreign company acquired an existing U.S. company. In both cases, a foreign-headquartered company owns a U.S. asset that could have been owned by a U.S.-headquartered company. However, there was a positive U.S. economic impact in the example where a foreign company made a new investment, while there was a negative U.S. economic impact in the example where a foreign company acquired an existing U.S. company and moved its headquarters overseas. These examples, and the U.S. economic impact described, are hypothetical, but they illustrate that the distinction between foreign ownership of an existing U.S. asset versus a new U.S. asset be important for the economic analysis. However, there is little

[156] David Card, Kevin F. Hallock, and Enrico Moretti, "The Geography of Giving: The Effect of Corporate Headquarters on Local Charities," *Journal of Public Economics*, vol. 94, nos. 3-4, April 2010, pp. 222-234.

empirical evidence on the extent to which these hypothetical examples reflect existing investment patterns, and if so, whether, on balance, U.S. ownership of U.S. assets provides greater economic benefits than foreign ownership of U.S. assets.

A general consideration to take into account is whether a U.S. asset is more productive under foreign ownership than U.S. ownership for purely economic reasons. A foreign company, for example, may have a stronger overseas presence (in the relevant markets) than prospective U.S. acquirers of a U.S. company, and may facilitate the global expansion of the U.S. company more effectively. The economic case for promoting U.S. ownership of the U.S. company in this situation is unclear. However, if the U.S. company is more productive under U.S. ownership, but for tax reasons is more valuable in the hands of a foreign owner, there may be a stronger case for designing tax rules to promote U.S. ownership of these assets.

2. Assessing the competitiveness of the U.S. tax system in a global economy

The United States is part of a global economy in which other governments may have also adopted policies intended attract investment and promote the overseas growth of their home-country multinationals. Over the past decade, there have been a number of policy developments around the world, and in OECD countries in particular, that have led policymakers to question whether the U.S. tax system is competitive: (1) the decline in statutory corporate income tax rates and the adoption of tax rules that exempt active foreign-source income from home-country taxation; and (2) preferential tax regimes for income derived from intellectual property.

Decline in statutory corporate income tax rates and adoption of exemption systems

Decline in statutory corporate income tax rates

The gradual decline in statutory corporate income tax rates is illustrated in Table 1, below, which details the top combined statutory corporate income tax rates in the OECD from 2004 to 2014 and reflects tax rates set by central governments as well as sub-central governments.

Table 1.−Top Combined Statutory Corporate Income Tax Rates in the OECD (Central and Sub-Central Governments): 2004-2014

	2004	2005	2006	2007	2008	2009	2010	2011	2012	2013	2014
Australia	30.0	30.0	30.0	30.0	30.0	30.0	30.0	30.0	30.0	30.0	30.0
Austria	34.0	25.0	25.0	25.0	25.0	25.0	25.0	25.0	25.0	25.0	25.0
Belgium	34.0	34.0	34.0	34.0	34.0	34.0	34.0	34.0	34.0	34.0	34.0
Canada	34.4	34.2	33.9	34.0	31.4	31.0	29.4	27.6	26.1	26.3	26.3
Chile	17.0	17.0	17.0	17.0	17.0	17.0	17.0	20.0	20.0	20.0	20.0
Czech Republic	28.0	26.0	24.0	24.0	21.0	20.0	19.0	19.0	19.0	19.0	19.0
Denmark	30.0	28.0	28.0	25.0	25.0	25.0	25.0	25.0	25.0	25.0	24.5
Estonia	26.0	24.0	23.0	22.0	21.0	21.0	21.0	21.0	21.0	21.0	21.0
Finland	29.0	26.0	26.0	26.0	26.0	26.0	26.0	26.0	24.5	24.5	20.0
France	35.4	35.0	34.4	34.4	34.4	34.4	34.4	34.4	34.4	34.4	34.4
Germany	38.9	38.9	38.9	38.9	30.2	30.2	30.2	30.2	30.2	30.2	30.2
Greece	35.0	32.0	29.0	25.0	25.0	25.0	24.0	20.0	20.0	26.0	26.0
Hungary	16.0	16.0	17.3	20.0	20.0	20.0	19.0	19.0	19.0	19.0	19.0
Iceland	18.0	18.0	18.0	18.0	15.0	15.0	18.0	20.0	20.0	20.0	20.0
Ireland	12.5	12.5	12.5	12.5	12.5	12.5	12.5	12.5	12.5	12.5	12.5
Israel	35.0	34.0	31.0	29.0	27.0	26.0	25.0	24.0	25.0	25.0	26.5
Italy	33.0	33.0	33.0	33.0	27.5	27.5	27.5	27.5	27.5	27.5	27.5
Japan	39.5	39.5	39.5	39.5	39.5	39.5	39.5	39.5	39.5	37.0	37.0
Korea	29.7	27.5	27.5	27.5	27.5	24.2	24.2	24.2	24.2	24.2	24.2
Luxembourg	30.4	30.4	29.6	29.6	29.6	28.6	28.6	28.8	28.8	29.2	29.2
Mexico	33.0	30.0	29.0	28.0	28.0	28.0	30.0	30.0	30.0	30.0	30.0
Netherlands	34.5	31.5	29.6	25.5	25.5	25.5	25.5	25.0	25.0	25.0	25.0
New Zealand	33.0	33.0	33.0	33.0	30.0	30.0	30.0	28.0	28.0	28.0	28.0
Norway	28.0	28.0	28.0	28.0	28.0	28.0	28.0	28.0	28.0	28.0	27.0
Poland	19.0	19.0	19.0	19.0	19.0	19.0	19.0	19.0	19.0	19.0	19.0
Portugal	27.5	27.5	27.5	26.5	26.5	26.5	26.5	28.5	31.5	31.5	31.5
Slovak Republic	19.0	19.0	19.0	19.0	19.0	19.0	19.0	19.0	19.0	23.0	22.0
Slovenia	25.0	25.0	25.0	23.0	22.0	21.0	20.0	20.0	20.0	17.0	17.0
Spain	35.0	35.0	35.0	32.5	30.0	30.0	30.0	30.0	30.0	30.0	30.0
Sweden	28.0	28.0	28.0	28.0	28.0	26.3	26.3	26.3	26.3	22.0	22.0
Switzerland	24.1	21.3	21.3	21.3	21.2	21.2	21.2	21.2	21.2	21.1	21.1
Turkey	33.0	30.0	20.0	20.0	20.0	20.0	20.0	20.0	20.0	20.0	20.0
United Kingdom	30.0	30.0	30.0	30.0	28.0	28.0	28.0	26.0	24.0	23.0	21.0
United States	39.3	39.3	39.3	39.3	39.3	39.1	39.2	39.2	39.1	39.1	39.1
OECD Median	30.0	29.0	28.0	27.0	26.8	26.0	25.8	25.5	25.0	25.0	25.0

Source: OECD Tax Database.

For each year, the cell corresponding to the country with the highest tax rate is shaded pink, while the cell associated with the country with the lowest tax rate is shaded blue. There has been a steady, downward trend in statutory corporate tax rates in OECD countries besides the United States. From 2004 to 2014, the median combined statutory corporate income tax rate fell from 30 percent to 25 percent. Moreover, in 2014, the United States currently had the highest combined statutory corporate income tax rate (39.1 percent) among OECD countries, while Ireland had the lowest (12.5 percent).

Adoption of exemption systems

Since 2000, there has been a significant increase in the number of OECD countries that have adopted some form of exemption system for the taxation of foreign-source income.

According to one report, of the 34 countries that make up the OECD, 28 have some form of an exemption system (compared to 13 at the start of 2000).[157]

Implications for the competitiveness of the U.S. tax system

Growth of U.S. multinationals abroad

In foreign markets, U.S. corporations may have more limited options for growth than some of their foreign competitors in that market. For example, consider a U.S. corporation and foreign corporation that both require an after-tax rate of return of 10 percent on the investments they pursue in a given market outside their home country, which is assumed to have a tax rate of 20 percent. If the earnings of the foreign corporation are exempt from home-country tax, this means that it will pursue investments that yield a required pre-tax rate of return of 12.5 percent.[158] In contrast, the U.S. corporation's required pre-tax rate of return may be greater than 12.5 percent, even though it can defer paying residual U.S. tax on its earnings, because it cannot reduce the present value of its U.S. residual tax liability below zero in the absence of cross-crediting. Therefore, the U.S. corporation may forgo investments—such as expansion of its manufacturing facilities or acquisitions of local companies—that it would have pursued if its returns were not subject to U.S. taxation. This may make it more difficult for the U.S. corporation to gain market share relative to the foreign corporation, and also may have an indirect, negative effect on employment and economic growth in the United States to the extent that a U.S. company's success overseas translates into increased domestic investment and employment. However, if the U.S. corporation is able to fully offset the residual U.S. tax liability on its earnings with credits allowed for income taxes paid in another jurisdiction, it would not be at a competitive tax disadvantage relative to the foreign corporation. Moreover, the ability of a U.S. corporation to defer paying residual U.S. tax on its earnings may limit its competitive tax disadvantage because its cash flow would not be immediately reduced by its U.S. tax liability.

Domestic investment by U.S. and foreign businesses

The economics literature has found that the location of foreign direct investment is sensitive to both the statutory tax rates and effective marginal tax rates, which is the effective rate of tax (accounting for all features of the tax system such tax incentives and methods of cost recovery) on a marginal investment.[159] Therefore, the United States may be at a competitive tax

[157] See PricewaterhouseCoopers, "Evolution of Territorial Tax Systems in the OECD," April 2, 2013.

[158] In equation form, $0.10/(1 - 0.8) = 0.125$. To see how this equation was arrived at, note that a pre-tax rate of return of 12.5 percent multiplied by 1 minus the foreign tax rate of 20 percent equals an after-tax rate of return of 10 percent. Therefore, to arrive at the required pre-tax rate of return for a given tax rate and after-tax rate of return, one divides the after-tax rate of return (in this case, 10 percent or 0.10) by 1 minus the foreign tax rate (in this case, 80 percent or 0.80).

[159] This research is surveyed in Ruud A. De Mooij and Sjef Ederveen, "Taxation and Foreign Direct Investment: A Synthesis of Empirical Research," *International Tax and Public Finance*, vol. 10, no. 6, November 2003, pp. 673-693. Studies do, however, find that foreign direct investment is more responsive to effective marginal tax rates than statutory tax rates.

disadvantage, relative to other countries, in attracting domestic investment by U.S. and foreign businesses, to the extent that the other countries have corporate tax rates lower than that of the United States. As described above in Table 1, this scenario may have grown increasingly likely over the last decade as statutory corporate tax rates in other OECD countries have gradually declined. However, the United States may be able to offset some or all of its competitive disadvantage by offering tax incentives, such as the section 199 domestic production activities deduction and accelerated cost recovery methods, that lower the effective marginal tax rate on income earned by foreign (and domestic) businesses.

Ownership of assets

Policymakers may be concerned that the U.S. system of worldwide taxation may put U.S. multinationals at a competitive disadvantage, relative to foreign multinationals, in acquiring U.S. and foreign assets; Tables 3 and 4 of Part IV provides data on cross-border acquisitions in the OECD. With respect to U.S. assets, since foreign multinationals may have more opportunities to grow overseas if they are based in countries that exempt active foreign income from home-country tax, a U.S. asset may be more valuable under foreign ownership than under U.S. ownership. For example, the U.S. asset may be a U.S. company that has opportunities to expand its global presence. If it can achieve greater success overseas under foreign ownership, that may allow foreign corporations to offer higher bids than U.S. corporations when acquiring the company.

However, it could be the case that the company is more valuable under U.S. ownership despite the U.S. system of worldwide taxation. For example, a particular U.S. corporation may manage the company more effectively, and integrate it more successfully into the corporation's overall business operations, than any foreign corporation could. The company would then be less valuable to any foreign corporation than it is to the U.S. corporation, so the U.S. corporation may submit a higher bid than any foreign corporation, and as a result acquire the company. The geographic pattern of the ownership of assets by owners' country of residence, then, can reflect a number of economic considerations unrelated to tax. Moreover, for any given U.S. company, the proposition that it can expand more successfully under an exemption system, versus a worldwide tax system with deferral, may not be true. That will depend on a number of factors, including the line of business the company is engaged in, its capital needs in the United States, and the type of growth opportunities it is interested in pursuing.

3. Intellectual property or "patent box" regimes

Innovation is an important determinant of economic growth, and a number of countries have made it a priority to promote domestic investment in the research and development that generates innovation. Some countries have done so by establishing intellectual property regimes (or "patent boxes"), which offer preferential tax treatment on income attributable to intellectual property. These countries include Belgium, Cyprus, France, Hungary, Luxembourg, Malta, the Netherlands, Portugal, Spain, and the United Kingdom. In addition, Italy and Ireland have recently announced that they are considering adopting new intellectual property regimes.

Table 2, below, summarizes three key design features of the intellectual property regimes enacted or contemplated by these countries: a definition of the type of intellectual property that qualifies for the regime; the required nexus between the intellectual property and the country offering the regime; and a description of income that qualifies for the regime and the preferential tax treatment available.

Table 2.−Summary of Existing Intellectual Property Regimes[160]

Country	Qualified IP	Nexus Requirement	Benefits
Belgium	Qualifying patents (excludes trademarks, designs, models, or secret recipes or processes)	Requires patent to be developed by Belgian company or acquired patent to be further improved by Belgian company	80 percent deduction of qualifying gross patent income
Cyprus	Patents, copyrights (including literary works, scientific works, artistic works, films, etc.), trademarks, designs and models	Property must be owned by the Cyprus resident company	80 percent of royalty income and profit generated from the disposal of qualified property is exempt
France	Patent granted in France, United Kingdom, or European Patent Office or specified European countries or if invention would have been patentable in France (excludes trademarks, design rights and copyrights)	Intellectual property rights must be owned by the French company, must own acquired rights for at least two years	Revenue or gain derived from the qualified property (does not include embedded royalties) taxed at 15 percent

[160] The descriptions of various intellectual property regimes relies largely on secondary sources including: Lisa Evers, Helen Miller, and Christoph Spengel, Centre for European Economic Research, *Intellectual Property Box Regimes: Effective Tax Rates and Tax Policy Considerations*, (Discussion Paper No. 13-070), November 2013, available at http://ftp.zew.de/pub/zew-docs/dp/dp13070.pdf; Japan External Trade Organization, *European Patent Box Regimes*, April 2013, available at https://www.jetro.go.jp/world/europe/ip/pdf/european_patent_box_regimes_en.pdf; Peter Merrill, *et. al.*, "Time for the United States to Consider the Patent Box?," *Tax Notes*, March 26, 2012, p.1665; Robert Atkinson and Scott Andes, The Information Technology & Innovation Foundation, *Patent Boxes: Innovation in Tax Policy and Tax Policy for Innovation*, October 2011, available at http://www.itif.org/files/2011-patent-box-final.pdf; Ernst & Young, *Patent Income Deduction*, 2011, available at http://www.ey.com/Publication/vwLUAssets/Patent_Income_Deduction_2011/$FILE/PID%202011.pdf; and Garrigues, *International Tax Review*, April 2008, available at http://www.garrigues.com/es/Publicaciones/Articulos/Documents/Antonio_Matute_04042008135214.pdf.

Country	Qualified IP	Nexus Requirement	Benefits
Hungary	Patents, know-how, trademarks, business names, business secrets and copyrights	Applies to developed and acquired intellectual property	50 percent deduction for royalties received from related or third parties for the use of property
Ireland[161]	Patents and property functionally equivalent to patents	Intent to follow OECD and EU modified nexus approach	
Italy[162]	Patents and property functionally equivalent to patents	Intent to follow OECD and EU modified nexus approach, must perform research and development activity either directly or in cooperation with universities, must enter into an advanced pricing agreement	Exemption for income sourced from intangible assets, 30 percent exemption in 2015, 40 percent exemption in 2016, 50 percent exemption after 2016
Luxembourg	Patents, trademarks, designs, domain names, models and software copyrights	Luxembourg company must be the economic owner of the rights (does not include rights acquired from a related party)	80 percent tax exemption for net income derived from the use or right to use qualified property
Malta	Patented intellectual property and qualifying copyrights	Must own the rights to the patented intellectual property and receive royalties or similar income	Full tax exemption for qualifying patented inventions and qualifying copyrights

161 Ireland Department of Finance, Tax Policy Division, *Public Consultation Paper: The Knowledge Development Box*, January 2015, available at http://www.finance.gov.ie/sites/default/files/Knowledge_Development_Box_%20DFinance_consultation_finalweb%20cover.pdf.

162 Domenico Borzumato & Annalisa Vergati, *Tax Notes International*, "News Analysis: Italy's Finance Bill -- Tax as a Tool for Growth, December 1, 2014.

Country	Qualified IP	Nexus Requirement	Benefits
The Netherlands	Worldwide patents and intellectual property arising from research and development activities for which the taxpayer has obtained a declaration from the Dutch government (trademarks, non-technical design rights and literary copyrights are not included)	Dutch company must be the economic owner and bear the risks associated with ownership, development activities must be conducted at the risk of the Dutch company, but research and development is not required to be performed in the Netherlands	Five percent rate on income from a qualifying intangible, includes embedded royalties if more than 30 percent of the derived income is attributable to the patent
Spain	Patents, drawings or models, plans, secret formulas or procedures, and rights on information related to industrial, commercial, or scientific experiments	Intellectual property must be created by the resident company and includes other requirements related to the use of the property	Exempts 60 percent of the net income derived from the qualified property
United Kingdom	Patents granted by the United Kingdom or European Patent Office (excludes trademarks and registered designs) and certain associated intellectual property	Requires legal ownership of the patent, must be developed by a company in the worldwide corporate group, U.K. company must make a significant contribution to developing the patent	10 percent tax rate on income from patented inventions and certain other innovations

There are similarities and differences in the intellectual property regimes described. While patents qualify for the benefits of the regime in all the countries, some countries offer benefits to non-patented property, including trademarks, copyrights, business secrets. Some countries only require that the intellectual property be owned by the resident company, while others may require that the intellectual property be developed or improved on by the resident company. The design of these regimes has been an area of focus and scrutiny under the OECD/G20 BEPS project, and some policymakers have been particularly concerned that intellectual property regimes may promote “unfair” tax competition if countries do not require some physical nexus between where the intellectual property is owned and the economic activities that helped produce that property, given that a company may have flexibility in choosing the country where it initially locates the legal entitlements to intellectual property.

Modified nexus approach

Recently, the European Commission and OECD's Forum on Harmful Tax Practices have conducted reviews of certain regimes, including intellectual property tax regimes. In particular, the OECD conducted reviews as part of the BEPS Action Plan item 5 on harmful tax practices.[163] The 2014 report on action item 5 of the BEPS Action Plan identified the agreement by countries on the goal of aligning the taxation of preferential regime profits with substantial activities conducted by the entity eligible for the preferential tax treatment. At the time of the 2014 report, there was no consensus on the approach that would be used to evaluate this substantial activity requirement. One approach discussed in the 2014 report is the nexus approach.

The nexus approach evaluates the regime based on whether it makes its benefits conditional on the extent of the research and development activities of the taxpayers receiving benefits. In this approach the research and development expenses act as a proxy for the amount of activities conducted. The amount of the expenditures is not the test; rather the test is based on the proportion of expenditures that demonstrate real value added by the taxpayer. Qualifying expenditures would be defined under this approach in a way that would prevent mere capital contributions or expenditures for research and development activities performed by parties other than the taxpayer from qualifying the taxpayer for benefits of the intellectual property regime.

In order to reach consensus within the OECD and G20 countries, the United Kingdom and German proposed a modified nexus approach. This approach has been endorsed by all OECD and G20 countries.[164] As part of the compromise, existing regimes would be allowed to continue for five years with no new entries into the regime after June 2016. The agreement calls for general acceptance of the modified nexus approach presented in the 2014 report with further modifications related to the level of qualifying expenditures, as well as an addition for an "up-lift." The up-lift would allow an additional 30 percent of qualifying expenses for outsourcing and intellectual property acquisition cost to be included as qualifying expenditures. For these purposes, qualifying intellectual property assets that could qualify for the preferential regime are patents and functionally equivalent intellectual property assets that are legally protected and subject to approval and registration processes, where such processes are relevant. Marketing-related intellectual property assets such as trademarks are explicitly excluded.

Economic analysis of intellectual property regimes and implications for the United States

Promoting domestic investment in research is important for U.S. policymakers. While the U.S. tax system already subsidizes research activities by offering a credit for certain qualified research expenditures and allowing research expenditures to be expensed instead of amortized

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[163] OECD/G20 Base Erosion and Profit Shifting Project, *Countering Harmful Tax Practices More Effectively, Taxing into Account Transparency and Substance*, 2013, available at http://www.oecd-ilibrary.org/docserver/download/2314271e.pdf?expires=1426166387&id=id&accname=guest&checksum=DCC77548D32DA7C88CD04F870ED76A59.

[164] OECD Press Release, "G20: Remarks for Session 5 - International Tax Issues," February 10, 2015, available at http://www.oecd.org/g20/topics/taxation/g20-remarks-session-5-international-tax-issues.htm.

over time, there is concern that the intellectual property regimes adopted by other countries will attract research activity away from the United States.[165] Some commentators have argued that the United States should also adopt an intellectual property regime.[166]

One economic rationale for intellectual property regimes is that they promote investment in research and development by lowering the tax burden on the returns to intellectual property, thereby increasing their after-tax returns. Assuming this were true, it may still be unclear, as a matter of general structural design, if an intellectual property regime is more effective than a research credit at promoting research activity. A research credit directly subsidizes research activity, while an intellectual property regime increases the after-tax returns to all activity that generates income related to intellectual property, including non-research expenditures such as marketing (which policymakers may or may not want to subsidize in the context of promoting research investment).[167] In that sense, a research credit is more targeted than an intellectual property regime, and it may be the case that some form of research credit may have a greater impact on research activity and economic growth, at the same or lower budgetary cost, than an intellectual property regime. If this claim were true, a more generous U.S. research credit (*e.g.*, one with a higher credit rate or one that was flat and non-incremental) may better address the concern that U.S. policymakers may have with intellectual property regimes, which is that they may drive research activity away from the United States. However, there is little empirical research on this particular claim.[168]

Policymakers have also pursued intellectual property regimes under the premise that the location of legal entitlements to intellectual property influences where companies make investments related to that intellectual property. For example, it may be the case that scientists who are making further developments to a piece of intellectual property are best located in the country under the laws of which the intellectual property is registered or owned. Although there are a number of studies showing that innovation is spatially concentrated—research and

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[165] For more detail on federal tax benefits for research activities, see Joint Committee on Taxation, *Background and Present Law Relating to Manufacturing Activities Within the United States* (JCX-61-12), July 17, 2012.

[166] For example, see Robert Atkinson and Scott Andes, "Patent Boxes: Innovation in Tax Policy for Innovation," The Information Technology and Innovation Foundation, October 2011, available at http://www.itif.org/files/2011-patent-box-final.pdf.

[167] Some countries attempt to exclude income arising from marketing intangibles from the income that is eligible for tax benefits.

[168] Some authors find that intellectual property regimes may have a greater impact than research credits on the quality of research and development activities by encouraging companies to pursue more profitable research projects than they would with a research credit. However, the study is limited by its measure of research quality (which is not directly observed), and it is unclear if research expenditures that generate greater private returns necessarily generate greater social returns. For example, the private returns to commercialization expenditures may be greater than the private returns to basic research, even if the social returns to basic research (the returns to which may be harder to appropriate) may be greater. See Christof Ernst, Katharina Richter, Nadine Riedel, "Corporate Taxation and the Quality of Research and Development," *International Tax and Public Finance*, vol. 21, no. 4, August 2014, pp. 694-719.

development activities can cluster in particular geographic areas—there are few studies that examine whether investments related to a particular piece of intellectual property are also concentrated where its rights are being held.[169]

Given the lack of conclusive research supporting arguments that intellectual property regimes have real economic effects, some policymakers are concerned that the economic benefits of these regimes may not outweigh possible reductions in tax revenue. For example, one study finds that while patent box regimes are likely to attract patent-related income, they may lead to significant decreases in tax revenue.[170] The significant decline in tax revenue, however, may have been accompanied by an increase in research activity, the economic benefit of which may offset at least some of the economic loss associated with the decline in tax revenue (*i.e.*, lower expenditures on public goods or higher levels of debt).

[169] Maryann P. Feldman and Dieter F. Kogler, "Stylized Facts in the Geography of Innovation," in Bronwyn H. Hall and Nathan Rosenberg (eds.), *Handbook of the Economics of Innovation*, vol. 1, pp. 381-410, North-Holland Publishing Co., 1986.

[170] Rachel Griffith, Helen Miller, and Martin O'Connell, "Ownership of Intellectual Property and Corporate Taxation," *Journal of Public Economics*, vol. 112, April 2014, pp. 12-23.

B. Economic Distortions Arising from Deferral

1. Deferral and the initial choice between foreign and domestic investment

Some U.S. policymakers are concerned that the ability of U.S. corporations to defer U.S. tax on foreign earnings may discourage investment in the United States. As the following example illustrates, a U.S. corporation may prefer a foreign investment opportunity to a domestic investment opportunity if the returns on the domestic investment are subject to current taxation, even if both investments yield the same pre-tax rate of return.

Suppose that a U.S. taxpayer in the 35-percent tax bracket is considering whether to make an investment in an active enterprise in the United States or in an equivalent investment opportunity in a country in which the income tax rate is zero. Assume the U.S. taxpayer chooses to make the investment in the foreign country through a CFC that earns $100 of active income today, and the U.S. taxpayer defers tax on that income for five years by reinvesting the income in the CFC. Assume further that the CFC can invest the money and earn a 10-percent return per year, and the income earned is not subject to foreign tax or current U.S. taxation under subpart F. After five years, the taxpayer will have earned $161.05 of income and will pay tax of $56.37 on repatriation, for an after-tax income of $104.68.

If, instead, the U.S. taxpayer pursues the equivalent investment opportunity in the United States, income from such an investment will not be eligible for deferral. As a result, the taxpayer receives $100 in income today, pays tax of $35, and has only $65 to reinvest. The taxpayer invests that amount at an after-tax rate of 6.5 percent (this is a 10-percent pre-tax rate less 35 percent tax on the earnings each year). At the end of five years, this taxpayer has after-tax income of only $89.06, as compared to the foreign investment option which generates after-tax income of $104.68. The result is that the foreign investment option to defer tax on the income for five years leaves the taxpayer with $15.62 more in profits than the domestic investment option that requires the taxpayer to pay tax on the income immediately, even though the pre-tax rate of return (10 percent) is the same for both investments. As a result, the foreign investment is the preferred choice (all else being equal).

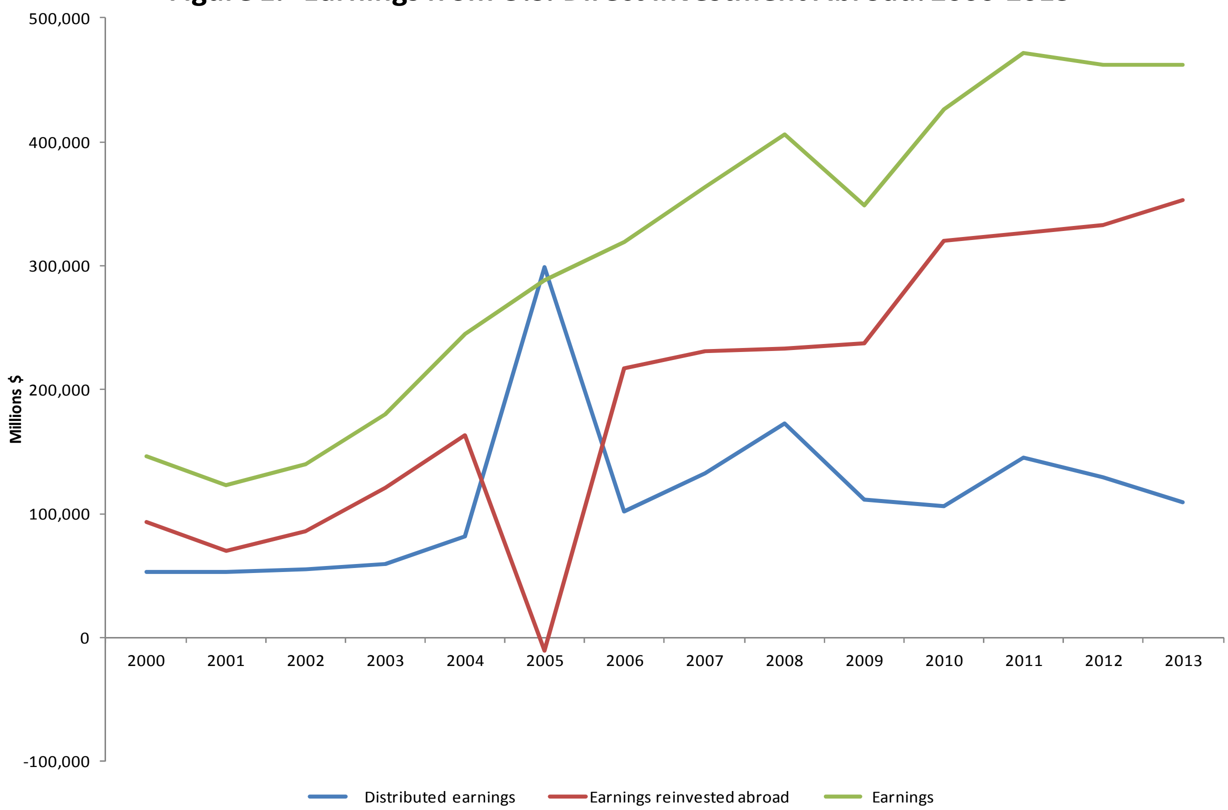
2. The "lockout effect" and the choice between repatriating or reinvesting foreign earnings

Policymakers are also concerned that U.S. tax rules may create a "lockout effect," which is a colloquial reference to the possibility that the overseas earnings of U.S. corporations are being "locked out" and not reinvested in the United States because U.S. corporations have a tax incentive, created by deferral, to reinvest foreign earnings rather than repatriate them. This may occur if corporations choose to make foreign investments, rather than domestic investments, because the ability to defer payment of residual U.S. tax liability on the returns to the foreign investments may make those foreign investments more attractive on an after-tax basis, even if they yield the same pre-tax return as a domestic investment. The lockout effect disappears if repatriation of overseas earnings has no tax consequence, as would be the case if foreign earnings were exempt from U.S. tax or if those earnings were subject to current U.S. taxation.

Figure 1 illustrates the extent to which foreign earnings are being reinvested overseas. From 2000 to 2013, earnings from U.S. direct investment abroad grew from $151.8 billion to

$470 billion, while the amount of those earnings that was reinvested overseas increased from $93.6 billion to $353.2 billion. The amount of earnings that was distributed rose from $52.9 billion in 2003 to $109 billion in 2013.[171] Although a significant amount of foreign earnings was reinvested abroad and not distributed, that does not necessarily mean that the lockout effect is significant. Such reinvestment may be the most economically productive use of a corporation's funds if the pre-tax rate of return on its foreign investment exceeds the domestic investment opportunities available to it. Since most growth by U.S. multinational corporations is occurring in foreign markets, companies may be making productive investment decisions by reinvesting a large portion of their foreign earnings to support their expansion overseas.

Figure 1.–Earnings from U.S. Direct Investment Abroad: 2000-2013



Source: Bureau of Economic Analysis.

However, a number of economists find the that burden of residual U.S. tax liability on repatriated earnings distorts a corporation's decision concerning how much to repatriate (and from which foreign subsidiaries), and that the economic cost of this distortion—which could cause U.S. corporations to incur more debt, or invest less in the United States, than they would if

[171] The large increase in distributed earnings, and corresponding decrease in earnings reinvested abroad, in 2004 and 2005 was due largely to the enactment of the section 965 repatriation holiday.

they had no residual U.S. tax liability on their foreign earnings—can be significant.[172] Some economists find that the cost of this distortion increases as the accumulated stock of deferred income increases.[173]

3. Distortions in shareholder payouts

Deferral may also contribute to distortions in how U.S. corporations manage shareholder payouts and debt. For example, deferral may provide U.S. corporations with an incentive to reinvest foreign earnings rather than repatriate the earnings and distribute the proceeds to shareholders in the form of dividends or share buybacks, leading to reduced shareholder payouts. Moreover, U.S. corporations may have larger levels of U.S. debt than they otherwise would because they are not repatriating foreign earnings to reduce their debt load, or because they choose to fund shareholder payouts through borrowing rather than out of repatriated foreign earnings.

[172] Mihir A. Desai, C. Fritz Foley, and James R. Hines Jr., "Repatriation Taxes and Dividend Distortions," *National Tax Journal*, vol. 54, no. 4, December 2001, pp. 829-851.

[173] Harry Grubert and Rosanne Altshuler, "Fixing the System: An Analysis of Alternative Proposals for the Reform of International Tax," *National Tax Journal*, vol. 66, no. 3, September 2013, pp. 671-712.

C. Shifting Income and Business Operations

Since 1962, the U.S. firms have grown as a result of both the growth of the U.S. market and the expansion of foreign markets.[174] As they increased their cross-border business transactions, multinational corporations (both U.S.-based and foreign-based) have been able to determine where and when income will be subject to tax, if any. In recent years, numerous articles and commentary have suggested that the ability to do so reflects either aggressive tax planning or deficiencies in present law, prompting concern that present law may encourage erosion of the U.S. tax base and shifting of income. As U.S. policymakers contemplate reform of the U.S. rules of international taxation, they face a challenge of balancing the calls for reform from a range of U.S. multinational corporations against concerns that many multinational corporations have shifted income to low-tax jurisdictions.[175]

Multinational corporations engage in foreign direct investment as they acquire or create assets abroad to manufacture or sell the corporation's goods and services. There are many business reasons that may motivate a U.S. multinational corporation to make outbound foreign direct investments. Building a plant abroad may be the most cost efficient way for a U.S. multinational corporation to gain access to a foreign market. Trade barriers or transportation costs could make it prohibitively costly to serve the foreign market via direct export from a U.S. location. Foreign direct investment may put the U.S. multinational corporation physically closer to its customers, allowing better customer service and providing a better understanding of the foreign market, which can serve as the basis for improved future marketing of goods and services. A U.S. multinational corporation may make an outbound foreign direct investment to lower operating costs by exploiting less expensive, or more skilled, foreign labor and less expensive access to raw materials or components from suppliers, or to permit operation in a less burdensome regulatory environment. Foreign direct investment may provide access to foreign-developed technology.

Tax burden is another factor that may motivate foreign direct investment by U.S. multinational corporations, in addition to the foregoing nontax business reasons. The phrase "to shift income" is used herein to refer to the broad range of tax-planning techniques that minimize tax liability by migrating income or items of income from a high-tax jurisdiction to a jurisdiction with a low- or zero-tax rate. Such migration may be achieved through the restructuring of a business and its supply chain, the transfer or sharing of ownership rights to intangible property, and use of the asymmetries between U.S. law and that of another jurisdiction in order to avoid

[174] The expansion of foreign markets has benefitted the growth of foreign corporations in those markets as well. Compare, for example, the number of Chinese corporations included in the Global 500 published by Fortune magazine in 1995 to number included in the Global 500 for 2014. In 1995, three Chinese corporations were included; in 2014, 95 Chinese corporations comprise approximately 20-percent of the list. See, www.fortune.com/global500.

[175] For case studies and analysis of how U.S. multinational corporations may shift income to low-tax jurisdictions, see Joint Committee on Taxation, *Present Law and Background Related to Possible Income Shifting and Transfer Pricing* (JCX-37-10), July 20, 2010.

income recognition under subpart F and ensure deferral. Depending on how migration is achieved, actual business operations may migrate as well, in whole or in part.

1. The principal structure and risk limitation

It is generally not possible for a taxpayer to structure its operations to avoid high-tax jurisdictions entirely. Companies may have distribution channels and customer support activities located where customers are located, or products may be difficult or expensive to ship, requiring manufacturing to take place where the product is ultimately used. Nevertheless, an integrated value chain may be structured in a way that achieves both business and tax objectives. Such structures would typically follow the principal model (described below) and limit contractual risks of certain entities.[176] Using a principal structure, a multinational corporation may devise a rational structure for the activities and entities that make up its global value chain while concentrating its more profitable functions in foreign jurisdictions where the average tax rate is lower and limiting the functions and risks in jurisdictions where the average tax rate is higher.

Companies that follow the principal model establish an entity as a foreign principal, typically located in a foreign jurisdiction where the principal is subject to low average corporate income tax rates because the jurisdiction has a low statutory tax rates on business income or as a result of specially negotiated tax rates. The principal owns intangible property rights and may have contractual responsibility for high value functions associated with such property, such as the continued development of intangible property, as well as the general management and control of business operations. In contrast, lower value functions such as contract manufacturing or limited risk distributor functions may continue to be performed in locations dictated by nontax business needs or historical precedent.   For example, proximity to suppliers and ultimate customers and an experienced workforce may require that manufacturing or a distribution center remain in a jurisdiction despite its high tax rate. In that case, those functions are performed by a contract manufacturer or other limited risk contractor. Although those contractors recognize positive taxable income based on the compensation required under their arrangements with the principal, such income is limited to a routine return because the contractors do not share the entrepreneurial risk that would entitle them to a profit potential of the business activities.

The tax objectives of the structure are met only if the tax authorities of both the United States and the foreign jurisdiction respect the chosen structure and allocation of entrepreneurial risk under the contractual arrangements. Risk allocation may be reviewed as part of several issues that could arise in tax examination. For example, questions about the compensation paid to a principal for its services or for the use of its intangible property rights may arise in transfer-pricing inquiries. Similarly, a party claiming treaty benefits with respect to an item of income may face questions about whether it has sufficient nexus with a jurisdiction in order to satisfy the limitations of benefits article in the treaty. Such questions may include inquiry into the substantiality of functions actually performed in the treaty jurisdiction.

[176] Contractual limitation of risk may also be accomplished using existing entities within a group and need not include the creation or reorganization of entities.

In the past, the OECD has recognized the importance of risk-taking and the value that efficient value chain structures contribute to lower the barrier to entry in new markets. [177] However, concerns that some allocations of risk may be mere formalities underlie several action items within the ongoing Base Erosion and Profit Shifting ("BEPS") project. The issues are addressed in both the report delivered on the digital economy and recommendations on the use of the profit-split method of pricing elements in global value chains.[178] In response to the request for comments from the public to a discussion draft on the latter, commentators have expressed concern that traditional transfer pricing principles are ignored by the OECD recommendations, and if adopted, the OECD proposals would make it difficult for a corporation to know to what extent its structures and risk allocations will be respected.

Surveys of corporate management suggest that there is increasing awareness of the concerns about certain tax practices that may lead to more cautious tax-planning.[179] Greater caution could take the form of avoiding the structure or contractual limitations when possible. On the other hand, it could also lead to loss of some high-value functions now performed in the United States on a contract basis, such as research and development. If corporate management perceives a possibility that its risk allocations to a principal will not be respected, or that limited contractual risk agreements may be recharacterized or disregarded, it may conclude that tax considerations in favor of moving activities outweigh the nontax reasons for not moving activities. As a result, business operations and the related management and supporting personnel may relocate to the jurisdiction of the foreign principal.[180]

2. Exploitation of intangible property rights

The taxation of income attributable to intangible property is a particularly difficult area for policymakers. A number of studies show that the location of intangible property—and the income derived from their exploitation—is highly sensitive to tax rates.[181] Some economists have found that income derived from intangible property accounts for a significant share of the

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[177] OECD (2013), Interconnected Economies: Benefiting from Global Value Chains, OECD Publishing. http://dx.doi.org/10.1787/9789264189560-en, p14.

[178] See, OECD, Base Erosion and Profit Shifting Project ("BEPS") Action 10: Discussion Draft on the Use of Profit Splits in the context of Global Value Chains;" and OECD BEPS Action 1, Addressing the Tax Challenges of the Digital Economy (September 2014).

[179] See, polling results from surveys conducted by KPMG LLP, as summarized in presentations at the 305h Annual TEI-SJSU High Tech Tax Institute, November 10 & 11, 2014, available at http://www.cob.sjsu.edu/acct&fin/tax-institute/2014_materials/BEPS_11-10-14.pdf, citing Spring 2014 – KPMG LLP, Tax Executives' Views on Tax Transparency and Base Erosion and Profit Shifting Survey, April 2014 and Summer 2014 – CFO Research, Survey of 112 financial executives in Aug.-Sept. 2014, sponsored by KPMG LLP, Copyright © 2014 CFO Publishing LLC.

[180] Alex Parker, Profit Shifting**:** *CFOs for Procter & Gamble, Eli Lilly Say Tax Concerns Crucial to Decision-Making,* DTR, Feb. 12, 2015

[181] Matthias Dischinger and Nadine Riedel, "Corporate Taxes and the Location of Intangible Assets Within Multinational Firms," *Journal of Public Economics*, vol. 95, no. 7-8, August 2011, pp. 691-707.

income shifted from high-tax to low-tax jurisdictions by U.S. corporations.[182] One study reports that income shifting, driven in large part by locating the ownership of intangible property in low-tax jurisdictions, can generate significant reductions in U.S. tax revenue.[183]

A U.S. person may transfer intangible property to a related person (typically, a foreign affiliate) in one of four ways: an outright transfer of all substantial rights in the intangible property, either by sale or through a non-recognition transaction (for example, a tax-free capital contribution of the intangible property to a corporate affiliate,[184] or an exchange made pursuant to a plan of reorganization that is entitled to nonrecognition treatment with respect to any built in gain,[185]); provision of services using the intangible property; a license of the intangible property, in which the U.S. person transfers less than all substantial rights in the intangible property to the foreign affiliate;[186] and qualified cost-sharing arrangements.

All licenses or sales of intangible property, and provision of a service that uses intangible property, are generally required to meet the arm's length standard under the transfer-pricing rules. A cost sharing arrangement is a particular form of intercompany cross-border transfer and sharing of intangible property rights that is defined and governed by the transfer pricing regulations.[187] Such an arrangement allows related parties to share costs and risks of developing intangibles in proportion to their reasonably anticipated benefits. They are not recognized as separate entities for purposes of the Code, nor are they governed by the rules applicable to partnerships between unrelated parties.[188]

Under the terms of a cost-sharing arrangement, a U.S. owner of existing intangible property rights agrees to make the rights available to a foreign affiliate in return for other resources and funds to be applied in the joint development of a new marketable product or service. Specified rights to existing intangible property can be transferred to other cost-sharing participants either through a sale or a license. In return, the U.S. owner receives a payment from the other cost-sharing participants for the initial contribution to the cost sharing agreement of any resource, capability or rights that provide the platform for the intangible development. In addition to the compensation for its initial contribution, the U.S. owner receives compensation

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182 Harry Grubert, "Intangible Income, Intercompany Transactions, Income Shifting, and the Choice of Location," *National Tax Journal*, vol. 56, no. 1, March 2003, pp. 221-242.

183 Kimberly Clausing, "Multinational Firm Tax Avoidance and Tax Policy," *National Tax Journal*, vol. 62, no. 4, December 2009, pp. 703-725.

184 Sec. 351.

185 Sec. 361.

186 The significance of the retained residual rights depends, in part, on the length of the license term as well as any restriction (express or implied by the taxpayer's conduct) on any potential competing use of the retained rights in the area of use belonging to the licensee.

187 Treas. Reg. sec. 1.482-7.

188 Treas. Reg. sec. 301.7701-1(c).

for a portion of the costs of research and development that it performs on a contractual basis for the cost sharing arrangement.[189] As a result of the arrangement, the foreign affiliate owns some or all of the rights to the new technology developed under the arrangement, from the outset. These rights typically include the right to develop such technology further. The foreign affiliate may have been formed specifically for its role in the arrangement, and received the funding necessary to satisfy its financial obligations under the arrangement from the U.S. parent. Such arrangements were widely used throughout the late 1990's and earlier this century to achieve the off-shoring of intangible property rights.

If a transfer of intangible property to a foreign affiliate occurs in connection with certain corporate transactions, nonrecognition rules that may otherwise apply are suspended. The transferor of intangible property must recognize imputed income as though he had sold the intangible (regardless of the stage of development of the intangible property) in exchange for payments contingent on the use, productivity or disposition of the transferred property in amounts that would have been received either annually over the useful life of the property or upon disposition of the property after the transfer.[190] The appropriate amounts of those imputed payments are determined using transfer-pricing principles, with the exception of transfers of intangibles specifically exempted by regulation, such as transfers of foreign goodwill or going concern value.[191]

3. Subpart F rules and disregarded entities.

Taxpayers are able to defer U.S. Federal income tax on a substantial percentage of their foreign earnings by effectively managing their exposure to the antideferral rules. Income earned by a domestic parent corporation from foreign operations conducted by foreign corporate subsidiaries generally is subject to U.S. tax only when the income is distributed as a dividend to the domestic parent corporation. Until that repatriation, the U.S. tax on the income generally is deferred, unless the income is within certain categories of passive or highly mobile income earned by foreign corporate subsidiaries, regardless of whether the income has been distributed as a dividend to the domestic parent corporation under the controlled foreign corporation ("CFC") rules of subpart F[192] and the passive foreign investment company rules.[193] As the discussion of the lockout effect in section III.B. demonstrates, the application of subpart F rules

[189] Treas. Reg. secs. 1.482-7(c)(1) and 1.482-7(b)(1)(ii). The payment for this contribution may offset the benefit of expense deductions for research and development previously performed in the United States; amounts received in excess of previously deducted research and development expenses incurred should represent the present value of the intangible property transferred, discounted for the risk assumed by the transferee. The ongoing cost-sharing payments offset deductions that the recipient of such payment takes for post-buy-in research and development activities. Such ongoing cost-sharing does not, however, include compensation for the return on any products that may result from that research and development.

[190] Sec. 367(d).

[191] Temp. Treas. Reg. sec. 1.367(d)-1T(b).

[192] Secs. 951-964.

[193] Secs. 1291-1298.

may distort decisions about whether to distribute foreign earnings and incur the residual U.S. tax on the previously deferred earnings. The initial deferral of the earnings can be achieved by use of the principal structure in conjunction with statutory or regulatory exceptions to avoid current taxation of foreign earnings, *i.e.*, by avoiding characterization of earnings as subpart F income. An example of a statutory exception is the look-through treatment for dividends between controlled foreign corporations, while contract manufacturing rules are an example of a regulatory exception. Additionally, transactions can be structured to result in royalties and other payments from higher-tax jurisdictions to entities in lower-tax jurisdictions.[194]

Taxation of income earned from foreign operations may depend upon the classification of the foreign entity conducting the foreign operations. The existence of hybrid and reverse hybrid entities[195] can affect whether income is currently includible under subpart F. In addition to selecting a jurisdiction in which to locate a foreign principal based on a favorable tax rate, the extent to which a company would locate employees and business operations in that country are also considered. If the desired tax rate is not available in a jurisdiction in which activities can be realistically located, the principal may nevertheless be able to have activities in other locations attributed to it by use of a hybrid entity organized immediately below the principal. Its fiscal transparency to the United States results in attribution of its activities and all related profits to the principal. Cross-border payments between disregarded entities may also be disregarded, thus avoiding foreign personal holding company income.[196]

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[194] See discussion below, in section III.D., describing how taxpayers may manage payment flows to ensure that deductions are taken in high-tax jurisdictions, with the income inclusion in a lower-tax jurisdiction.

[195] A hybrid entity is disregarded for U.S. tax purposes but is respected in its country of origin. Conversely, a reverse hybrid is fiscally transparent to its home jurisdiction but is recognized by the U.S tax authorities.

[196] For examples of the flexibility with which a multinational corporation may determine whether it recognizes subpart F income under the antideferral rules, see the discussion of "Managing Subpart F Exposure" in the case studies of Bravo, Echo, Delta and Foxtrot corporations, at pages 122 through 127, in Joint Committee on Taxation, Present Law and Background Related to Possible Income Shifting and Transfer Pricing (JCX-37-10), July 20, 2010. In particular, see Figures 8 and 13, at pages 63 and 71, respectively, and accompanying discussion of Bravo Company. For an example of the ability to use the asymmetry of foreign and U.S. law on corporate residency, see U.S. Senate Permanent Subcommittee on Investigations, "Memorandum: Offshore Profit Shifting and the U.S. Tax Code - Part 2 (Apple Inc.)," May 21, 2013, available at http://www.hsgac.senate.gov/download/?id=CDE3652B-DA4E-4EE1-B841-AEAD48177DC4.

D. Locating Deductions in the United States

Introduction

Deductions are one of the central elements in the determination of federal income tax liability, among other elements such as gross income and tax rates, and have been a fundamental part of the U.S. income tax system since its enactment in 1913.[197] Moreover, although later superseded and never effective, the concept of allowing deductions to reduce gross income in the income tax liability computation has its beginnings with the first Civil War Income Tax Act of 1861.[198] Conceptually, deductions are tied to a decrease in the taxpayer's wealth and should be taken into account in determining the income tax base. Generally, ordinary and necessary expenses paid or incurred during the taxable year in carrying on a trade or business are deductible,[199] with exceptions for certain allowances or disallowances provided by the Code.[200]

Deductions related to cross-border activity

Certain features of the U.S. tax system provide incentives to multinational enterprises to maximize tax deductions by U.S. affiliates as a trade off for higher income earned, or lower deductions incurred, by their foreign affiliates. First, the U.S. has the highest combined statutory corporate income tax rate in the OECD.[201] As such, a tax deduction in the U.S. is generally more valuable than a tax deduction in other OECD jurisdictions. Second, the worldwide system of taxation coupled with deferral of eligible income from current U.S. taxation provides additional incentive to locate deductions in the United States.

U.S.-parented multinational groups

In the context of U.S.-parented groups, present law provides detailed rules for the allocation of deductible expenses between U.S.-source income and foreign-source income. These rules do not, however, affect the timing of the expense deduction. Rather, in the case of expenses incurred by a domestic corporation, they apply principally for purposes of determining the foreign tax credit limitation, which is computed by reference to the corporation's U.S. tax

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[197] Act of October 3, 1913, c. 16, Pub. L. No. 16, 63rd Cong., 1st Sess.

[198] Even though the bill expressly allowed deductions only of taxes assessed on the property generating the income, the Presiding Officer, in response to a concern expressed on the floor of the Senate that the bill might be interpreted as levying tax on gross rather than net income, replied that "…nobody can mistake the word income…it is the net profits…for the year, and the Secretary of the Treasury will provide all the ways and means to ascertain it." Cong. Globe, 37th Cong., 1st Sess. Page 315 (1861).

[199] Sec. 162.

[200] See, for example, allowance for depreciation and partial disallowance for meals and entertainment, under secs. 167 and 274, respectively.

[201] Combined statutory corporate income tax rate reflect taxes levied by U.S. State and local jurisdictions.

liability on its taxable foreign-source income in each of two limitation categories.[202] Consequently, those rules primarily affect taxpayers that claim the foreign tax credit, and among that group, only those that may not be able to fully utilize their foreign tax credits because of this limitation. A domestic corporation may claim a current deduction, even for expenses that it incurs to produce tax-deferred income through a foreign subsidiary. The resulting mismatch between the timing of income recognition and the deductibility of expenses may provide incentive to taxpayers to make tax-deferred investments offshore.[203]

For example, a U.S. corporation may deduct the interest expense[204] incurred on borrowings made for purposes of funding its operations. Because money is fungible, it is very difficult, if not impossible, to determine whether the borrowed funds were in fact used for the stated purpose of any particular borrowing. For the same reason, a U.S. multinational can choose to locate its borrowing in the country where the interest expense deduction will produce the highest tax benefit, *i.e.*, the country with the highest tax rate and the fewest restrictions on deductibility. The fact that a U.S.-based multinational can claim a current U.S. tax deduction for borrowing to invest in low-taxed countries increases the after-tax return of those investments and may encourage some investments that would not otherwise be made. In this respect, the current U.S. tax system can be viewed as subsidizing overseas growth and investment by U.S.-parented groups.

Similarly, the Code allows a U.S. taxpayer a deduction or credit for expenditures in relation to research and experimentation activities.[205] A U.S. corporation may undertake research and experimentation activities in the U.S. and claim associated deductions and credits against its U.S gross income. However, once the research activities yield the discovery of innovative techniques, processes, or formulas, the U.S. corporation may undertake a transfer of the resulting intellectual property to a foreign affiliate through a variety of techniques as discussed above in Section III.C.3. Following transfer of the IP, the profits may accumulate in a low tax environment offshore in a manner in which it is shielded from current U.S. taxation. This provides a clear example of the distortions that may be created by the U.S. tax regime, which features a high statutory tax rate coupled with deferral from taxation of certain income earned offshore. While generous with the claiming of deductions and credits, despite a portion being potentially designated as foreign-sourced, the associated income may be deferred from U.S. taxation despite the potential for it to be directly or indirectly derived from U.S. sources. On the other hand, the current treatment of research and experimentation expenses, and the

[202] Secs. 901 and 904. This limit is intended to ensure that the credit serves its purpose of mitigating double taxation of foreign-source income without offsetting U.S. tax on U.S.-source income.

[203] There have been several proposals in recent years for tax reform with respect to deductibility of foreign related expenses by U.S.-parented multinational groups. While the scope as to application to specific expense categories of the various proposals has differed, the underlying policy was to defer deductions for expenses of a U.S. person that are properly allocated and apportioned to foreign-source income to the extent the foreign-source income associated with the expenses is not currently subject to U.S. tax.

[204] Sec. 163.

[205] Secs. 41 and 174.

associated income from these activities, encourages the performance of research and experimentation activities in the United States. That is, the current policy may implicitly encourage the practice of shifting income attributable to valuable intangible assets from the United States without adequate compensation in the form of royalties or other payments, which boosts the potential for profitable returns on investment and therefore encourages additional research activities in the United States.

Foreign-parented multinational groups

A U.S. corporation with a foreign parent may reduce the U.S. tax on the income derived from its U.S. operations through the payment of deductible amounts such as interest, royalties, management or service fees, rents, and reinsurance premiums to the foreign parent or other foreign affiliates that are not subject to U.S. tax on the receipt of such payments.[206] Taking excessive tax deductions in this manner, when motivated by U.S.-income tax avoidance, is known as "earnings stripping." Although foreign corporations generally are subject to a gross-basis U.S. tax at a flat 30-percent rate on the receipt of such payments if they are from sources within the United States, this tax is commonly reduced or eliminated under an applicable income tax treaty.

In general, earnings stripping provides a net tax benefit only to the extent that the foreign recipient of the income is subject to a lower amount of foreign tax on such income than the net value of the U.S. tax deduction applicable to the payment, *i.e.*, the amount of U.S. deduction times the applicable U.S. tax rate, less the U.S. withholding tax levied at a percentage as provided under the relevant income tax treaty. That may be the case if the country of the income recipient provides a low general corporate tax rate or reduced taxes with respect to financing or other arrangements.

The generation of excessive interest deductions arguably is the most available form of earnings stripping.[207] However, as mentioned above in Section II.B.3, present law limits the ability of foreign corporations to reduce U.S. tax on income derived from their U.S. subsidiaries' operations through earnings stripping interest payments.[208]

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[206] It is also possible for U.S.-controlled corporations to reduce their U.S. taxable income by making excessive deductible payments to foreign corporations that they control. In general, however, this type of tax planning is greatly limited by the anti-deferral rules of subpart F.

[207] U.S. Department of the Treasury, *Report to the Congress on Earnings Stripping, Transfer Pricing and U.S. Income Tax Treaties*, p. 7. Although payments of other deductible amounts by a U.S. corporation to tax-exempt or partially exempt related parties also provide an opportunity to shift income out of a U.S. corporation, the use of related-party debt arguably is the most readily available method of shifting income out of U.S. corporation. *Id*.

[208] Tax reform proposals intended to curtail the tax benefits of earnings stripping by foreign-parented U.S. corporations have been proposed in different varieties, largely directed at interest payments. Those proposals generally involved the tightening of the objective criteria in relation to determining whether interest expense is excessive under present law. There have been proposals to: (1) eliminate the debt-to-equity safe harbor ratio of 1.5 to 1; (2) reduce the modified taxable income threshold limit of 50 percent to a lower level; (3) shorten the carryforward period for disqualified interest; and/or (4) eliminate the ability to carryforward of excess limitation.

Like any business, a foreign corporation has the option of financing its U.S. subsidiaries through equity or some combination of debt and equity. There are certain advantages to utilizing some degree of debt financing. For example, debt financing may allow a business to raise funds at a lower cost, where the return to debt investors may be lower because such investment is less risky than an equity investment in the same business, and without surrendering ownership. Depending on the differences between the U.S. tax rate and the rate of tax imposed on the recipient of the interest by the applicable foreign country, the use of substantial debt financing facilitates a lower effective rate of U.S. tax on the U.S. operations, thereby lowering the foreign parent corporation's overall tax rate on its worldwide operations. Debt may also be a tax-advantaged source of financing because debt principal may be repaid on a tax-free basis, while redemption of equity held by a foreign parent is generally treated as a dividend distribution to the extent of the corporation's earnings and profits.[209]

As mentioned, the potential for earnings stripping is also associated with transactions involving the payment of other deductible amounts such as royalties, management or service fees, rents, reinsurance premiums and similar types of payments to related foreign entities. For example, the U.S. corporation may enter into a licensing or distribution agreement with its foreign parent with respect to exploitation of intellectual property in the U.S. market in exchange for fixed or variable royalty payments from the U.S. corporation. The royalty payments have the effect of eroding the U.S. tax base, particularly when the payments are excessive in relation to the benefit derived. Alternatively, the U.S. corporation may transfer performance or other risks to a foreign parent or affiliate in exchange for service or similar fees, leaving a small profit margin in the U.S. reflecting the local market distribution activities. Indeed, as opportunities for stripping earnings based on interest payments are exhausted, taxpayers may increasingly find it attractive to strip earnings through other means. Although the generation of earnings stripping payments other than interest, such as royalties, may require a real movement of tangible or intangible assets or a change in business operations of the corporation, firms may engage in this tax planning to improve the after-tax return on investment.

In contrast to arguments regarding the negative impact of earnings stripping on the U.S. tax base, there may be some economic benefit to sanctioning its practice. A Treasury Department report suggests that income shifting may support increased investment in high-tax jurisdictions (such as the United States) by lowering the effective tax rate with respect to such investments.[210] In fact, the question of whether the ability of U.S. businesses to pay interest to

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Some proposals have been directed at groups that include expatriated entities, as defined within the bill, and some would have applied to all foreign-parented U.S. groups. For example, refer to the President's proposals for fiscal years 2005-2014, which contained variations of proposals to modify application of the limitations under sec. 163(j).

[209] See secs. 301 and 302(d). If certain narrow exceptions are met, the distribution may be treated as a distribution in exchange for the stock. See sec. 302(b).

[210] U.S. Department of the Treasury, *Report to the Congress on Earnings Stripping, Transfer Pricing and U.S. Income Tax Treaties,* p. 24. Existing empirical research does not address this question. *Id.* The linkage between foreign investment and labor compensation requires that a number of things be held constant–for example, that any potential loss of revenue associated with income shifting not also "crowd out" investment in the United States by either domestic or foreign investors.

related foreign debt-holders should be further abated may be part of a larger policy discussion that balances revenue requirements and other economic objectives. It is difficult to determine the optimal rate of U.S. tax on foreign-controlled domestic corporations (or conversely, the appropriate level of leverage) that would maximize the overall economic benefit to the United States. Nevertheless, one way to encourage increased investment in the United States (by foreign or domestic investors) is to increase the after-tax return to investment, and that outcome is more efficiently achieved by, for example, lowering the U.S. corporate income tax rate than by narrow policies such as the facilitation of earnings stripping.

Empirical studies

Although few academic studies have analyzed the effect of tax rates on the location of deductible expenses directly, a number of papers have looked at the relationship between a country's statutory corporate income tax rate and the leverage ratios of companies operating in that country, thereby providing indirect evidence of how multinational corporations interest expenses in response to tax rates. The studies generally find that the tax incentive to use internal debt to finance a foreign subsidiary's operations increases as the tax rate in that foreign country increases, as does the incentive to issue external foreign debt in that country.[211] One paper finds that higher tax rates in a particular country lead to higher leverage ratios for U.S. affiliates operating in that country.[212] Another study, focusing on European multinationals from 1994 through 2003, also finds that multinational corporations respond to increases in tax rates in a particular country by increasing their leverage in that country, which the authors interpret as evidence of international debt shifting.[213]

The effectiveness of present law in limiting earnings stripping was the subject of a 2007 Treasury Department report, which used 2004 tax return data to compare certain financial characteristics of foreign-controlled domestic corporations with domestic corporations.[214] The report concluded that there was strong evidence that inverted corporations were stripping earnings out of U.S. operations, and, consequently, that Code section 163(j) was ineffective at preventing earnings stripping by such corporations. The results for other foreign-controlled domestic corporations were not conclusive. The report found that foreign-controlled domestic corporations were generally less profitable (as measured by the ratio of net income to total receipts) than their domestically controlled counterparts, which may suggest that foreign-

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[211] See John Graham, "Do Taxes Affect Corporation Decisions? A Review," in G.M. Constantinides, Milton Harris, and Rene M. Stulz (eds.), *Handbook of the Economics of Finance*, vol. 2A, North-Holland Publishing Co., 2013, pp. 123-210.

[212] See Mihir Desai, C. Fritz Foley, and James R. Hines, Jr., "A Multinational Perspective on Capital Structure Choice and Internal Capital Markets," *The Journal of Finance*, vol. 59, no. 6, pp. 2451-2487.

[213] See Harry Huizinga, Luc Laeven, and Gaeten Nicodeme, "Capital Structure and International Debt Shifting," *Journal of Financial Economics*, vol. 88, no. 1, pp. 80-118.

[214] Department of the Treasury, *Report to the Congress on Earnings Stripping, Transfer Pricing and U.S. Income Tax Treaties*, 2007.

controlled domestic corporations are reducing their taxable income through earnings stripping.[215] However, the report also found that, on average, foreign-controlled domestic corporations in the nonfinancial sector and the manufacturing industry have interest expense relative to cash flow that is virtually the same as comparable domestically controlled corporations, which may suggest that foreign-controlled domestic corporations are not incurring excess interest expense in the United States.[216] Overall, the report did not find conclusive evidence that foreign-controlled domestic corporations are engaged in earnings stripping, and could not determine with precision whether Code section 163(j) is effective in preventing earnings stripping by foreign-controlled domestic corporations.[217]

[215] *Ibid.*, p. 13. These analyses were performed separately for the nonfinancial and financial sectors. In addition, a separate analysis was done for the manufacturing industry, which is a component of the nonfinancial sector.

[216] *Ibid.*, p. 18.

[217] *Ibid.*, pp. 25-26.

E. Inversions

The preceding four sections of this pamphlet have described policy issues related to the U.S. taxation of cross-border business operations. These four sections identify ways in which the U.S. international tax rules, alone and in combination with the international tax rules of other countries, affect cross-border investment and business operations and the location of reported tax profits. Among other effects, the U.S. international tax rules may alter cross-border merger and acquisition activity. For example, if foreign corporations can derive higher after-tax returns from ownership of particular assets than U.S. corporations could derive from ownership of the same assets even though the pre-tax returns to foreign owners would be the same as the pre-tax returns to U.S. owners, the tax rules may create an incentive for foreign corporations to acquire assets from U.S. owners. Policy makers and commentators have devoted much recent attention to a particular variety of tax-motivated cross-border acquisitions colloquially referred to as inversions. This section gives an overview of possible tax motivations for inversions and describes policy concerns related to, and possible responses to, inversions. Tables 3, 4, and 5 of Part IV of this document include data related to cross-border acquisitions generally and inversions in particular.

Tax motivations for inversions

In a typical inversion transaction after the 2004 enactment of the section 7874 anti-inversion rules, described previously, a domestic corporation acquires a smaller foreign corporation, and the parent company of the combined group is a foreign corporation for U.S. tax purposes. In this transaction, the sanctions of section 7874 either do not apply or are sufficiently insignificant that they do not stop the transaction.[218] From 2009 through November 15, 2014, at least 30 companies completed or announced inversion transactions. These transactions are listed in table 5 of Part IV of this document.

Inversions may be motivated by tax considerations. To the extent U.S. tax considerations encourage mergers and acquisitions that create foreign-parented groups, a broad reason for this tax incentive is the disparity between the U.S. taxation of U.S. parented groups and the U.S. taxation of foreign-parented groups.[219] The Code imposes potentially greater taxation on both the foreign earnings and the U.S. earnings of U.S. parented groups than it does on the foreign and U.S. earnings of foreign-parented groups. For foreign earnings of multinational companies, the Code taxes foreign earnings of foreign branches of U.S. parented groups in the year of the earnings; taxes foreign business earnings of foreign subsidiaries of U.S. parent companies when

[218] A domestic parented multinational company might become foreign parented by means of an internal restructuring, rather than by combining with a foreign company, if, as one possibility, the newly foreign-parented company has substantial business activities in its new country of organization, in which case section 7874 does not apply.

[219] For contrasting analyses of tax considerations related to recent inversions, compare Edward D. Kleinbard, "'Competitiveness' Has Nothing to Do With It," *Tax Notes,* September 1, 2014, pp. 1055-69, with Kimberly S. Blanchard, letter to the editor, *Tax Notes,* September 15, 2014, p.1335, and William McBride, letter to the editor, *Tax Notes,* September 1, 2014, p. 1086.

the earnings are repatriated to the United States as dividends; and generally does not tax foreign earnings of foreign-parented groups (unless the foreign earnings are earned by a foreign subsidiary of a U.S. subsidiary of the foreign parent company). Consistent with this structure, the Code creates U.S. taxation when a foreign subsidiary of a U.S. company makes a loan to or an equity investment in a U.S. shareholder, but not when the foreign subsidiary makes a loan to or an equity investment in a foreign affiliate, including a new foreign parent company following a cross-border acquisition.[220] Because many U.S. multinational companies have large amounts of untaxed, unrepatriated earnings in their foreign subsidiaries, they have large potential U.S. tax liabilities if they are considering repatriating those earnings to, or otherwise accessing those earnings in, the United States. If they remain U.S. parented, these multinational companies also face potential U.S. taxation on future foreign earnings. And if a U.S. parented company undertakes a merger with a foreign-parented company and the combined group has a U.S. rather than foreign parent, the foreign earnings of the foreign merger partner are brought into the U.S. taxing jurisdiction.

As for U.S. earnings of multinational companies, multinational companies that are foreign parented may be able to reduce U.S. tax on U.S. earnings more readily than can multinational companies that are U.S. parented. For example, subject to the section 163(j) limitations on the deductibility of interest payments on related-party loans, a foreign parent company or its foreign affiliate may loan funds to a U.S. subsidiary so that the U.S. subsidiary can reduce its U.S. earnings with deductible interest payments on the loan. If, by contrast, a multinational company has a U.S. parent company with foreign subsidiaries, and one of the foreign subsidiaries makes a loan to its U.S. parent, the U.S. parent generally cannot use deductible interest payments to reduce its U.S. earnings because the loan generally is considered an investment in U.S. property and thereby triggers an income inclusion to the U.S. parent company under section 956, and the interest on the loan is subpart F income, includible to the U.S. parent company, when received by the foreign subsidiary. As a business matter, a foreign-parented multinational company may be better positioned than a U.S. parented multinational company to locate functions performed for the multinational group, such as oversight and managerial functions, outside the United States and thereby generate deductible payments for those functions for U.S. members of the group.

<u>Policy concerns and possible policy responses</u>

There are several policy concerns related to cross-border acquisitions generally and to inversions in particular. Different policy goals may be in tension with one another and may therefore argue for different policy responses.

One policy concern is that cross-border acquisitions, specifically inversions, may erode the U.S. tax base. A recent Congressional Budget Office ("CBO") publication provides empirical support for this concern.[221] The CBO has forecast that corporate income tax receipts

[220] Sec. 956. But see Notice 2014-52, 2014 I.R.B. LEXIS 576 (Sept. 22, 2014), described above in footnote 45.

[221] Congressional Budget Office, *The Budget and Economic Outlook: 2015 to 2025*, January 2015, p. 98.

will decline from 2.3 percent of gross domestic product in fiscal year 2016 to 1.8 percent of gross domestic product in fiscal year 2025.[222] According to the CBO, inversions account for part of this decline:

> CBO expects that increasing adoption of such strategies [as aggressive transfer pricing, intercompany loans, and inversions] will result in progressively larger reductions in corporate receipts over the 2015–2025 projection period. By 2025, in CBO's baseline, corporate income tax receipts are roughly 5 percent lower than they would be without that further erosion of the corporate tax base; slightly more than half of that difference is attributable to the shifting of additional income out of the United States.[223]

Protecting the U.S. tax base may be in tension with other possible policy goals related to cross-border mergers and acquisitions. One tax policy goal might be complete neutrality toward cross-border transactions – in other words, that the U.S. tax rules would have no effect on cross-border transactions. Given the complexities of cross-border business activities and the variations among tax systems of countries around the world, achieving full U.S. tax neutrality toward cross-border transactions is likely not realistic.

A related goal is minimizing the extent to which the U.S. tax rules affect cross-border transactions in ways that reduce investment or employment in the United States. In the context of inversions, a question is whether inversions have adverse effects on economic activity in the United States. Inversions might meaningfully reduce U.S. economic activity if the location of a multinational company's tax residence is positively correlated with the location of its capital and labor. On the other hand, cross-border acquisitions involving U.S. companies might have the overall effect of increasing rather than decreasing investment and employment in the United States if new management operates the company more effectively. An article surveying the relevant literature and describing case studies involving recent inversions concludes that the effects of inversions on meaningful economic activity in the initial home country of the inverting company are uncertain and are dependent on the particular circumstances of the relevant companies.[224] Notwithstanding the uncertain evidence related to the economic effects of inversions, some commentators have made the broader argument that policy makers should reduce the U.S. tax burden on cross-border income of U.S.-domiciled companies. Under this argument, reducing the tax burden on foreign profits of U.S.-headed firms will promote portfolio investment in the United States and will encourage U.S.-parented firms to remain U.S. parented

[222] *Ibid.*

[223] *Ibid.*

[224] Omri Marian, "Home-Country Effects of Corporate Inversions," *Washington Law Review*, vol. 90, 2015 (forthcoming).

and start-up firms to organize themselves in the United States, thereby making it more likely that firms will locate headquarters and other activities in the United States.[225]

These varying policy concerns may argue for contrasting responses to inversions. If a goal is to protect the U.S. tax base, a response may be to impose stricter U.S. tax rules related to inversions, either by broadening the scope of transactions to which the sanctions of section 7874 apply or by eliminating tax benefits of inversion transactions.

Imposing stricter rules related to inversions may, however, not further, and may in fact run counter to, the goal of maximizing long-term investment and employment in the United States. On the other hand, there is no clear answer to the question of what sort of tax rules related to cross-border investment and business operations might maximize long-term domestic investment and employment, particularly under the overall residence-based structure of the current U.S. corporate tax. Because capital is mobile across borders (and because laborers also may move) and because some large countries have significantly reduced the tax burden on home-country businesses, one question in this context is the extent to which the United States can collect any corporate tax revenue on foreign business income under the current structure of the U.S. corporate tax if the main policy goal is to maximize domestic investment and employment.

[225] E.g., John M. Samuels, "John Samuels Addresses Inversions and Tax Reform," *Tax Notes,* Feb. 9, 2015, pp. 815-18.

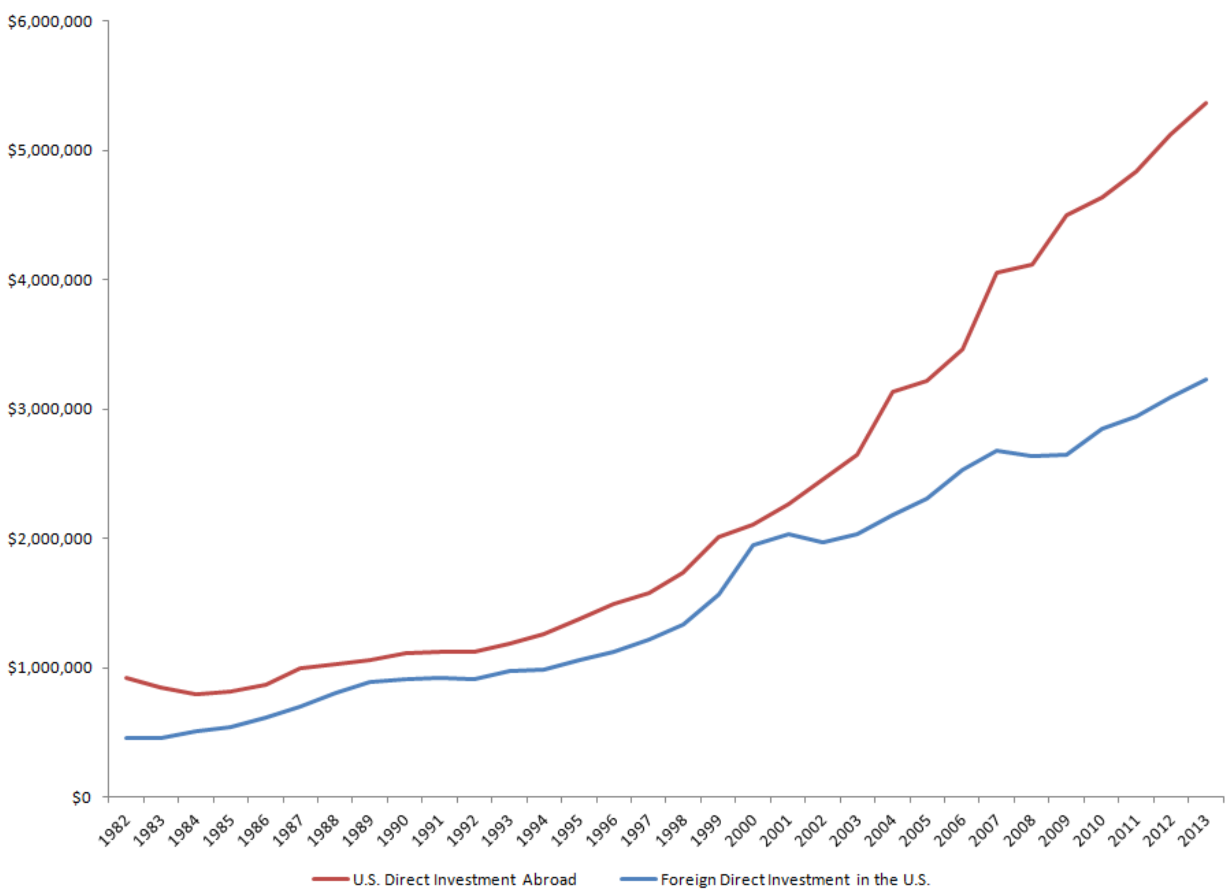
IV. BACKGROUND DATA

This part of the pamphlet provides background data on U.S. cross-border economic activity, income flows, and acquisitions.

Cross-border economic activity and income flows

Figure 2, below, charts the growth in the stock of U.S. direct investment abroad, and foreign direct investment ("FDI") in the United States, from 1982 to 2013. In 2013, the stock of U.S. direct investment abroad totaled $5.3 trillion while the stock of FDI in the United States totaled $3.2 trillion (all valued on a current-cost basis). For context, the value of the stock of private fixed assets in the United States was $38.0 trillion (on a current-cost basis). From 2003 to 2013, the stock of U.S. direct investment abroad grew at a 9.9 percent rate, while the stock of FDI in the United States grew at a 7.3 percent rate.

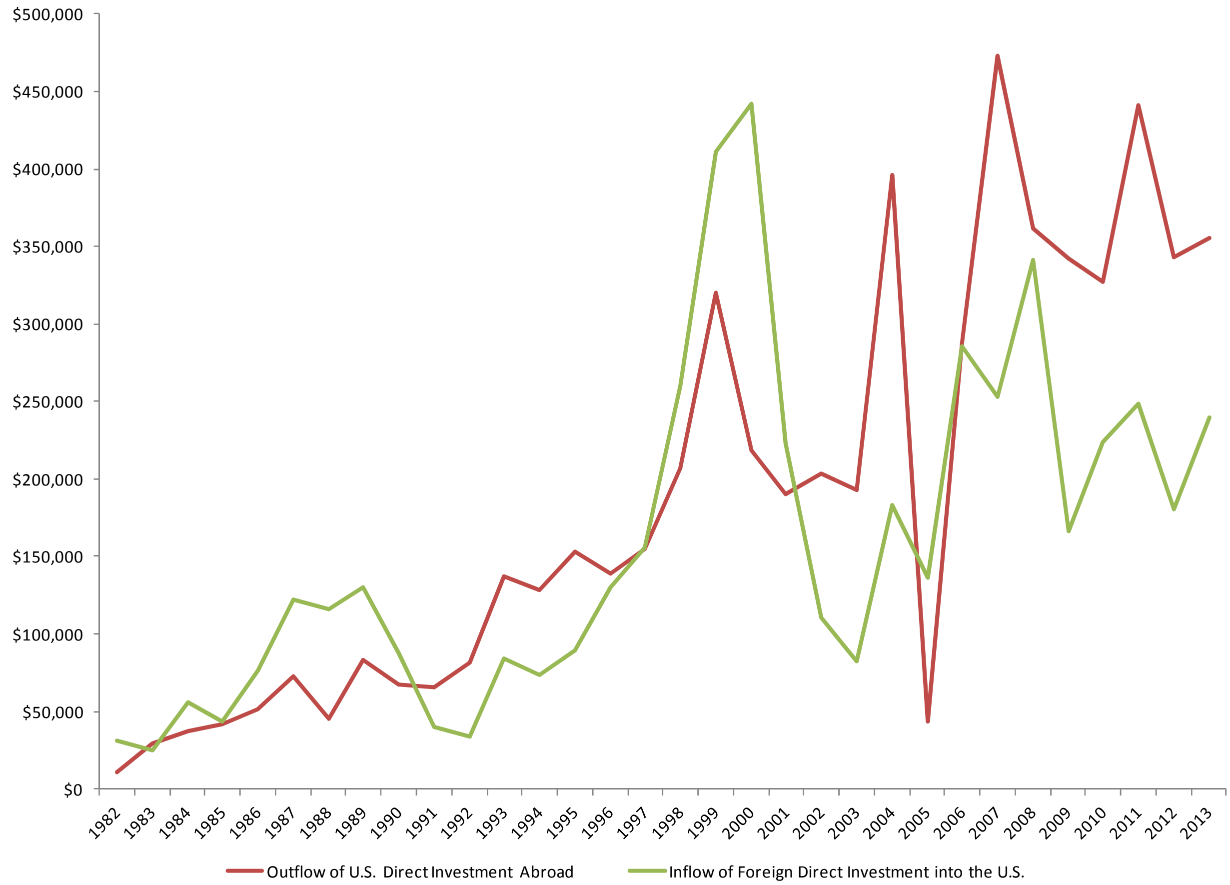
Figure 2.−Stock of Foreign Direct Investment in U.S. and U.S. Direct Investment Abroad, 1982-2013 (on current-cost basis, in millions)



Source: Department of Commerce (Bureau of Economic Analysis).

Figure 3, below, illustrates the outflow of U.S. direct investment abroad, and inflow of foreign direct investment to the United States, from 1982 to 2013. In 2013, the outflow of U.S. direct investment abroad was $355.2 billion, while the inflow of foreign direct investment to the United States was $236.2 billion (all in 2014 dollars).

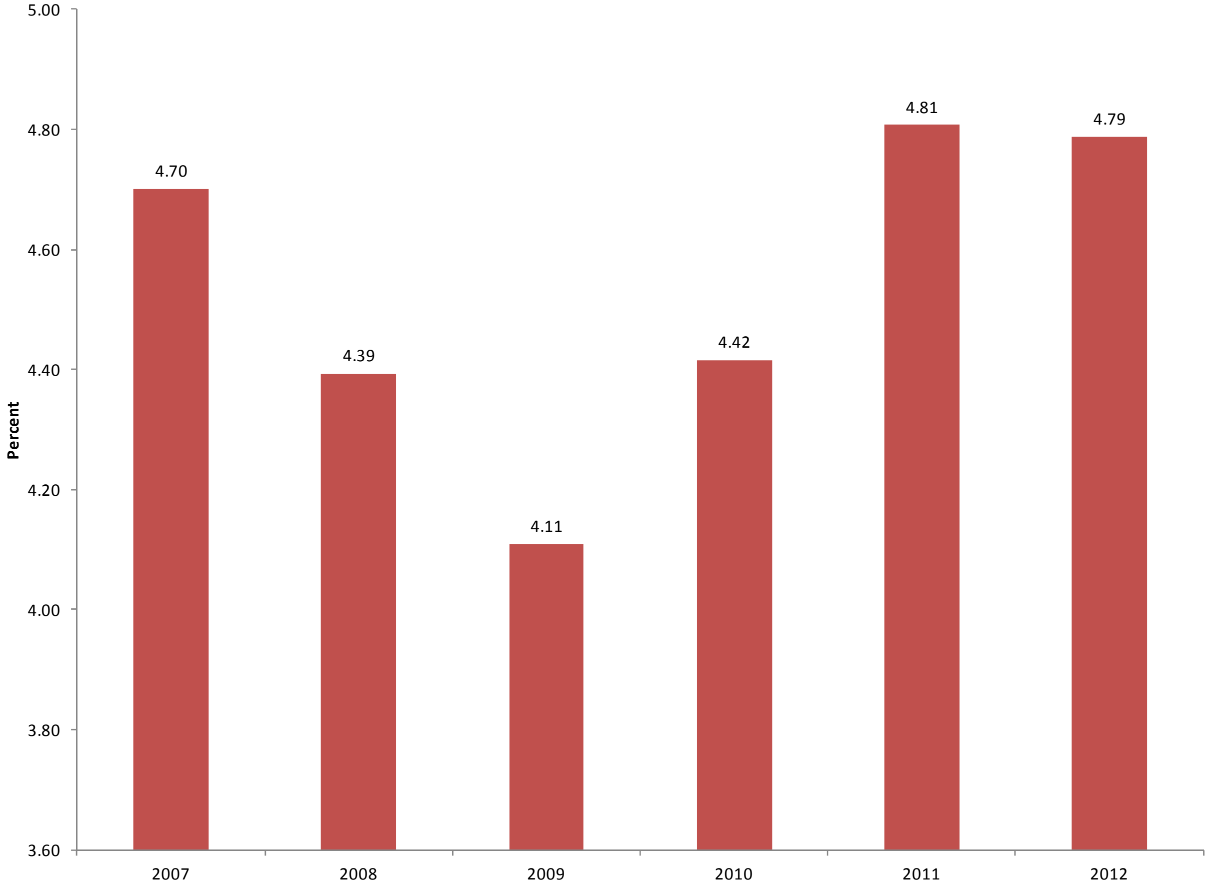
Figure 3.−Direct Investment Flows, 1982-2013
(in millions of 2014 dollars)



Source: Department of Commerce (Bureau of Economic Analysis) and Department of Labor (Bureau of Labor Statistics).

Figure 4, below, shows the contribution to GDP of foreign valued-added by majority-owned U.S. affiliates from 2007 to 2012. In 2012, foreign value-added by majority-owned U.S. affiliates was $773.8 billion (in 2014 dollars) and accounted for 4.79 percent of U.S. GDP.

Figure 4.−Foreign Value-Added by Majority-Owned U.S. Affiliates, as Percentage of GDP, 2007-2012

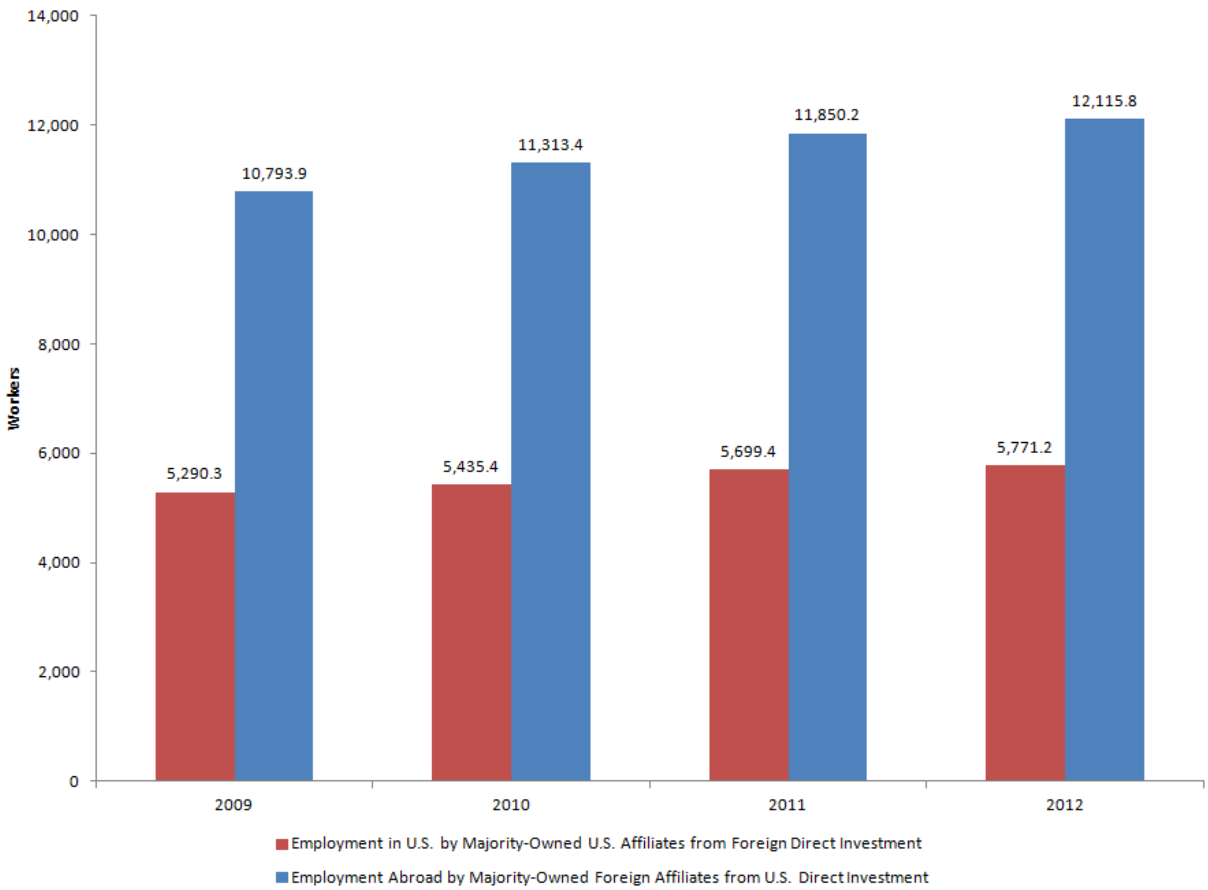


Source: Department of Commerce (Bureau of Economic Analysis).

Figure 5, below, describes the level of employment, in majority-owned affiliates, arising from U.S. direct investment abroad and foreign direct investment in the United States. In 2012, overseas employment by majority-owned foreign affiliates of a U.S. parent was 12.1 million workers, while employment in the United States by majority-owned affiliates of a foreign parent was 5.8 million workers. To put these numbers in context, total private non-farm employment in the United States, as reported by the Bureau of Labor Statistics, was 112.2 million workers in 2012.[226]

[226] The data on employment arising U.S. direct investment abroad and FDI in the United States come from the Bureau of Economic Analysis. Those employment figures are not directly comparable to the employment figures reported by the Bureau of Labor Statistics because the data are collected from different surveys.

Figure 5.−Employment from Foreign Direct Investment in U.S. and U.S. Direct Investment Abroad, Majority-Owned Affiliates, 2009-2012 (in thousands)

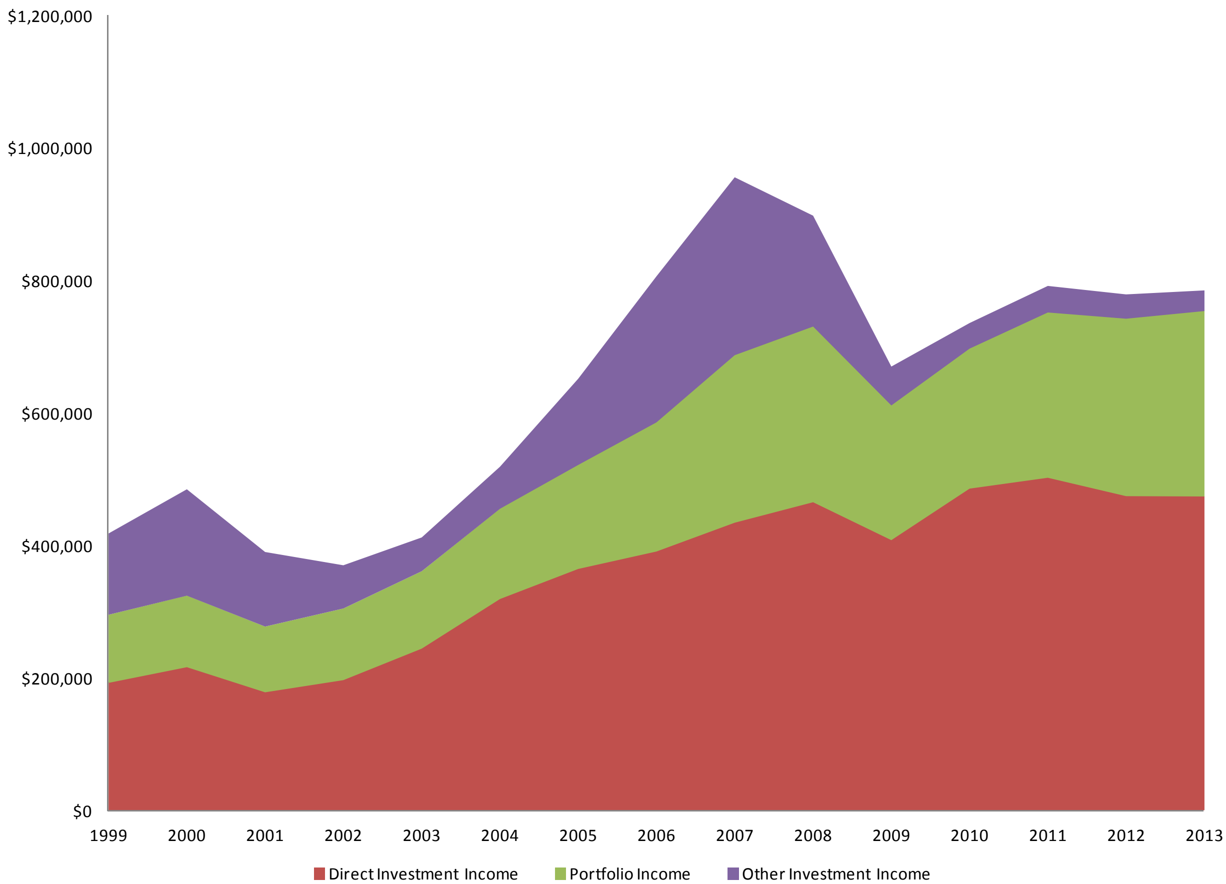


Source: Department of Commerce (Bureau of Economic Analysis).

Figure 6, below, describes the amount of foreign investment income received by U.S. persons from foreign assets, broken down into three categories: direct investment income, portfolio income, and other investment income. In 2013, the total amount of foreign investment income received by U.S. persons was $785.5 billion.[227] Direct investment income was $474.2 billion (60.4 percent of the total), while portfolio income was $280.1 billion (35.7 percent) and other investment income was $31.1 billion (4.0 percent).

[227] Values for the amount of foreign investment income received by U.S. persons are expressed in 2014 dollars. The percentage totals do not sum to 100 percent because of rounding.

Figure 6.−Foreign Investment Income Received by U.S. Persons from Foreign Assets, 1999-2013 (in millions of 2014 dollars)



Source: Department of Commerce (Bureau of Economic Analysis), Department of Labor (Bureau of Labor Statistics), and calculations by the staff of the Joint Committee on Taxation.

Figure 7, below, is similar to Figure 6, but reports the amount of U.S. investment income received by foreign persons from U.S. assets. In 2013, this figure totaled $574.0 billion.[228] Of this total, direct investment income received by foreign persons was $178.7 billion (31.1 percent of the total), while the amount of portfolio income received was $378.7 billion (66.0 percent) and the amount of other investment income received was $16.6 billion (2.9 percent).

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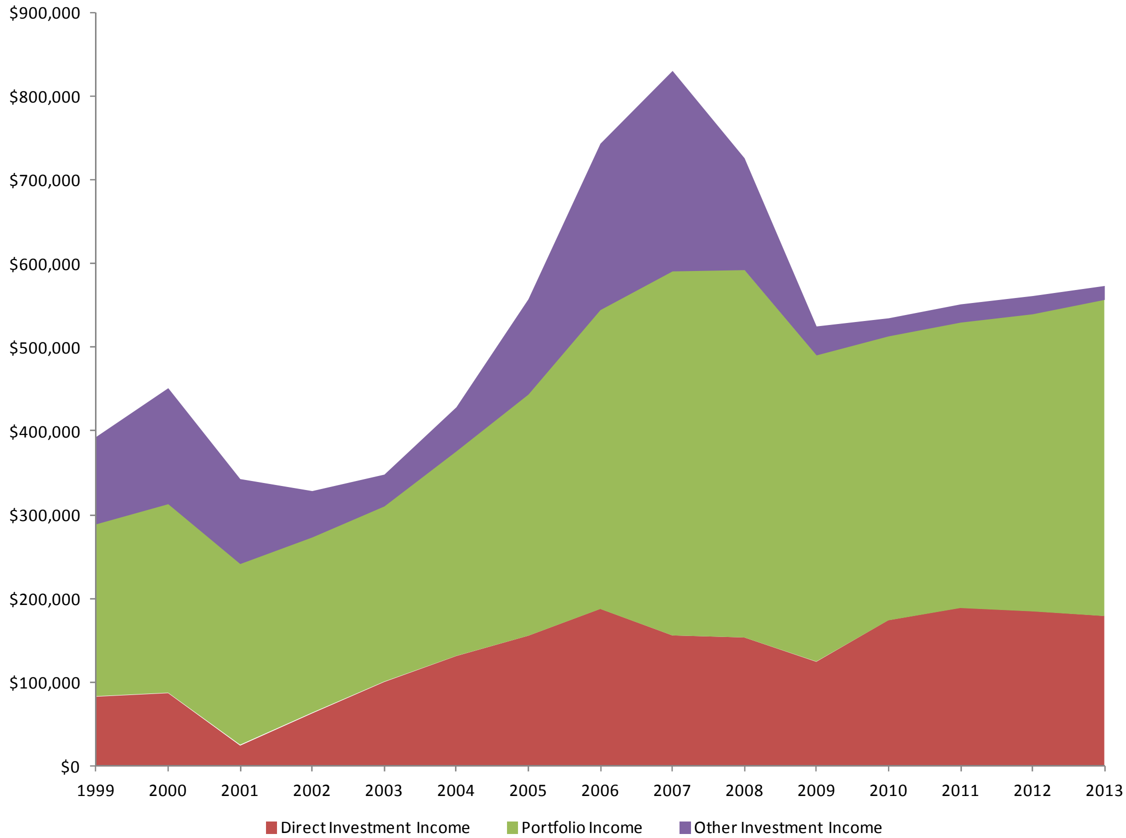
[228] Values for the amount of direct investment income received by U.S. persons are expressed in 2014 dollars.

Figure 7.−U.S. Investment Income Received by Foreign Persons from U.S. Assets, 1999-2013 (in millions of 2014 dollars)



Source: Department of Commerce (Bureau of Economic Analysis), Department of Labor (Bureau of Labor Statistics), and calculations by the staff of the Joint Committee on Taxation.

Figure 8, below, illustrates the share of FDAP and similar income received by foreign persons, as reported on Form 1042-S ("Foreign Person's U.S. Source Income Subject to Withholding"), accounted for by particular items of income for tax year 2012. In 2012, a total of $672.9 billion of FDAP and similar income was reported by foreign persons on Form 1042-S, with 89.9 percent exempt from withholding and 10.1 percent subject to withholding. Interest income accounted for 41.3 percent of the FDAP and similar income received by foreign persons, while dividends and rents and royalties represented 20.1 percent and 7.3 percent, respectively. Other types of income accounted for the remaining 31.3 percent.[229] The amounts of interest,

[229] Other types of income include Social Security and Railroad Retirement payments, personal services income, and notional principal contract income

dividends, and rents and royalties received by foreign persons in 2012 were $278.2 billion, $135.3 billion, and $49 billion, respectively.

Figure 8.−Share of FDAP and Similar Income Received by U.S. Persons by Item of Income, 2005-2012

Source: Internal Revenue Service (Statistics of Income Division), Department of Labor (Bureau of Labor Statistics), and calculations by the staff of the Joint Committee on Taxation.

Cross-border acquisitions

Cross-border acquisitions involving the United States and another OECD country

The Zephyr database, maintained by the Bureau Van Dijk, includes mergers and acquisitions data for a wide range of companies worldwide. Tables 3 and 4, below, provide information on cross-border acquisitions in OECD countries from 2006 to 2014, where a U.S. company was either the target or acquirer of a company based in another OECD country. The data reported below only includes transactions where final acquisition values and ownership stakes are known. As a result, the data is not comprehensive and all figures should be interpreted in light of these sampling restrictions.

Table 3, below, shows the number of acquisitions that occurred during each year of the sample period. For the sample in 2014, 238 companies from an OECD country (besides the United States) were acquired by U.S. companies, while 226 companies in the United States were acquired by a company based in another OECD country. For the sample from 2006 to 2014, there is no clear trend in the number of acquisitions involving companies based in the United States and another OECD country.

Table 3.−Number of Cross-Border Acquisitions Involving U.S. and Another OECD Country, 2006-2014

Year	U.S. Acquirer	U.S. Target
2006	324	311
2007	298	334
2008	243	277
2009	128	130
2010	219	169
2011	242	226
2012	181	175
2013	199	142
2014	238	226

Source: Zephyr Database, Bureau Van Dijk, and calculations by the staff of the Joint Committee on Taxation.

Table 4, below, shows the value of the acquisitions reported in Table 3. In 2014, the value of acquisitions made by a U.S. company of a company based in another OECD country totaled $91.2 billion (in nominal U.S. dollars). The value of acquisitions of a U.S. company by a company based in another OECD country totaled $155.7 billion (in nominal U.S. dollars). As in Table 3, there is no discernible directional trend in the data in Table 4, but the value of acquisitions involving a U.S. target was higher than the value of acquisitions involving a U.S. acquirer in seven out of the nine years in the sample.

Table 4.−Value of Cross-Border Acquisitions Involving U.S. and Another OECD Country, 2006-2014 (nominal dollars, in billions)

Year	U.S. Acquirer	U.S. Target
2006	$83.8	$119.1
2007	$88.9	$181.9
2008	$54.0	$164.5
2009	$24.4	$80.4
2010	$67.1	$59.6
2011	$109.0	$105.3
2012	$55.4	$62.9
2013	$47.5	$74.8
2014	$91.2	$155.7

Source: Zephyr Database, Bureau Van Dijk, and calculations by the staff of the Joint Committee on Taxation.

Inversions

Table 5, below, provides a list of corporate inversions that have been completed, or proposed but not rescinded, from January 1, 2009, to November 15, 2014. The list is based upon a review of public available financial statements and press accounts and may not include all inversions completed or proposed during that time period. Twenty-two inversion transactions in the list were completed, while eight were proposed but not rescinded during the time period. Since the list is derived from different information sources than the sources used to construct Tables 3 and 4, this list is not directly comparable to the transactions described in those tables. Only public companies and companies that have engaged in widely reported transactions are listed, and only in situations where historic shareholders of the former domestic parent company hold more than 50 percent of the shares of the new foreign parent company. The list includes the year of the transaction; the name and country of incorporation of the acquirer and the target; and the name and place of incorporation of the new foreign parent. These inversion transactions may have resulted from business combinations, internal reorganizations, and spin-offs.

Table 5.−List of Corporate Inversions Completed or Proposed, (January 1, 2009 to November 15, 2014)[230]

Year	Acquirer (State of Incorporation)	Target (Country of Incorporation)	Surviving/Resulting Corporation (Country of Incorporation)
2009	ENSCO International Inc. (ENSCO) (Delaware)	None	Ensco plc (England and Wales)
2009	Tim Hortons Inc. (THI) (Delaware)	None	Tim Hortons Inc. (Canada)
2009	Hungarian Telephone and Cable Corp. (HTC) (Delaware)	None	Invatel Holdings A/S (Netherlands)
2009	Alyst Acquisition Corp. (Delaware)	China Networks Media Ltd. (British Virgin Islands)	China Networks International Holdings Ltd. (British Virgin Islands)
2009	2020 ChinaCap Acquirco Inc.; Exceed Co Ltd. (Delaware)	Windrace International Company Ltd. (China)	Exceed Co Ltd. (British Virgin Islands)
2009	Ideation Acquisition Corp. (Delaware)	SearchMedia Holdings Ltd. (Cayman Islands)	Tiger Media Inc. (Cayman Islands)
2009	InterAmerican Acquisition Group Inc. (Delaware)	Sing Kung Ltd. (China)	CNC Development Ltd. (British Virgin Islands)
2010	Plastinum Polymer Technologies Corp. (Delaware)	None	Plastinum Polymer Technologies B.V. (Netherlands)
2011	Alkermes Inc. (Pennsylvania)	Elan Drug Technologies unit of Elan Corporation plc (Ireland)	Alkermes Public Limited Company (Ireland)
2012	Rowan Companies Inc. (Delaware)	None	Rowan Companies plc (England and Wales)
2012	Aon Corp. (Delaware)	None	Aon plc (England and Wales)

[230] Spin-off transactions are denoted with an asterisk. The list is based upon a review of public available financial statements and press accounts and may not include all inversion transactions.

Year	Acquirer (State of Incorporation)	Target (Country of Incorporation)	Surviving/Resulting Corporation (Country of Incorporation)
2012	Tronox Inc. (Delaware)	Exxaro Resources Limited’s mineral sands operations (EMS)	Tronox Limite(Australia)
2012	Jazz Pharmaceuticals, Inc. (Jazz) (Delaware)	Azur Pharma plc(Ireland)	Jazz Pharmaceuticals plc (Ireland)
2012	Eaton Corp. (ETN) (Ohio)	Cooper Industries plc (CBE) (Ireland)	Eaton Corp plc (Ireland)
2012	Stratasys, Inc. (SSYS) (Delaware)	Objet Ltd. (Israel)	Stratasys Ltd. (Israel)
2013	Actavis, Inc. (ACT) (Nevada)	Warner Chilcott plc (WCRX) (Ireland)	Actavis plc (Ireland)
2013	Perrigo Company (Michigan)	Elan Corp plc (ELN) (Ireland)	Perrigo Company plc (Ireland)
2013	Tower Group, Inc. (TWGP) (Delaware)	Canopius Holdings Bermuda Ltd. (Bermuda)	Tower Group International Ltd. (Bermuda)
2013	Liberty Global, Inc. (LBTYA) (Delaware)	Virgin Media Inc. (VMED) (Delaware)	Liberty Global plc (England and Wales)
2014	Endo Health Solutions Inc. (ENDP) (Delaware)	Paladin Labs Inc. (Canada)	Endo International plc (ENDP) (Ireland)
2014*	Theravance, Inc. (TBPH) (Delaware)	None	Theravance Biopharma, Inc. (TBPH) (Cayman Islands)
2014	Horizon Pharma Inc. (HZNP) (Delaware)	Vidara Therapeutics International Ltd. (Videra) (Ireland)	Horizon Pharma plc (Ireland)
Prospective	C&J Energy Services Inc. (CJES) (Delaware)	Nabors Industries Ltd. (NBR) (Bermuda)	C&J Energy Services, Ltd. (Bermuda)
Prospective	Applied Materials Inc. (AMAT) (Delaware)	Tokyo Electron Ltd. (TYO) (Japan)	Eteris (Netherlands)
Prospective	Burger King Worldwide Inc. (BKW) (Delaware)	Tim Hortons Inc. (THI) (Canada)	(Canada)
Prospective	Mylan Inc. (MYL) (Pennsylvania)	Generic drug unit of Abbott Laboratories (ABT) (Illinois)	(Netherlands)

Year	Acquirer (State of Incorporation)	Target (Country of Incorporation)	Surviving/Resulting Corporation (Country of Incorporation)
Prospective	Medtronic Inc. (MDT) (Minnesota)	Covidien plc (COV) (Ireland)	(Ireland)
Prospective	Steris Corporation (Ohio)	Synergy Health plc (UK)	(United Kingdom)
Prospective	Civeo Corp. (Delaware)	None	(Canada)
Prospective	Wright Medical Group Inc. (Delaware)	Tornier N.V. (Netherlands)	(Netherlands)