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Thank you Dr. Atkeson. I'm not quite sure why you selected a New Englander practicing in New York to talk on "Trends in the Taxation of Foreign Income", but I am very happy to have been invited and to be here.

My talk today is somewhat preempted by the stimulating speech Assistant Secretary of the Treasury Stanley Surrey recently delivered entitled, "The United States Tax System and International Tax Relationships—Current Developments, 1967"* which was referred to by our last speaker.

Possibly because Mr. Surrey has pre-empted me, I shall not restrict myself to 1967. In fact, any discussion of trends in the taxation of foreign income must go back to the era prior to the enactment of the Foreign Investors Tax Act of 1966 and the enactment of the Revenue Act of 1962, with its incredible complexity in the foreign area, and to the time when the tax environment in the foreign area was different because the Internal Revenue Service either did not use or was unaware of the tremendous enforcement tool that it had in Section 482.

Traditional Jurisdictional Concepts

A brief review of our jurisdictional concepts with respect to the taxation of income might be helpful. Historically, the United States, with certain exceptions applicable primarily to earned income of citizens, has taxed its citizens, residents and domestic corporations on world-wide income. Double taxation of the same income by more than one taxing jurisdiction has been avoided primarily by allowing United States citizens and domestic corporations to credit foreign income taxes against United States tax liability. The credit is subject to the limitations set forth in Section 904.

Prior to the enactment of the Foreign Investors Tax Act of 1966, which taxes limited classes of foreign source income "effectively connected" with a United States trade or business, the United States taxed nonresident aliens and foreign corporations only on their United States source income. This was true even though a foreign corporation was controlled by United States shareholders and even though "management

*Remarks before The National Foreign Trade Council Convention delivered on November 1, 1967.

and control" or the "seat of management" of the foreign corporation was in the United States.

Before the Revenue Act of 1962, United States shareholders of foreign corporations, other than foreign personal holding companies, were not taxable on the earnings of the foreign corporation until the earnings were distributed. Some of the rules for determining whether income is foreign or United States source, particularly in the sales area, are such that the management or controlling shareholders of foreign corporations could determine whether particular items of income would be treated as foreign or United States source. To be sure, the desired result could be achieved only if business relationships were altered somewhat, and there might be non-tax consequences flowing from the conversion of United States source income to foreign source income. Largely because of the United States conception of how and to whom foreign income should be taxed and the source rules, it was and often is still to the advantage of the United States corporation to use foreign entities for non-United States operations, particularly after the development period.

Let us review the way in which these traditional rules operate in several situations: first, a corporation engaged in manufacturing activities abroad. Ofttimes local non-tax considerations would dictate the use of a foreign entity; United States and foreign tax considerations might also make a foreign entity desirable. If a foreign corporation were used and if the foreign tax on the foreign corporation's income were lower than the United States tax, the difference between the tax the United States would have imposed had a domestic corporation been used and the foreign tax could be plowed back into the business and used for expansion. Furthermore, in many situations the rate of foreign tax applicable to a locally incorporated subsidiary might be less than the rate applicable to a foreign branch of a United States corporation. On the other hand, tax considerations might make the use of a domestic corporation or of a branch desirable, particularly if losses were expected during the developmental period which could be offset against other United States income.

Foreign corporations were also commonly used by United States taxpayers making sales to non-United States destinations. A United States manufacturing company which sells some of its products abroad may prefer to sell through a foreign entity. Rather than selling directly to the foreign customer, the United States company sells to a subsidiary company incorporated in Panama or Switzerland which then resells to the ultimate customer with title to the products passing outside the United States. Thus the income derived from selling activity has been separated from income derived from United States manufacturing. Since the sales income is foreign source income earned by a foreign corporation, prior to the Revenue Act of 1962 it could have been insulated from United States tax until distributed to the United States parent.

The export company has also been used to reduce the burden of foreign taxes. For example, the United States parent might have a German manufacturing subsidiary. The use by the subsidiary of a foreign sales company to handle sales outside Germany might serve just as much purpose as its use by the United States company, except that the taxes being avoided were German taxes.

The foreign corporation has been utilized by United States taxpayers to transmit know-how, other intangibles and services to foreign customers or to related companies operating abroad. Prior to the Revenue Act of 1962 the foreign source income which a foreign corporation realized from the performance of services abroad or the licensing of foreign patents was not taxed by the United States. Ofttimes such services have been performed by the foreign sales company.

Foreign corporations engaged in sales and service activities were also utilized to hold a group of foreign subsidiaries. To the extent that the foreign holding corporation had stock investments in subsidiaries which paid local taxes lower than United States taxes, dividends from such corporations to the holding corporation might have been reinvested in other foreign operations, without repatriation and tax in the United States. In addition, the use of a holding corporation often enabled the United States parent to determine the mix of foreign income repatriated with a resulting effect on the amount of foreign tax credit available to the United States parent.

To be sure the foreign base company had been used to some extent to avoid United States tax. But to the extent that United States tax was avoided, it was the United States tax on foreign source income.

Revenue Act of 1962

In 1961 radical changes were proposed with respect to the taxation by the United States of foreign corporations. These legislative proposals ultimately became the Revenue Act of 1962. The original proposal was that the United States tax United States shareholders of a "controlled" foreign corporation on the annual increase in the earnings and profits of the controlled foreign corporations. The basic theory of this proposal was that there should be no United States income tax advantage in operating abroad through foreign corporations, and that the tax burden imposed on distributed and undistributed earnings of a foreign corporation should be equal to the tax which would be borne if the foreign corporation's foreign income had been received by a United States corporation. As originally defined, a controlled foreign corporation was any foreign corporation more than 50 percent of whose voting stock was held by United States persons. There was, of course, a furor when the legislation was proposed, and ultimately a compromise version of the original proposal was enacted. Under the Revenue Act of 1962, a controlled foreign corporation is a foreign corporation more than 50 percent of whose voting stock is owned by "United States shareholders". A "United States shareholder" is defined as a United States person who actually or constructively owns 10 percent or more of the voting stock.

Subpart F Income

The Revenue Act of 1962 affected United States shareholders of controlled foreign corporations in several respects. First, the Revenue Act of 1962 provides for the annual taxation to the United States shareholder of his pro-rata share of a controlled foreign corporation's Subpart F income. Subpart F income is taxed currently to a "United States Shareholder" of a controlled foreign corporation whether or not such income is distributed. The principal component of Subpart F income for most companies is "foreign base company income." Foreign base company income, in turn, has three components: foreign personal holding company income, foreign base company sales income and foreign base company services income.

1. For purpose of Subpart F foreign personal holding company income consists of dividends, interest, royalties and gains from the disposition of securities, with certain exceptions for dividends and interest received from corporations incorporated in the same jurisdiction as the recipient corporation or by corporations engaged in the conduct of a banking or financing business.

2. Foreign base company sales income is income generated from the resale of tangible personal property manufactured by a related person or from the purchase from an independent company for resale to a related entity. It should be noted that the foreign base company sales income provision applies whether the sale was of goods manufactured by a related United States entity or by a foreign entity. Thus, it operates without regard to whether the resale avoids United States or foreign taxes.

3. The third type of foreign base company income is foreign base company services income. It is similar to foreign base company sales income except that it involves services performed for related companies.

Relief Provisions

The treatment of foreign base company income under the Revenue

Act of 1962 is ameliorated by several provisions. Two should be mentioned. The first is the so-called "30-70 rule", which provides that none of the income of a controlled foreign corporation shall be treated as foreign base company income if less than 30 percent of its gross income consists of foreign base company income. (On the other hand, if more than 70% of gross income is foreign base company income, all of the controlled foreign corporation's income is.)

A second exception is the very important provisions dealing with minimum distributions by controlled foreign corporations. Under these provisions, the Subpart F provisions do not apply if certain minimum distributions are made each year by a controlled foreign corporation. These provisions work basically as follows: if a United States entity has a foreign subsidiary which makes dividend distributions so that the effective rate of taxation on the foreign subsidiary's distributed and undistributed income, paid both in the United States by the United States entity and abroad by the foreign subsidiary, is approximately 90 percent of the United States tax (before foreign tax credit) which would have been paid had all of the subsidiary's income been distributed, it has made the required minimum distribution necessary to avoid Subpart F. In determining the amount of minimum distributions, a United States corporation has the option of computing the required minimum distribution by taking into account all of its foreign subsidiaries, by looking at each foreign subsidiary separately, or by electing one or more chains of foreign corporations from which to make minimum distributions with some choice of how far down the chain it will go. In addition, there are various elections under the minimum distribution provisions with respect to the exclusion of less developed country corporations, the treatment of deficit operations and the treatment of branch income. In the event of non pro-rata distribution, appropriate adjustment of allowable foreign tax credits is required.

Section 1248

The second important change with treatment of controlled foreign corporation made by the Revenue Act of 1962 was the enactment of Section 1248 of the Code. That section provides that gain from the sale or exchange of an interest in a controlled foreign corporation by a United States person owning 10% or more of the corporation's voting stock will be treated as dividend income to the extent of earnings and profits accumulated by the corporation in taxable years beginning after December 31, 1962 during the period which the stock was held, subject, of course, to a foreign tax credit. Thus, to the extent that United States shareholders of controlled foreign corporations avoid current taxation of earnings and profits under Subpart F, the difference between United States tax payable on such earnings and the foreign tax actually paid will be taxed at the time of disposition as if a dividend had been distributed.

Investment in United States Property

The third principal change made by the Revenue Act of 1962 with respect to controlled foreign corporations is to treat an increase in such a corporation's investment in United States property during a taxable year as the equivalent of a dividend to the United States shareholders to the extent of any accumulated earnings and profits.

The provisions on investment in the United States property serve no useful purpose. Many people have been caught unnecessarily by the fact that an increase in investment in the United States property by a foreign corporation is treated as a dividend. On the other hand, more sophisticated United States corporations have found that where they had had a second tier of foreign subsidiaries subject to high rates of tax, an investment by such subsidiaries in United States property is a wonderful means of getting earnings and profits out of the subsidiaries with a high foreign tax credit in a case in which the foreign tax credit would have been diluted had the earnings been distributed to a first tier subsidiary and then passed home.

Experience Under the Revenue Act of 1962

Five years have passed since the enactment of the Revenue Act of 1962, and since my assigned topic is "trends", I will give you my assessment of what has been accomplished with respect to controlled foreign corporations by the enactment of that Act. First, I think the minimum distribution provision has made the current taxation of foreign base company income almost meaningless. As a practical matter, the availability of the minimum distribution provision has at least given the large corporate taxpayer with extensive foreign operations the opportunity to avoid as much United States tax on foreign source income as ever it could prior to the Revenue Act of 1962. This is particularly true if the foreign operations are expanding and there are loss operations in particular areas which can be used to reduce the amount of foreign income which has to be distributed.

Subpart F has been fun for the sophisticated lawyer. The provisions dealing with foreign base companies have presented him with a challenge; to the extent he enjoys dealing with mathematical puzzles, he has delighted in working out minimum distribution arrangements. But one wonders how worthwhile Subpart F has been. I doubt that much revenue has been obtained. As to whether the Revenue Act of 1962 is a deterrent to foreign investment, at least from my own experience, it has had no effect whatsoever. Arguably, Section 1248 has made foreign accumulation investments less desirable. But I think in many cases Section 1248 has held up the repatriation of individual foreign investments which would otherwise have been brought home.

In my opinion all of what was intended by the provisions in the Revenue Act of 1962 dealing with controlled foreign corporations, could have been accomplished by enacting the minimum distribution section, or by merely applying an accumulated earnings tax to foreign investments and penalizing the United States shareholder who accumulated income abroad beyond the reasonable needs of the foreign business by treating such excess income as distributed.

Section 482

The Revenue Act of 1962 heralded a change in administrative attitude. Most important is the increased use of Section 482 about which our last speaker spoke to you. This has forced the United States to face the problems of conflicts of jurisdiction with respect to items of income. Our Internal Revenue Service and Treasury Department should be applauded for Revenue Procedures 64-54 and 65-17, to which our last speaker referred. I certainly agree with him that the offset of foreign tax credit provision in Revenue Procedure 64-54 should, if possible, be extended, even though this may mean that the United States will bear the economic burden of double taxation of income and even though the extension may in some instances relieve any pressure on the foreign government to retreat from its position. Revenue Procedure 65-17, which permits certain tax-free dividends or the establishment of an account receivable when there is a Section 482 allocation of income, has also been a worthwhile procedure. My only quarrel with the procedure is the requirement that there be a finding of no tax avoidance in order for the procedure to be employed.

Excess Foreign Tax Credit

Another change in the tax environment in the foreign area has come about because of the reduction of United States tax rate to 48 percent and increases in the tax rate of some foreign countries. These changes have often generated foreign taxes which cannot be credited against United States tax because of the limitations at Section 904 of the Code.

There are measures which may alleviate partially the problem of unused foreign taxes. The use of foreign base companies to avoid or reduce foreign taxes may create a source of foreign source income which is subject to low foreign taxes, it being of no concern that such income may be Subpart F income. Similarly, royalty and loan arrangements may generate foreign source income which reduces the effective foreign tax rate because it is subject to low withholding taxes or none at all. An investment in United States property by a controlled foreign corporation may change the order of applying foreign tax credits to the overall advantage of the United States parent. Unfortunately, the excess foreign tax credit problem may cause the postponement of dividends from high tax countries in order to avoid further withholding taxes which may not be credited, and thus may cause reinvestment in those countries where reinvestment from a United States point of view may be less desirable.

The problem of unusable foreign tax credit has also caused a closer scrutiny by the Internal Revenue Service of expenses incurred in earning foreign source income. This reflects a realization by the Service that the foreign tax credit is reduced to the extent that the amount of foreign source income, or the amount of per country income, is reduced by allocating to such income expenses that might be attributable to it. The Service has also taken a closer look at what constitutes foreign and United States source income.

Foreign Investors Tax Act of 1966

The second major legislative development in the foreign area is the enactment of the Foreign Investors Tax Act in 1966. While this Act deals primarily with the United States tax problems of foreign individuals investing in the United States, it contains important provisions dealing with the taxation of foreign corporations.

Prior to the enactment of the Foreign Investors Tax Act, foreign source income was not subject to United States tax. Some examples: Let us assume that we have a Panamanian company, owned either by foreign or United States shareholders, which is engaged in export operations. It buys goods from independent parties in the United States and resells abroad with title passing abroad. It has an office in Norfolk, Virginia. Previously, this type of entity, although engaged in business in the United States, was not subject to United States tax on this foreign source income which it earned on the resale of the goods. Nor would Subpart F apply since its dealings are entirely with unrelated parties.

Or assume the following: we have a large manufacturing company located abroad which makes substantial sales to United States customers. It has an office in New York actively soliciting sales. Title to the goods sold always passes abroad. Despite the activity carried on by the New York office of the foreign corporation, there was no United States income tax on its sales income prior to the Foreign Investors Tax Act of 1966. Occasionally, there have also been foreign corporations which are dealers in securities conducting operations from the United States, and which have no United States source income because the transactions are consummated entirely in markets outside the United States. In addition, corporations engaged in the licensing of intangibles and having only foreign source income may be managed in the United States.

Under the Foreign Investors Tax Act of 1966, income from sales of goods, royalties and securities trading realized by foreign corporations is subject to United States tax to the extent that such income is available to an office of the foreign corporation in the United States. This income is still foreign source income, but it is characterized by the Foreign Investors Tax Act of 1966 as "income effectively connected with the conduct of a trade or business in the United States" and is taxed by the United States, subject to a credit for taxes imposed by the foreign corporation's incorporation.

Effectively Connected Sales Income

We have two rules with respect to sales income effectively connected with the conduct of a trade or business within the United States. If the foreign corporation has an office in the United States and the sale is to a United States destination income attributable to the United States office is taxable in the United States regardless of where title to the goods sold passes and regardless of whether a foreign office materially participated in the sale. If the sale is to a non-United States destination, however, there is no tax if a foreign office materially participated in the sale. The question of how much of the sales income is attributable to the United States office is an unanswered question. I believe the word "attributable" means the income which would have been realized by the office had such office been separately incorporated as a United States company and acted as an independent sales agent.

Treaties

The final area which I would like to discuss is developments in the Treaty area. In my opinion, this is one of the most important areas in the taxation of foreign income. The United States has one of the largest networks of bi-lateral tax treaties in the world. These treaties are primarily with European countries and other economically developed countries. In the past our treaties have generally tried to exempt completely so-called business income, defined usually as industrial and commercial profits, unless the United States company has a permanent establishment abroad or the foreign company has a permanent establishment in the United States. Depending on whether there is a permanent establishment, most of our treaties have provided either an exemption or a lower rate of withholding tax for royalties, dividends and interest income. In addition the treaties provide for the exchange of information, and occasionally operate to avoid double taxation by providing authority for the two governments to get together.

Tax treaties have been very valuable to both United States business and to the Treasury. The provisions with respect to permanent establishment and the taxation of industrial and commercial profits have usually ensured that there will be no foreign tax unless there is more than a minimal contact between the United States entity and the foreign country. The exemptions and reduced rates for royalties, dividends and interest have usually permitted a ready transfer of funds and technical information between entities. The reduced withholding on dividends has reflected a realization, particularly on the part of the developed countries, that the imposition of a tax on corporate profit and a tax on the receipt of dividends results in too large a tax burden.

The United States has a financial interest in these treaties. Ofttimes the taxes which would be imposed in the absence of a treaty, on royalties and interest, or on industrial and commercial profits in a case where there is no permanent establishment would reduce United States revenue because of the foreign tax credit. On the other hand, under the older treaties the benefits conferred on dividends, royalties, interest and capital gains have depended primarily on whether a company was engaged in trade or business through a permanent establishment since if a company had a permanent establishment in a country, that country could tax all income derived from sources within that particular country, irrespective of whether the activities carried on by the permanent establishment were related to the other income.

In our older treaties the definition of permanent establishment is not detailed enough. Nor is there an attempt to deal with the double taxation resulting from different characterizations of income by different countries. What do you do when the United States considers certain types of sales income as United States source income and the United Kingdom regards the same income as United Kingdom income?

As many of you know a new treaty between the United States and France has recently been proposed; this treaty is meant to be a model of what the United States would like to achieve in treaties with developed countries. There are certain aspects of the French treaty which I should bring to your attention: The concept of business profit has taken the place of industrial and commercial profits. Business profits include dividends, interest, royalties and capital gains which are effectively connected with the business carried on by the permanent establishment. Dividends, interest, royalties and capital gain which have nothing to do with that business receive the benefits and are subject to reduced withholding or exemptions. The provisions envisioning governmental consultation in cases of double taxation have been expanded so that different determinations of the source of income and other problems may now be considered. In addition there is a recognition of the fact that certain types of home office expense should be deductible in determining the profit of a permanent establishment.

The definitional aspects of the French treaty are considerably improved over previous treaties. The definition of a permanent establishment can be understood without interpretive regulations or the knowledge of past interpretation of tax treaties.

The proposed treaty with France contains an interesting provision providing that each government may enforce the tax claims of the other.

In addition to treaties with developed countries, the Treasury Department has also started a treaty program with less developed countries, where ofttimes United States persons have been subject to rather substantial withholding taxes on royalty, interest and dividend income. Often the amount of withholding tax has been so great that the foreign tax credit cannot be fully utilized. In order to obtain concessions in these areas, the Brazilian treaty affords an investment credit for investment in Brazil. This provision bears witness to the imagination of the Treasury Department.

Double Taxation of the Same Income

The biggest over-all problem remaining today in the taxation of foreign income is that of double taxation of the same item of income. And I think this is the area where our government probably has the greatest responsibility. The mutual agreement procedures between governments provided for in the treaties are not procedures which the taxpayer himself can initiate and in which he can actively participate. I wonder whether the burden of double taxation of the same item of income is not one which should be borne by the United States government and whether the risk of obtaining consistent treatment by different taxing jurisdictions of the same item an income is not a risk which should be borne by the United States rather than the taxpayer. Perhaps some procedure could be developed whereby only one tax is collected (at the higher of the two rates imposed) and placed in a pool; every six months or every year there could be a reckoning between the two governments with respect to the pool, in which the taxpayer need not be involved.

Conclusion

The problem of double taxation of the same income is the problem which now requires the most imaginative solutions. There has been some effort to attack this problem in the new bilateral treaties and in administrative rulings. Perhaps this is the area in which, during the next few years, the significant developments in the foreign tax area will take place.