Deferral: Consider Ending It Instead of Expanding It

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In Notice 98-35, the U.S. Treasury Department asked for comments on the continued viability of the policy objectives underlying subpart F. A number of commentators have responded, including the National Foreign Trade Council, Inc., which has published a comprehensive study (the NFTC study) of the "deferral privilege." Subsequently, the House Ways and Means Committee and the Senate Finance Committee held hearings on the impact of U.S. tax rules on international competitiveness and on international tax reform, respectively, both of which focused in part on the deferral privilege and the proper scope of subpart F. Last summer, both houses of Congress approved a tax bill that would have reduced the scope of subpart F by adding additional exceptions to its rules, but President Clinton vetoed the bill in September.

The deferral privilege is the feature of U.S. international income tax law that generally allows a U.S. person to conduct business or investment activity abroad through a foreign corporation without paying U.S. tax on the corporation's foreign-source earnings until they are distributed to the U.S. person or the U.S. person sells the foreign corporation's stock. When the foreign country involved is one that imposes only low rates of tax, this privilege allows U.S. taxpayers to defer substantial amounts of U.S. tax at the cost of only a small foreign levy. Hence, the deferral privilege operates as a tax "subsidy" for U.S. persons with corporate operations in low-tax foreign countries. This subsidy provides a major incentive for U.S. persons to conduct business operations in foreign countries that impose...
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little or no tax on the earnings of a resident corporation. This deferral subsidy violates the tax policy principle of capital export neutrality.6

To prevent abuse of the deferral privilege, Congress over the years has enacted a number of so-called “anti-deferral” regimes, which curtail deferral in certain specified circumstances but leave the privilege intact in a large residual area.7 The most important and comprehensive of these antideferral regimes is the controlled foreign corporation provisions found in subpart F of the code.8

Rather than narrowing subpart F’s deferral restrictions, Congress should consider ending the deferral privilege by adopting a passthrough regime.

The recent debate over subpart F has been narrowly framed in terms of the effect of subpart F on the competitiveness of U.S.-parented multinationals. The proponents of reducing the scope of subpart F, however, have not candidly acknowledged the broad nature of the scope of the existing deferral privilege (particularly after the repeal of the excess passive asset rules of former section 956A in 1996 and the elimination of the controlled foreign corporation/passive foreign investment company overlap in 1997) and that the deferral privilege operates as a tax subsidy for foreign operations. More importantly, they have not analyzed whether the operation of the deferral privilege is an efficient subsidy.

We are tax policy commentators, not economists, and claim no special expertise in the economics arena. Nonetheless, we could stipulate the correctness of some of the arguments put forward by proponents of deferral (including the authors of the NFTC study), without being persuaded that they are sufficient to justify the deferral privilege. For example, we agree that the global economy has changed dramatically since 1962 and that foreign investment is beneficial to the U.S. economy. We also strongly favor free and open international trade of goods and services and would disfavor measures (tax or otherwise) specifically designed to reduce international trade. On the other hand, we believe the deferral privilege, like any other tax subsidy, can only be justified by a cost/benefit analysis. In the case of deferral, this would ultimately require a showing that the benefited foreign-source income from operations outside the United States is deserving of a lower effective tax rate than income from equally productive activity in the United States. We do not believe that such a showing has been made.

The proponents of deferral, including the authors of the NFTC study, argue that the deferral privilege is necessary to make U.S. businesses competitive overseas and that subpart F’s modest limitations on deferral of U.S. tax on foreign-source business income should be curtailed so that subpart F’s coverage would be restricted to primarily foreign-source passive income.9 We disagree. We conclude that the proponents of deferral have the burden of proving that the deferral privilege is indeed necessary to overcome tax advantages enjoyed by foreign competitors that actually undermine the competitiveness of U.S. businesses operating abroad, and that this burden of proof has not been, and is unlikely to be, met. In our view, rather than narrowing subpart F’s deferral restrictions, Congress should consider ending the deferral privilege by adopting a passthrough regime that we describe in part VII of this article.

1Under capital export neutrality, a U.S. person should pay the same total (U.S. and foreign) tax on all income, regardless of whether the income is from U.S. or foreign sources. Thus, capital export neutrality is aimed at reducing the influence of tax considerations on the decision whether to locate investments in the United States or in a foreign country. See, e.g., Gustafson, Peroni, and Pugh, supra note 3, at 17; see also David P. Harton, “Notice 98-11 Notwithstanding, What Should Be Done With Subpart F?” Tax Notes, Apr. 20, 1998, p. 388. For the view by one leading commentator that, under certain circumstances, deferral of home country tax on foreign-source income can enhance economic efficiency, see James R. Hines, Jr., “The Case Against Deferral: A Deferential Reconsideration,” 52 Nat’l Tax J. 385 (1999) (arguing that deferral might increase economic efficiency but that, at present, the evidence is inconclusive and that more work needs to be done) [hereinafter Hines, “Deferral: A Deferential Reconsideration”].


3Sections 951-964.

Current U.S. income tax (subject to the allowance of a credit for foreign income tax) is generally paid on income realized from:

- U.S. business or investment activities carried on by an individual, corporation, LLC, or partnership;
- foreign business or investment activities carried on by a foreign branch of a U.S. corporation; and
- foreign business or investment activities carried on by a U.S. individual or by an LLC or partnership composed of U.S. members or partners.

Under the doctrine of Moline Properties, Inc. v. Commissioner, the U.S. income tax law usually regards a foreign corporation, whether or not controlled by U.S. persons, as a foreign taxpayer that is legally distinct from its shareholders. This principle applies to any entity (including an LLC) classified as a foreign corporation for U.S. tax law purposes, whether under the current “check-the-box” entity classification system or under the prior “corporate resemblance” entity classification regulations. Thus, except to the extent that the Internal Revenue Code’s various antideferral regimes provide otherwise, U.S. tax on foreign-source business and investment income earned by a U.S. person through a foreign corporation, even a U.S.-taxpayer-controlled foreign corporation, is generally deferred until (1) the income is repatriated to the United States through corporate distributions or (2) the stock is sold. These antideferral regimes have different trigger points (definition of the entity covered by the antideferral regime, types of income for which deferral is curtailed, and types of U.S. shareholders for whom deferral is curtailed) and different antideferral mechanisms (current income inclusion, characterization of the U.S. shareholder’s gain from sale of stock in the entity as ordinary income, or an interest charge on the deferred U.S. income tax at the time the U.S. shareholder receives a dividend distribution from the foreign corporation or realizes gain from a sale of the corporation’s stock). They also overlap to some considerable extent; thus, a U.S. shareholder’s ownership interest in a foreign corporation may be subject to more than one of these antideferral regimes at the same time.

The code’s antideferral regimes, however, constitute a weak barrier to deferral, particularly regarding active business income. For example, the controlled foreign corporation (CFC) provisions are the most comprehensive of these regimes. When they apply, they impose current U.S. tax on five categories of current CFC income, including both active and passive items, that are collectively referred to as subpart F income. The tax is implemented by treating U.S. persons who own at least 10 percent of the voting power of a CFC’s stock, actually or by statutory attribution, as if each had received a dividend of their pro rata shares of the CFC’s subpart F income for the year. In addition, these same persons are also treated as receiving dividends equal to their pro rata shares of the CFC’s earnings and profits that have not been previously or currently taxed to them as subpart F income and that are invested in certain U.S. assets during the year. Section 960 adds that U.S. persons who are charged with the voting stock of the foreign corporation and is either a U.S. domestic corporation or an individual who elects under section 962 to be taxed as a corporation with respect to the income. Sections 902, 960. The amount of the U.S. shareholder’s actual dividend, income inclusion, or deemed dividend will be “grossed up” (that is, increased) by the amount of the foreign corporation’s foreign taxes deemed paid by the U.S. shareholder. Section 78. The U.S. shareholder will also receive a direct credit for any foreign tax withheld from an actual dividend. Section 901.

The code contains various rules for coordinating the application of these regimes in light of their overlapping scope. See, e.g., sections 551(g), 951(c), (d), (f), 1293(g)(1)(A), 1297(d), (e).


Sections 951(a)(1)(A)(i), 952. Although subpart F income is usually foreign source, see section 952(b), it is theoretically possible for U.S.-source passive income that has been subject to U.S. withholding tax to nevertheless be included in subpart F Income, see sections 952(b), 954(c)(1)(A); Treas. reg. section 1.952-1(b)(2).

Sections 951(a), (b).

Sections 951(b).

Sections 951(a)(1)(A)(i), (a)(2).

Sections 951(a)(1)(A)(i), (a)(2).

receipt of either of these constructive dividends are also entitled to an indirect credit for foreign income tax liabilities allocable thereto, if the U.S. persons actually own at least 10 percent of the CFC’s voting stock and if the U.S. persons are either domestic corporations or individuals who have elected under section 962 to be taxed as domestic corporations.28

The CFC regime, however, applies only if more than 50 percent of the voting power or value of the CFC’s shares29 is owned by U.S. persons who each own at least 10 percent of the voting power of the CFC’s stock.30 Moreover, constructive dividends of subpart F income and amounts invested in U.S. assets are imputed only to those U.S. shareholders who own, actually or by statutory attribution, at least 10 percent of the CFC’s stock voting power.31 This means that the CFC provisions are avoidable to the extent that U.S. persons keep their ownership of a CFC’s stock from exceeding 50 percent of the voting power or value of the outstanding shares, or to the extent that each U.S. shareholder restricts his stock ownership to shares representing less than 10 percent of voting power. Furthermore, subpart F income excludes manufacturing income.32 Thus, a CFC is effectively outside the subpart F constructive dividend provisions to the extent that its income is earned through selling goods of its own manufacture. By carefully observing the stock ownership rules described above33 or by ensuring that a CFC has only manufacturing income and that it avoids investments in U.S. assets, U.S. shareholders of a CFC can, and do, readily avoid current U.S. tax on the CFC’s income.34

Section 1248 is often mentioned as included in the code’s CFC provisions. Generally speaking, section 1248 employs a complex set of rules to convert gain readily avoid current U.S. tax on the CFC’s income.> described above” or by ensuring that a CFC has only earned through selling goods of its own manufacture. By carefully observing the stock ownership rules required for qualification as an FPHC.30 Thus, the FPHC provisions are avoidable to the extent that FPHC’s income “deemed paid” by the U.S. corporate shareholder on account of the deemed dividend. In addition, realization of dividend income under section 1248 on the sale or liquidation of a CFC’s stock often has the advantage of avoiding the FPHC provisions. Nevertheless, it is largely ineffectual as an antideferral device because it does not affect deferral’s time-value-of-money benefit, illustrated below.36

The foreign personal holding company (FPHC) provisions are an additional antideferral regime. They tax U.S. persons who are shareholders of an FPHC as if they had received current pro rata distributions of the company’s undistributed foreign personal holding company income (basically, the corporation’s worldwide taxable income, with certain adjustments) for the year.38 However, a foreign corporation is not an FPHC unless initially 60 percent or more of its annual gross income is comprised of certain types of passive or personal service income.39 This benchmark generally drops to 50 percent for years after the first year of qualification as an FPHC.40 Thus, the FPHC provisions are generally avoided if the foreign corporation has predominantly active business income. Moreover, these provisions require that at some time during the tax year, more than 50 percent of the voting power or value of the foreign corporation’s stock must have been owned, directly or indirectly, by five or fewer individuals who were U.S. citizens or residents.41 This stock ownership requirement provides an easy path to avoidance of the FPHC provisions.

Yet another antideferral regime is found in the foreign investment company provisions.42 If they apply, a U.S. shareholder who disposes of stock must treat any gain as ordinary to the extent of the share-
holder's pro rata share of the foreign corporation's earnings and profits accumulated after 1962. Like section 1248, these provisions are a rather feeble attack on deferral because they only deal with the character of gain and not the time-value-of-money advantage derived from deferral. Furthermore, they require that the foreign corporation be registered under the Investment Company Act of 1940 as either a management company or a unit investment trust, or that it be primarily engaged in the business of investing, reinvesting, or trading in securities or commodities. Corporations predominantly engaged in active commercial operations outside the securities or commodities business are not covered. Furthermore, the foreign investment company provisions are inapplicable unless at least 50 percent of the vote or value of the foreign corporation's stock is owned by U.S. persons. This provides a ready escape from the foreign investment company provisions.

The code's antidefferral regimes constitute a weak barrier to deferral, particularly regarding active business income.

A final antidefferral regime is found in the passive foreign investment company (PFIC) provisions. Generally speaking, this regime attacks deferral through a complex offsetting interest charge mechanism applied at the shareholder level. Its coverage is quite broad in two important respects — its antidefferral mechanism applies to any U.S. person that owns stock in a foreign corporation that meets the definition of a PFIC, no matter how small that shareholder's ownership interest in the corporation, and the definition of a PFIC does not depend on any degree of concentrated ownership by U.S. persons of stock in the corporation. The PFIC regime, however, is inapplicable to foreign corporations predominantly engaged in active business operations because it applies only if a corporation's annual gross income is at least 75 percent passive, or at least 50 percent of the average value (or, in specified circumstances, adjusted basis) of the corporation's assets held during the year produced passive income or were held for the production of passive income. A foreign corporation that meets the definitions of both a CFC and a PFIC, however, is not treated as a PFIC with respect to a U.S. person owning stock in the corporation who meets the definition of a 10 percent-or-more "United States shareholder" in section 951(b), thus eliminating this overlap between the CFC and PFIC regimes. Following the repeal in 1996 of the excess passive asset rules of former section 956A, the PFIC 50 percent passive asset test was the only aggregate limitation on a CFC's ability to accumulate earnings not taxed by the United States. The elimination of the CFC/PFIC overlap has freed CFCs to defer indefinitely U.S. tax on unlimited amounts of low-taxed foreign-source earnings.

As demonstrated by the preceding discussion, the Internal Revenue Code's antidefferral provisions do not reach substantial amounts of low-taxed foreign-source earnings, if for example, the foreign corporation has substantial active business income or its U.S. ownership is below applicable thresholds. In short, the antidefferral regimes are substantially avoidable barriers to achieving deferral of U.S. tax on foreign business income of foreign corporations controlled by U.S. shareholders.

The Incongruity of Elective Deferral

Various proponents of the deferral privilege, including in particular the authors of the NFTC study, describe the general availability of deferral as representing a balance between (1) a concern for the ability of U.S. businesses to compete in foreign markets and (2) protection of the U.S. tax base and, perhaps, the goal of promoting worldwide economic well-being through the principle of capital export neutrality. To be specific, the general availability of deferral for CFC income reduces the effective rate of U.S. tax on foreign-source income. This outcome is said to make U.S. con-
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trolled businesses more competitive in low-tax foreign jurisdictions vis-à-vis foreign-controlled corporations whose home countries either impose no home country tax on income earned outside their borders or permit deferral of home country tax until the income is repatriated from the low-tax jurisdiction.

In the limited circumstances when subpart F or the other deferral regimes strip away the deferral privilege, unprivileged foreign-source income is subject to current U.S. tax as if it had been earned in the United States. Therefore, U.S. taxation becomes a neutral factor in the decision of a U.S. taxpayer to locate the unprivileged income-generating operations in either the United States or abroad — a result that effectuates the principle of capital export neutrality as well as protecting residence-based taxation. Thus, this elective deferral, tempered by antidifferential limitations, is often characterized as balancing international competitiveness objectives against a concern for capital export neutrality.

Arguably, however, the code’s overall structure strikes a different balance regarding the taxation of foreign-source income earned by U.S. persons and the general rule of CFC income deferral represents a dramatic departure from this larger balance. To be specific, since 1913, the code has provided that all U.S. domestic taxpayers, individual and corporate, are taxable on their worldwide income, including their foreign-source earnings. The 1913 language expressed this point by imposing the tax on “gains or profits and income derived from any source whatever.” The current statutory language is “all income from whatever source derived.”

The 1918 credit was limited to the U.S. tax on a domestic taxpayer’s foreign-source income and this limitation, with many additional layers of complexity, persists today.

Of course the countries in which foreign-source income is earned assert a right to impose their own levies. This means that the U.S. tax on foreign-source income of U.S. persons is effectively a second layer of taxation that would, in the absence of mitigation, cause foreign-source income to be much more heavily burdened than domestic-source income. The United States responded to this problem in 1918 by adopting a foreign tax credit, which allows a U.S. person to take a credit against her U.S. income tax liability for qualifying foreign taxes. But if this credit had been allowed, without limitation, in the full amount of a U.S. resident’s foreign tax liability, the U.S. person who earned income in a country with income tax rates greater than U.S. rates could have used the excess of her foreign tax payments over the U.S. tax on her foreign-source income to offset U.S. tax on her domestic-source income. If this were permitted, foreign countries could adopt very high rates of tax and feel secure in the knowledge that the excess tax on Americans would actually be paid out of the U.S. Treasury in the form of foreign U.S. tax on U.S.-source income. To prevent this result, the 1918 credit was limited to the U.S. tax on a domestic taxpayer’s foreign-source income and this limitation, with many additional layers of complexity, persists today.

This U.S. tax structure, consisting of a current levy on domestic taxpayers’ income “from whatever source derived,” but mitigated by a foreign tax credit limited to the U.S. tax on foreign-source income, achieves a balance of multiple competing factors. First, it balances the claim of the United States to a current tax on foreign-source income of its residents against the legitimate taxing claims of the source countries with respect to that income; but in turn, this structure also balances the source country taxing claims against the legitimate U.S. interest in preventing foreign governments from raiding the U.S. Treasury to finance their operations and programs. The general structure that emerges from this balance is that foreign-source income of U.S. persons is subject to current U.S. tax except to the extent that a foreign creditable tax offsets the U.S. tax.

When the U.S. tax structure is understood in these terms, the elective deferral of U.S. tax on a U.S. CFC’s foreign-source income, even when the foreign country imposes little or no tax of its own, stands out as a startling incongruity. Of course, a deferral proponent will point out that this deferral flows naturally from another structural aspect of the code — C corporations are generally regarded as legally distinct from their shareholders and, therefore, as separate taxpayers. When the C corporation is a foreign taxpayer with only foreign income, the restrictions imposed on the definition of a foreign corporation’s gross income by the Internal Revenue Code lead inexorably to the result that no current U.S. tax is payable on the foreign income by the foreign C corporation. The reason is that foreign corporations incur U.S. tax only on income effectively connected with a trade or business conducted within the United States and on certain U.S.-source investment income.

Moreover, no current income tax is payable on the foreign C corporation’s income by its U.S. shareholders because the shareholders and the corporation are legally distinct and the income was earned by the latter. The code’s larger pattern, however, requires U.S. business owners and investors to pay current U.S. tax on their realized income “from whatever source derived” unless the income is earned through a C corporation. But in that case, the realized income “from whatever source derived” is subjected to a current U.S. tax at the corpo-
rate level, except for foreign-source income of a foreign C corporation. Thus, the code’s exception for realized foreign-source income earned by U.S. persons through a controlled foreign C corporation also appears incongruous when viewed in comparison to the general tax treatment of business owners and investors.

Exploring the Substance of the Deferral Privilege

As discussed above, the deferral of U.S. tax on foreign-source income of a foreign corporation controlled by U.S. taxpayers provides an incentive for U.S. taxpayers to carry on business and investments in low-tax countries through CFCs. The following example is one approach to demonstrating the operation of this incentive.

Assume that U.S. Corp., taxed under section 11, on 35 percent, earns $100 of taxable income from branch operations in a foreign country that imposes a 10 percent income tax but no branch profits tax or dividend withholding tax. U.S. Corp. would currently incur a net 25 percent U.S. tax (35 percent U.S. tax minus a section 901 direct foreign tax credit for the 10 percent foreign tax).

But if U.S. Corp. carries on its foreign operations through a wholly owned foreign subsidiary, and if the antideferral provisions are inapplicable, the 25 percent net U.S. tax (35 percent U.S. tax minus a section 902 indirect foreign tax credit) on the subsidiary’s $100 of taxable income is deferred until the subsidiary’s income (grossed up under section 78) is distributed to U.S. Corp. or until U.S. Corp. sells the subsidiary’s stock. During the deferral period, U.S. Corp. has the interest-free use of the $25 of deferred tax and is, therefore, commonly described as the beneficiary of a $25 interest-free loan from the U.S. Treasury. The following table shows two ways of illustrating the value of this benefit.

<table>
<thead>
<tr>
<th>Deferral Period</th>
<th>U.S. Corp.’s Total Avoided Interest Expense on $25</th>
<th>U.S. Corp.’s Year 1 Cost of $25 Deferred Tax</th>
</tr>
</thead>
<tbody>
<tr>
<td>5 years</td>
<td>$15.26</td>
<td>$15.52</td>
</tr>
<tr>
<td>20 years</td>
<td>$143.19</td>
<td>$3.72</td>
</tr>
</tbody>
</table>

Although the preceding interest-free loan analysis is the usual method for illustrating the effect of deferral, it is arguably more accurate to describe deferral as a system by which U.S. shareholders compel the Treasury to invest in their CFCs. This is because the amount the Treasury can lose is not a fixed rate of forgone interest but is, instead, a variable amount that is dependent on the CFC’s business fortunes during the deferral period. Moreover, if things go well during the deferral period, the Treasury can actually have a gain that is analogous to an equity investor’s variable rate of return instead of a lender’s fixed rate of return. To illustrate these points, assume again that U.S. Corp., a 35 percent bracket U.S. taxpayer, is the sole shareholder of a CFC operating in a foreign country that imposes a 10 percent income tax but no dividend withholding tax. The CFC earns $100 of net business profits on the last day of year 1 but does not distribute this amount until the end of year 2. If the CFC were a branch of a domestic corporation, the U.S. Treasury would be entitled to a $25 net tax for year 1 (35 percent U.S. tax minus a section 901 direct credit for the 10 percent

55If a branch profits tax or dividend withholding tax were imposed, it would likely result in a section 901 direct credit as an "in lieu of" tax under section 903. Thus, to simplify this and succeeding examples, we assume that the foreign country does not impose these taxes.

56See Gustafson, Peroni, and Pugh, supra note 3, at 337; Isenbergh, supra note 16, at 1:22; see also Green, supra note 7, at 34 (1993).

The elective deferral of U.S. tax on a U.S. CFC's foreign-source income, even when the foreign country imposes little or no tax of its own, stands out as a startling incongruity.

The Treasury's tax collection, however, is $13.75 instead of the $12.50 (one-half of $25) that one would intuitively expect in view of the fact that one-half of the Treasury's $25 "investment" was lost during year 2. How do we account for the extra $1.25 collected by the Treasury? This is exactly equal to the Treasury's $12.50 year 2 loss multiplied by the 10 percent foreign tax rate. In other words, the Treasury has effectively realized a $1.25 foreign tax saving just as any nongovernmental equity investor would if it deducted a $12.50 investment loss from income otherwise taxable at a 10 percent rate.

Of course, if the CFC doubled its money to $180 during year 2 (a $90 gain), paid a $9 foreign tax on the gain at the end of year 2 and then distributed $171 ($180 - $9) to U.S. Corp., the distribution would be grossed up to $190 ($171 + $10 + $9) and the U.S. Treasury would collect a net 25 percent tax of $47.50 instead of $25; in other words, the Treasury would take a share of the CFC's year 2 profit just like an equity investor. But in this gain scenario, why is the U.S. tax only $47.50 instead of $50? The reason is that when the $25 that was the Treasury's share of the CFC's year 1 retained profits doubled to $50, thus producing a $25 gain for the Treasury, the foreign government took 10 percent ($2.50) of this gain as tax, just as if the Treasury were a nongovernmental investor. This left the Treasury with a net gain of $22.50 that, when added to the Treasury's initial $25 "investment," yielded $47.50 — the amount of the Treasury's year 2 tax collection. As the preceding gain and loss scenarios both illustrate, instead of viewing deferral as providing U.S. shareholders with an interest-free loan, it is arguably better to think of deferral as a means by which U.S. shareholders cause the U.S. Treasury to provide equity capital for their CFCs.

There is also an alternative approach for analyzing deferral that draws on an insight commonly used in analyzing consumption tax regimes. This insight holds that if tax rates remain constant, allowing a deduction for the cost of an investment before taxing all returns thereon (including recovery of basis or principal) is generally equivalent to disallowing a deduction for the investment's cost but then excluding all returns thereon from the tax base. When this insight is applied to CFCs, it reveals that deferral of tax on a CFC's retained income (which is equivalent to allowing a current deduction for the cost of investments made by the CFC out of that income) effectively treats the CFC as if a current U.S. tax were paid on the retained income but the CFC were then allowed a U.S. tax exemption for all returns from investing its after-tax retained income.

To demonstrate this proposition, assume, as above, that U.S. Corp., a 35 percent bracket U.S. taxpayer, has a wholly owned CFC that earns $100 of net income from operations in a foreign country imposing a 10 percent income tax and no dividend withholding tax and that none of the U.S. antideferral provisions apply. All of the CFC's year 1 earnings occur at year-end and are distributed by the CFC to U.S. Corp. at the close of year 2. During the 12-month deferral period, the CFC invests its $90 of retained earnings (after payment of the $10 foreign tax) at a 10 percent per annum pretax rate of return. The investment earns $9 ($90 x 0.10) and at the close of year 2, the CFC pays a $0.90 foreign tax thereon and distributes $98.10 ($90 + $9 - $0.90) to U.S. Corp., the distribution will be grossed up under section 78 (including recovery of basis or principal) whereas the Treasury never had discretionary use of the $11.25 that it lost in the CFC scenario.

The Treasury's $11.25 loss is different from the loss it suffers when a domestic corporation claims a net operating loss carryback deduction. This is because the Treasury has usually had an interest-free discretionary use of the refund generated by the carryback deduction (see section 6611(f)(1), (4)), whereas the Treasury never had discretionary use of the $11.25 that it lost in the CFC scenario.

Of course, in the gain scenario, the Treasury is compensated for the risk that it undertakes. The point, however, is that the variable rate of gain and the loss exposure mean that the Treasury's position is different from an interest-free lender and is like an equity investor.

Flaws in the Operation of the Deferral Privilege

Regardless of which of the preceding analytical approaches is used to describe deferral (an interest-free loan, a device to make the U.S. Treasury a forced equity investor, or a regime for achieving tax-free reinvestment of retained earnings), the deferral privilege is clearly a substantial tax incentive that is not made available for earnings from domestic operations. Moreover, as discussed above, the earnings yield an equity-based instead of a fixed income-based return.

The deferral privilege is clearly a substantial tax incentive that is not made available for earnings from domestic operations.

Thus, if U.S. tax on CFC income is deferred until the income is distributed to U.S. shareholders, the CFC is effectively permitted to receive a return on investments of those earnings during the deferral period that is free of U.S. tax forever. This means that deferral creates an exemption regime for the investment return on a CFC’s retained earnings. It also means that with respect to a CFC’s retained earnings, deferral allows the CFC to function for its U.S. shareholders as if it were a section 103 tax-exempt bond fund. But unlike the section 103 exemption, the effective exemption for the investment return on the CFC’s retained earnings does not inure to the benefit of a U.S. state or local government. Instead, the exemption is captured by the CFC’s U.S. shareholders. Moreover, as discussed above, the earnings yield an equity-based instead of a fixed income-based return.

We speculate that the pretax equity-based return for CFCs would be higher than for a comparable investment conducted through a foreign branch because deferral is elective (by making the choice to use a foreign business entity taxable for U.S. purposes as a corporation) and, to the extent the CFC engages in related-party transactions, there is an incentive at the margin to shift income to the lower-taxed entity. Because U.S. transfer pricing regulations acknowledge that a range of prices may be considered to be arm’s length, see Treas. reg. section 1.482-1(e), it is possible for such income shifting to occur without running afoul of the section 482 transfer pricing rules. Moreover, to the extent U.S. income that otherwise would be subject to current U.S. taxation is shifted to a CFC and is eligible for deferral, U.S. revenue loss will result.

5. Deferral is fully available regardless of the degree to which the CFC’s U.S. shareholders are, or are not, adversely affected by the foreign tax credit limitation, the interest allocation rules, and other elements of the U.S. tax system that proponents of deferral believe discriminate against foreign-source income.

6. The availability, and degree of benefit from, deferral is unrelated to whether the United States has a foreign policy or economic assistance objective that is furthered by having the U.S. taxpayer operate in a particular country.\(^{66}\)

It is useful to ask whether the deferral privilege would have ever come into U.S. law if it had been directly proposed as any of its economic analogs.

At this point, it is useful to ask whether the deferral privilege would have ever come into U.S. law if it had been directly proposed as any of its economic analogs — that is, as either (1) a program of unlimited interest-free loans made wholly at the demand of private U.S. investors, but only to finance foreign operations, (2) a program under which private U.S. investors could compel the U.S. Treasury to take nonvoting equity stakes in foreign, but not domestic, business ventures with the business type and location being selected wholly by the U.S. investor,\(^{70}\) or (3) the creation of a class of offshore investment vehicles featuring tax-free reinvestment of earnings. Surely the prospects for congressional enactment of any of these programs would have been highly doubtful, particularly when they would have had the troubling effects and characteristics described above. Since the deferral privilege would be unacceptable if offered for congressional enactment in the form of any of its economic analogs, it seems difficult to justify in its current form.

Even if one accepts the premise that the United States should provide U.S. multinationals with a subsidy for foreign investment to enhance their competitiveness in the global economy, it is inappropriate to effect that subsidy through a tax preference that is so poorly correlated with the competitiveness goal as is the deferral privilege. Tax expenditure analysis supports the conclusion that tax subsidies are generally less effective than direct government grants and have monitoring problems.\(^{71}\) Traditional critiques of tax expenditures apply with equal force to the deferral privilege.

Transfer Pricing Rules & the Antideferral Regimes

One of the important functions of subpart F and the other antideferral regimes is to serve as a backstop to the section 482 rules on intercompany pricing as they apply to outbound transactions. The NFTC as well as other proponents of deferral argue that "transfer pricing law and administration have undergone profound changes that call into serious question the continued relevance of subpart F to transfer pricing enforcement."\(^{72}\) We respectfully disagree.

The arm’s-length standard, as interpreted in the current regulations under section 482, allows a taxpayer to use a range of prices and still be treated as in full compliance with the transfer pricing rules.\(^{73}\) This approach to applying the arm’s-length standard leaves ample room for U.S. corporations to shift income at the margin to foreign subsidiaries in low-tax foreign jurisdictions under the protection of the section 482 regulations.

Moreover, recent studies suggest that, notwithstanding the improvements in transfer pricing law and administration, revenue losses due to transfer pricing may be substantial.\(^{74}\) Accordingly, antideferral limitations continue to be an important backstop to enforcement of the transfer pricing rules.

Finally, even if transfer prices are set in total harmony with prices in comparable uncontrolled transactions, the deferral privilege is still objectionable for the reasons given in parts III and IV above. Thus, developments under section 482 do not justify any loosening of the antideferral limitations. Indeed, a major advantage of our passthrough proposal for dealing with

\(^{66}\) A member of the NFTC Study Drafting Group, Peter R. Merrill, has recently conceded that the deferral privilege cannot be reformed to address the second of the above defects, and this concession seems equally applicable to all of the above six points. See Merrill, "Response to Avi-Yonah," supra note 9, at 1804.

\(^{70}\) It is true that a domestic deferral incentive, such as accelerated depreciation or nondeductible individual retirement accounts, has similar attributes. This observation was made by a participant at an International Tax Policy Forum meeting in Washington, D.C. on September 8, 1999.


\(^{73}\) NFTC Study, supra note 2, at 3-7.

\(^{74}\) See Treas. reg. section 1.482-1(e); see also supra note 66.
the deferral privilege, discussed below in part VII of this article, is that it would, if adopted, significantly take pressure off the transfer pricing rules by substantially reducing the incentive for U.S. multinationals to shift income to their foreign subsidiaries in low-tax foreign jurisdictions.

Portfolio Investment

The NFTC study argues that subpart F’s limitations on deferral cannot effectively enforce the capital export neutrality principle. This is because subpart F does not apply to portfolio investments by U.S. residents in the shares of foreign corporations that enjoy zero, or minimal, home country taxes on earnings from low-tax jurisdictions. This point is correct, and in the next part of this article, we advance a passthrough proposal that would partially ameliorate this defect in the antideloar regulations by imposing current U.S. tax on foreign portfolio investments by U.S. persons.

Our Passthrough Proposal

As discussed above, the complex array of antideloar regulations of current law represents an uneasy and flawed compromise between completely ending deferal of U.S. tax on income earned by U.S. persons through foreign corporations and allowing such deferral without limitation. Congress has made numerous revisions to the antideloar regimes over the years and has changed directions several times in terms of strengthening or weakening those regimes. These revisions have only made the U.S. international tax system more complex without significantly eliminating the problems caused by the deferral privilege. The end product of this legislative ineffectiveness is a highly complicated set of statutory provisions that leaves the deferral subsidy largely intact, thus encouraging U.S. taxpayers to shift their operations abroad to low-tax foreign jurisdictions, but requiring that a taxpayer navigate through a number of antideloar hurdles to obtain that result. Moreover, the current rules make deferral elective for the well-advised U.S. taxpayer and create traps for the unwary in the case of other U.S. taxpayers, thus undermining taxpayer confidence in the fairness and efficiency of the tax system.

We propose ending deferral by treating each U.S. person (including U.S. multinational corporations) that owns stock in a foreign corporation (regardless of whether the foreign corporation is a CFC as defined in section 957) as if that shareholder directly earned a pro rata share of the foreign corporation’s gross income and expenses (regardless of whether the corporation’s income is active or passive and regardless of whether the income is earned in the country of incorporation or another country). Under this passthrough approach, each U.S. person owning stock in the foreign corporation (even if less than a 10 percent interest) would be required to currently include a pro rata share of that income or expense in computing his own U.S. tax liability. Thus, deferral would be ended with respect to the U.S. shareholders’ full shares of all of the foreign corporation’s income, not merely certain categories of income earned by CFCs described in section 957 (as is true under subpart F of current law). In addition, each U.S. person owning stock in a foreign corporation would be attributed a share of the foreign taxes paid by the corporation during the year and could claim a direct credit for those taxes to the extent they are creditable taxes under section 901 or section 903 and subject to the limitations in section 904.

As numerous other commentators have noted, the elective nature of the deferral privilege has been fortified and made more explicit by the Treasury Department’s adoption of the “check-the-box” entity classification system. See T.D. 8697, 1997-1 C.B. 215. Under the check-the-box classification system, U.S. persons operating abroad through foreign entities (other than per se foreign corporations) are more readily able to elect whether to obtain deferral of U.S. tax on their foreign-source income by electing whether to have the foreign entities treated as corporations or partnerships (or disregarded as an entity separate from its owner in the case of an entity with a single owner) for tax purposes. See, e.g., Avi-Yonah, “End Deferral,” supra note 7; Michael L. Schler, “Initial Thoughts on the Proposed ‘Check-the-Box’ Regulations,” Tax Notes, June 17, 1996, p. 1679. For example, a U.S. taxpayer is likely to elect partnership or branch (disregarded entity) status for a subsidiary engaged in foreign operations that are generating losses, or for a subsidiary operating in a high-tax foreign country because the U.S. taxpayer can use the foreign tax credit to offset both the U.S. tax on the subsidiary’s foreign-source income and the U.S. tax on other low-tax foreign-source income earned by the U.S. taxpayer in other countries. The latter planning strategy works only when the high-tax and low-tax foreign-source income falls within the same basket limitation category in section 904(d)(1). See, e.g., Gustafson, Peroni, and Pugh, supra note 3, at 293-94, 301, 471-72.) In addition, a U.S. taxpayer is likely to elect partnership or branch status for foreign subsidiaries in situations in which flow-through status will circumvent certain restrictions and limitations on the foreign tax credit under current law. See Schler, supra, at 1687.

For a more complete discussion of the advantages and disadvantages of this passthrough proposal, see Peroni, Fleming, and Shay, supra note 7, at 52-16.
Under this passthrough regime, a U.S. person owning stock in a foreign corporation would be allowed to reduce his taxable income by a pro rata share of the foreign corporation’s losses. This feature of the proposed pass-through regime would remove the bias that exists under current law against use of the corporate form in international start-up situations when significant deductions in excess of income in the early years of a venture are anticipated.

Other important features of this passthrough regime include the following.

The character of the foreign corporation’s items of income and expense would flow through to the U.S. shareholders under principles similar to those developed under section 702(b) of subchapter K and 1366(b) of subchapter S. Thus, the character distortion caused by subpart F’s constructive dividend approach to curtailing deferral (under which all subpart F income attributed to a U.S. shareholder is treated as ordinary income) would be avoided with this passthrough regime. Similarly, the distortions resulting from subpart F’s differential treatment of cross-border and same-country income would be eliminated.

To determine each U.S. shareholder’s pro rata share of the foreign corporation’s income, losses, and foreign taxes, passthrough rules similar to those developed under subchapter K would apply in modified form. All such allocations would have to survive the “substantial economic effect” test of section 704(b). Alternatively, one could adopt a principle for determining a U.S. shareholder’s pro rata share of the foreign corporation’s income, expenses, and taxes that does not allow contractual special allocations of such items to be determinative (notwithstanding their passing muster under the section 704(b) regulations). Under this alternative approach, a U.S. shareholder’s pro rata share of the foreign corporation’s income, expenses, and taxes would correspond to the shareholder’s economic interest in the corporation. In determining the U.S. shareholder’s economic interest in the foreign corporation, one could look primarily at three factors: (1) the shareholder’s voting rights in the corporation; (2) the shareholder’s right to participate in current earnings and accumulated surplus; and (3) the shareholder’s right to share in the corporation’s net assets on liquidation.

There are, however, two major problems with this alternative approach for determining a U.S. shareholder’s share of the foreign corporation’s items of income, expense, and taxes. First, in a case in which there are multiple classes of stock with differing voting rights, dividend rights, and liquidation preferences, it may be very difficult, as a practical matter, for the U.S. shareholder to determine his economic interest in the foreign corporation. Second, by ignoring special allocations if a foreign corporation is used to conduct the foreign business but continuing to respect such allocations if a partnership or LLC is used, the same choice of entity distortions induced by the special allocation rules in the partnership area under current law would be perpetuated by our passthrough proposal.

Basis adjustments similar to those in both section 705 of subchapter K and section 1367 of subchapter S would apply to prevent double taxation of the foreign corporation’s earnings when they are distributed to a U.S. shareholder or a U.S. shareholder sells the corporation’s stock. Thus, for example, items of income that flow through to the U.S. shareholders would increase those shareholders’ bases in their stock in the foreign corporation, and deductions or losses flowing through to the U.S. shareholders would reduce their stock bases. Distributions to the U.S. shareholders would also reduce their bases in the corporation’s stock.

Any losses flowing through from the foreign corporation to a U.S. person owning stock in the corporation would be limited to the extent of the U.S. shareholder’s basis in the corporation’s stock and the U.S. shareholder’s basis in any loans to the foreign corporation. This loss limitation rule is analogous to the section 704(d) limit on the deduction of partnership losses and the section 1366(d)(1)(A) limit on the deduction of S corporation losses.

Footnote 84 continued on next page.
Distributions from the foreign corporation would be tax-free to the extent of the shareholder’s basis in the corporation’s stock. Any distributions in excess of stock basis would be treated as gain from the sale of the corporation’s stock.85

Suppose the U.S. person owning stock in the foreign corporation does not have sufficient information to determine her pro rata share of the corporation’s income, either because the shareholder owns a small percentage of stock in a closely held foreign corporation that is otherwise owned by uncooperative foreign persons or the shareholder owns a small percentage of stock in a publicly traded foreign corporation that is indifferent to the information needs of shareholders under U.S. tax law.86 As a practical matter, how would such a U.S. person determine her pro rata share of the foreign corporation’s income and expenses? What accommodations can be made in the pass-through regime to reflect these compliance concerns?

If the foreign corporation’s stock is publicly traded, the U.S. person could be given a mark-to-market election similar to the one provided in section 1296 of current law for passive foreign investment companies. The mechanics of this mark-to-market approach would be similar to those in section 1296.

The proponents of the deferral privilege have not met their burden of proving that the privilege should be continued, let alone expanded by weakening the modest subpart F limitations.

Alternatively, if the U.S. person owns a less than 10 percent stock interest in the voting power of a foreign corporation the stock of which is not publicly traded, the U.S. shareholder could be allowed to base the amount of the current inclusion on generally available liabilities to third parties in the stock basis for less limitation purposes. See section 1366(d) (allowing a shareholder of an S corporation to deduct losses flowing through from the corporation only to the extent of the shareholder’s basis in the S corporation stock and in any indebtedness of the S corporation to the shareholder). However, this latter approach would perpetuate a choice-of-entity bias in favor of the partnership form of conducting a foreign business if the business is expected to incur losses and will be financed with third-party debt incurred by the entity.

"Cf. sections 301(c)(3), 1368(b)(2).

"This is actually a smaller problem than it might seem because foreign corporations actively seek U.S. portfolio investors and this gives the latter leverage to demand accommodations. See, e.g., Greg Steinmetz and Michael R. Sestit, "Big Bang: Rising U.S. Investment in European Equities Galvanizes Old World," Wall St. J., Aug. 4, 1999, at A1. Moreover, financial information of the corporation, with adjustments to reflect U.S. tax accounting principles for certain "material items" that would be "reasonably identified" by the U.S. person.87 The reason we would limit this alternative reporting approach to less than 10 percent shareholders is that, as a practical matter, a U.S. person owning 10 percent or more of the voting power of a foreign corporation should have sufficient economic clout to obtain the necessary information concerning the foreign corporation’s income and deductions to report under the general pass-through approach.88 In determining whether a U.S. person is a 10 percent or more shareholder in the foreign corporation for this purpose, a modified version of the foreign entity indirect ownership and constructive ownership rules in section 958 would apply.

We recognize, however, that there may be a number of situations when the less than 10 percent U.S. shareholders of a nonpublicly traded foreign corporation do not possess sufficient financial information concerning the foreign corporation to properly report their income under the pass-through method. Accordingly, it may be appropriate to use a modified version of the approach taken in section 1291 of the current law PFIC provisions—namely, allow such less than 10 percent U.S. shareholders to defer U.S. tax on their shares of the foreign corporation’s income but recapture the benefits of deferral by imposing an interest charge when the U.S. shareholder receives an extraordinary distribution (that is, an "excess distribution") from the corporation or the U.S. shareholder sells the foreign corporation’s stock.

However, in calculating that interest charge on the benefit of deferral, we would not use the straight-line accrual calculation method of section 1291, which calculates the interest charge by allocating the taxpayer’s income realized at the time of an excess distribution or sale of the PFIC’s stock over the shareholder’s entire holding period for the stock on a ratable or straight-line basis. We would not use that method because it assumes more tax deferral than would occur if income had been earned at a constant rate (that is, it "front-loads" the deferred income) and thus probably overcompensates for the benefits of deferral in most cases.89 Instead, we would calculate the interest charge by using economic accrual and assuming that the undistributed income had been earned at a constant rate.

85See Shay, supra note 7, at 1061.

86This premise is consistent with the assumption underlying both the indirect credit provisions in sections 902 and 960 and the look-through rules used for foreign tax credit limitation purposes in sections 904(d)(3) and 904(d)(4) that 10 percent or more U.S. shareholders in foreign corporations are able to obtain detailed information concerning a foreign corporation’s income, deductions, and foreign taxes.

87See Stephen B. Land, "Defeating Deferral: A Proposal for Retrospective Taxation," 52 Tax L. Rev. 45, 65, 67 (1996); see also, e.g., 3 Isenbergh, supra note 16, at par. 44.16.
Transition From a Deferral to a Passthrough System

The transition from a deferral to a passthrough regime for taxing foreign income of foreign corporations poses daunting issues. Taxable U.S. shareholders would realize an unprecedented windfall if their foreign corporations were converted to a passthrough regime and asset basis representing untaxed (by the United States) earnings and profits were allowed to carry over without including pre-change earnings in income. If, however, the current law rules governing a change in status from a corporation to a partnership were applied, a U.S. shareholder in a foreign corporation either would recognize gain or loss in a taxable disposition or, if an 80 percent corporate shareholder, deferred earnings in a section 332 liquidation. We propose as a transition rule that assets be deemed transferred to the pass through entity with a carryover basis and that the shareholder recognize over a five year period pre-change accumulated earnings and deficits.

Conclusions

The proponents of the deferral privilege have not met their burden of proving that the privilege should be continued, let alone expanded by weakening the modest subpart F limitations. Accordingly, we urge Congress not to expand the deferral privilege by enacting any additional exceptions to the existing subpart F rules. Instead, given the overall structure of the code, we believe a strong case can be made that deferral should be further restricted or eliminated, and that a passthrough regime for income earned by U.S. persons through foreign corporations would be the most effective way to accomplish this desirable policy objective.

90For a more detailed discussion of the transition issues relating to our passthrough proposal, see Peroni, Fleming, and Shay, supra note 77, at 519-23.

91This policy issue was identified by Charles Kingson in connection with analyzing the appropriate “toll charge” for an inbound corporate liquidation. See Charles I. Kingson, “The Theory and Practice of Section 367,” 37th N.Y.U. Inst. on Fed. Tax’n 22-1, 22-7 to 22-30 (1979).

92The foreign corporation would be deemed to distribute its assets to shareholders in liquidation and the shareholders would be deemed to reconstitute the assets to the new partnership. Treas. reg. section 301.7701-3(g)(1)(ii). Section 1248 would apply to a U.S. shareholder’s taxable disposition of CFC stock and recharacterize the gain as dividend income to the extent of untaxed earnings and profits accumulated during the period the shareholder was a U.S. shareholder and the foreign corporation was a CFC. The passthrough entity would obtain a fair market value basis in the assets deemed contributed back to the passthrough entity, or in the case of a section 332 liquidation, a carryover basis.