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AN INQUIRY INTO THE FOREIGN TAX BURDENS
OF U.S. BASED MULTINATIONAL CORPORATIONS

by

WALTER F. O'CONNOR

A dissertation submitted to the
Graduate Faculty in Business in
partial fulfillment of the require-
ments for the degree of Doctor of
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New York.

1976

This manuscript has been read and accepted for the Graduate Faculty in Business in satisfaction of the dissertation requirement for the degree of Doctor of philosophy.

Feb 4, 1976
date

Samuel A. Dyckman
Chairman of Examining Committee

Feb 4, 1976
date

John H. Zimm
Executive Officer

Prof. Samuel Dyckman, Chairman

Prof. Abraham J. Briloff

Prof. James E. Wheeler
Supervisory Committee

The City University of New York

PREFACE

The income tax was only five years old in the United States when Congress was faced with the decision of how to deal with the double taxation problem presented to U.S. based corporations by the tax burdens they were incurring in foreign jurisdictions. Up to the Revenue Act of 1918, foreign taxes were only permitted as a deduction in arriving at the taxable income base of U.S. corporations. In that Act, however, the foreign tax credit mechanism was adopted so that U.S. corporations could utilize the foreign tax burdens that they incurred as a direct offset against their U.S. tax liability.

Since that time, the United States has witnessed a dramatic growth in the foreign activities of its corporate enterprises. This growth has carried with it a significant increase in the foreign tax burdens incurred by U.S. corporations as well as an increase in the complexities of the U.S. tax law dealing with the absorption of these foreign tax burdens within the U.S. tax system. As late as mid-1975, we see members of the U.S. Congress

challenging the specific tax rules and the underlying tax policies of the U.S. tax treatment of foreign tax burdens suffered by U.S. corporations which by now bear the title "multinational".

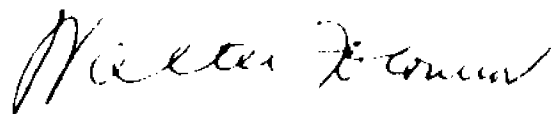
But are U.S. based multinationals really "suffering" foreign tax burdens? Or are they merely incurring these burdens and reducing their U.S. tax burdens by an equal amount so that the pain of any such potential suffering is really shifted via the tax system to the U.S. public in general? To seek an answer to this question and its many sub-parts is the goal of this study.

We strive in this study to ascertain how foreign tax burdens are being incurred by U.S. based multinational corporations. Then we seek to evaluate the extent to which these foreign tax burdens incurred impact adversely on those corporations from various tax aspects as well as from the standpoint of financial reporting. Based on these discoveries, we then probe into the techniques and mechanisms that U.S. corporations utilize to manage and control these foreign tax burdens in their tax planning activities.

Our research consists of an exposition of the

unilateral and bilateral tax rules forming the conceptual base of the U.S. and foreign tax systems and an in-depth analysis of the actual data of a number of U.S. based corporations which have generated income outside the United States and have incurred foreign tax burdens of significant amounts. From the research made possible by the availability of this important data base, we have been able to draw conclusions and make recommendations which we hope will be a meaningful contribution to what appears to be a continual review of the foreign tax burdens incurred by U.S. based multinational corporations and their impact on the U.S. tax system.

December 20, 1975

A handwritten signature in cursive script, reading "Walter F. O'Connor".

Walter F. O'Connor

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CHAPTER I

THE CONCEPTS UNDERLYING THE U.S. TAXATION OF FOREIGN INCOME OF U.S. CORPORATIONS

The purpose of this study is to examine the impact that taxes imposed by foreign jurisdictions make on U.S. based corporations conducting their operations on a multi-national scale. In order to achieve this overall objective, it was necessary to engage in a significant degree of analytical research using empirical data collected specifically for the purpose of this study. The succeeding chapters in this study will discuss in detail the nature of the research performed to achieve numerous sub-objectives and the conclusions reached from that research. They will also cover the recommendations made for adjusting U.S. tax policy and U.S. tax rules based on the conclusions reached.

Before commencing the investigation based on the empirical data, however, it was essential that we examine the underlying U.S. tax framework into which these foreign tax burdens must fit in order to gain an appreciation of the true nature of the

impact that foreign tax burdens have on U.S. corporations. The purpose of this chapter is to provide that insight into the U.S. tax system as it relates specifically to the treatment of foreign tax burdens incurred by U.S. based corporations. Once the nature of this aspect of the U.S. taxing system is understood, we will then be in a position to examine the empirical data within the framework of this U.S. tax system.

A. Basic Principles of U.S. Taxation As They Relate to Foreign Income

1. Worldwide Jurisdiction

The most fundamental aspect of the U.S. tax system relating to the foreign tax burdens incurred by U.S. corporations to be appreciated is that the U.S. tax system extends its jurisdiction so as to tax U.S. corporations on a worldwide basis.¹ As more simply put in the U.S. tax regulations, gross income means all income from whatever source derived, unless excluded by law, including income realized in any form, whether in money, property or services.² This expression of jurisdiction in the Internal Revenue Code and regulations provides a scope to the U.S. taxation of foreign income of U.S. corporations that is more

-
1. The Internal Revenue Code imposes an income tax on income from all sources (under Section 61) of every individual (Section 1) and of every corporation (Section 11). All statutory references throughout the study are to the U.S. Internal Revenue Code of 1954, as amended, unless otherwise indicated.
 2. Treas. Regs. Sec. 1.61-1(a)

expansive than that which exists in many countries.³ At the very outset then, one can see that we are dealing with an all-encompassing system from the standpoint of the U.S. based corporation which forms the basis for our study.

a) Foreign Income and Losses

Basically, the United States income tax is founded on two independent jurisdictional contacts: the status of the taxpayer and the source of its income. Since the United States has jurisdiction over domestic corporations, they are taxed on their worldwide income.⁴ For this purpose, domestic corporation means a corporation created or organized in the United States under Federal or State law.⁵ The United States does not use the "seat of management" test to delineate its jurisdictional reach over corporations. Rather, the place of incorporation is decisive in determining whether a corporation is taxable on

3. For example, in those countries that follow the Napoleonic Code concepts, such as France, Italy and many Latin American countries, only income generated within their boundaries is subject to tax. See Taxation in France - World Tax Series, International Tax Program, The Law School of Harvard University, (Commerce Clearing House, Inc., Chicago, 1964) Section 11/1.3, p. 709. See Taxation in Italy - World Tax Series, International Program in Taxation, The Law School of Harvard University (Commerce Clearing House, Inc., Chicago, 1964) Section 11/2.1, p. 549. See also Alemann, R. Tax Policies in Argentina, Tax Policy on United States Investment in Latin America, Tax Institute of America, Princeton, New Jersey, 1963, pp. 57-63.

4. Section 11 of the Code.

5. Section 7701(a)(4) of the Code.

worldwide income.⁶ A corollary to this jurisdictional approach is the fact that U.S. based corporations incurring losses outside the United States are permitted to deduct them in computing the taxable income base on which they are taxable in the United States.⁷

b) Determination of Foreign Source Income

As we will appreciate as we proceed through our study, another important basic concept to the U.S. tax system from an international standpoint is the segregation of income between foreign and U.S. source. The "source rules" sections of the Internal Revenue Code are basically definitional provisions.⁸ They are the rules which determine whether a particular item of income will be considered "foreign" or "domestic" for purposes of the tax law. They only become operative when applied under other Code sections. Whether a receipt comes within the definition of income under U.S. tax law does not depend in any way on these source of income provisions, since they simply ascribe a geographical

6. Many countries that do tax domestic corporations on their global income do not rely on place of incorporation to define domesticity. For example, Canada imposes global taxation on corporations resident in Canada, which means corporate entities whose mind and management are in Canada. See Section 28(1) Income Tax Act, Chapter 148, Revised Statutes of Canada, 1952, as amended. Similarly, the United Kingdom imposes worldwide taxation on corporations managed and controlled in the United Kingdom, regardless of where they are incorporated. See United Kingdom Finance Act of 1972, Part IV, Section 64.

7. Section 165(a) of the Code.

8. Section 861-863 of the Code.

source to the global income which is subject to tax. However, the determination of the geographical source of income is essential for the application of many Code provisions dealing with the international area of the U.S. tax system.⁹ This is a somewhat unique feature of the U.S. tax system since it provides a single place in the Code in which specific rules dealing with the source of many items of income can be found.¹⁰ These source of income rules determine the source of such items as dividends, interest, rents, royalties, gain or loss on the sale of personal property, gain or loss on the sale of real estate, income from services and many other types of income which U.S. corporations may generate outside the United States.¹¹

While the worldwide tax jurisdiction principle does not depend on the manner in which this income is sourced using these rules, the determination of source of income becomes quite important in connection with certain preferential types of treatment of foreign income enjoyed by U.S. based corporations

-
9. For example, the source of income rules determine the tax base for the U.S. taxation of aliens and foreign corporations, as well as special benefits provided to U.S. individuals on income earned abroad. See Section 871-872, 881-882 and 911 of the Code.
10. Boris I. Bittker and Lawrence F. Ebb, United States Taxation of Foreign Income and Foreign Persons, (Federal Press, Inc., Branford, Connecticut, 1968) pp. 113-184.
11. Section 862 of the Code.

under the U.S. tax system.¹² It must always be borne in mind that foreign income of U.S. based corporations - however that source is determined - is includable in the U.S. tax base as a general rule of U.S. taxation. But, as in the case of most general rules, there are exceptions and the Internal Revenue Code does grant preferential treatment to certain types of foreign income generated by U.S. corporations. A knowledge of these exceptions is important since they form part of the basis for later discussions of the manner in which foreign tax burdens enter into the overall tax impact of U.S. corporations.

c) Preferential Treatment of Certain Foreign Income

Notwithstanding the general rule that U.S. corporations are subject to U.S. taxation on their worldwide income, some preferential treatment is given to foreign income of certain U.S. corporations. For purposes of our study, it is meaningful to be cognizant of three types of U.S. corporations which illustrate this special treatment: namely, the Western Hemisphere Trade Corporation, Possessions Corporation, and Domestic International

12. Taxation in the United States - World Tax Series, International Program in Taxation, The Law School of Harvard University (Commerce Clearing House, Inc., Chicago, 1965) Section 11/3.1, p. 1007.

Sales Corporation.¹³

(1) Western Hemisphere Trade Corporation

Under Section 921 of the Code, a Western Hemisphere Trade Corporation is effectively taxed at a rate which is 14 percentage points less than the U.S. corporation generally, or at 34 percent rather than 48 percent.¹⁴ The reduction in tax is obtained by means of a special deduction in computing the taxable income of a qualifying corporation.¹⁵ This preferential tax rate for Western Hemisphere Trade Corporations was originally granted to eliminate a competitive disadvantage, vis-a-vis foreign owned corporations, of U.S. corporations operating in foreign countries within the Western Hemisphere. The provisions were introduced in 1942, when because of the war, foreign business activities of U.S. corporations were being extensively carried on only in the Western Hemisphere.¹⁶

In order to qualify for this preferential

13. For example, the source of income rules are a factor in determining eligibility for Western Hemisphere Trade Corporation treatment (Section 921), Possessions Corporation treatment (Section 931) and Domestic International Sales Corporation treatment (Section 991).

14. Section 922(2)(a) and (b) of the Code.

15. Section 921(1) and (2) of the Code.

16. Stanley S. Surrey, "Current Issues in the Taxation of Corporate Foreign Investment", 56 Columbia Law Review 815 (1956) and H.P. Crawford, "Western Hemisphere Trade Corporation", 47 California Law Review 621 (1959).

tax rate for any taxable year, a corporation must satisfy four requirements: (a) it must be a domestic corporation, i.e. one created under the laws of the United States or of any state of the United States or of the District of Columbia; (b) all of its business must be done in North, South, or Central America or in the West Indies; (c) ninety-five percent or more of its gross income for the three year period preceding the close of the taxable year must be from foreign sources using the source rules to which we referred above; and (d) ninety percent or more of its gross income for this three year period must be derived from the active conduct of a trade or business.¹⁷ Western Hemisphere Trade Corporations have been used to a significant degree as vehicles for international trade, especially the export trade. Companies engaged in mineral and oil extraction have also used them substantially in conducting their foreign activities.¹⁸ The qualification provisions have generally necessitated the creation of subsidiary Western Hemisphere Trade Corporations since domestic corporations, manufacturing goods in the United States and selling them abroad, could not satisfy the requirement that ninety-five percent of its gross income be derived from foreign

17. Section 921(1) and (2) of the Code.

18. Remarks by Representative Charles A. Vanick (D.-Ohio), House Ways and Means Committee Member on House Floor, December 17, 1974, on his "Study of Taxes of the Nations' 160 Largest U.S. Corporations".

sources. Thus, the usual pattern one finds employed is that of an ordinary domestic corporation which sells to its Western Hemisphere Trade Corporation subsidiary which in turn exports the goods. The income of the Western Hemisphere Trade Corporation subsidiary is often consolidated with that of the U.S. parent company in the consolidated tax return so that dividends may pass from the subsidiary to the parent without further U.S. taxation.¹⁹ Here, then, in the Case of the Western Hemisphere Trade Corporation, we see one major instance in which the worldwide jurisdictional principle of the U.S. tax system is somewhat eroded through the granting of a preferential U.S. tax rate to U.S. corporations conducting certain types of operations in foreign areas.

(11) Possessions Corporation

The second type of U.S. corporation that receives special U.S. tax treatment on foreign income is the so-called Possessions Corporation. In this case, all foreign source income of a U.S. corporation is exempt under Section 931 provided two basic conditions are met: (a) 80 percent or more of the gross income of the U.S. corporation must be derived from sources within one or more possessions of the United States; and (b) 50 percent or more of the U.S. corporation's gross income must be derived from the active conduct of a trade or business

¹⁹. Section 1504(b) of the Code.

within a United States possession.²⁰ An important point to recognize here is that, if the corporation qualifies as a Possessions Corporation, all of its foreign source income is exempt from U.S. taxation and not only that which is foreign source income attributable to the possessions activity.²¹ This provides a significant departure from the worldwide jurisdictional principle adopted by the U.S. tax system generally.

Generally speaking, the Possessions Corporation is taxed in the same manner as a foreign corporation engaged in business in the United States. That is, its foreign source income is exempt from U.S. taxation whereas its U.S. income is subject to U.S. taxation.²² Unlike the Western Hemisphere Trade Corporation, it cannot be included in a U.S. consolidated tax return and no dividends received deduction is allowed to a corporate shareholder on the receipt of dividends from a Possessions Corporation.²³ Furthermore, it is treated like a foreign corporation in that a corporate shareholder is entitled to claim a tax credit for foreign taxes levied on the earnings out of which a dividend is paid by it.²⁴ In essence then, this preferential

20. Section 931(a)(1) and (2) of the Code.

21. Section 931(a) of the Code.

22. H. J. Rudick and G. S. Allen, "Tax Aspects of Operations Under the Puerto Rican Exemption Program", 7 Tax Law Review 403 (1952).

23. Section 1504(b)(4) of the Code and Section 901(c) of the Code.

24. Section 901(d)(1) of the Code.

tax treatment to U.S. tax corporations is one which provides complete exemption for foreign source income to the qualifying U.S. corporation and is a significant departure from the U.S. worldwide jurisdictional principle designed to encourage investment in U.S. possessions.

(iii) Domestic International Sales Corporation

The Domestic International Sales Corporation is a third major type of U.S. corporation that receives preferential U.S. tax treatment on foreign income. The DISC concept was created in order to give U.S. tax preference to the export of U.S. products.²⁵ A DISC is a U.S. corporation that is not subject to U.S. corporate income tax at all. Rather, one-half of its taxable income is imputed to its shareholders annually, whereas the other half of the income may be retained by the DISC and the tax on it deferred until ultimately distributed.²⁶ In order to qualify as a DISC, a U.S. corporation must basically have at least 95 percent of its gross receipts from qualified export activity and 95 percent or more of its assets must be invested in assets related to export activities.²⁷ Of particular interest

25. Report of the Senate Committee on Finance on H. R. 10947, 93rd Congress, 2nd Session, Sections 501-502.

26. Section 991 and Section 995(b)(1)(D) of the Code.

27. Section 992(a)(1) of the Code.

in the DISC area is the fact that it is a U.S. corporate entity that need have very little in the way of substance with special rules having been developed to assure it a certain amount of profit even though it need not meet the regular arm's length criteria set forth in Section 482 of the Code as described later.²⁸ This type of U.S. corporation highlights the preferential treatment which U.S. corporations can receive notwithstanding the basic jurisdictional principal that U.S. corporations are subject to tax on their worldwide income.²⁹

At this point then, we can appreciate that there are exceptions of the types noted above to the general rule that U.S. corporations are subject to tax on their worldwide income and are able to deduct their worldwide losses. We will now examine how this erosion of the global taxing jurisdiction extends still further in the area of foreign subsidiary earnings.

2. Deferral of U.S. Tax on Certain Foreign Income

A foreign corporation, which is defined under U.S. tax law as a corporation created under the laws of a foreign country, is not subject to U.S. income tax on its income unless it is engaged in trade or business in the United States or generates income from U.S. sources.³⁰ Its earnings and profits

28. Treas. Regs. Sec. 1.994-1(a)(1).

29. Section 991 of the Code.

30. Section 881 and 882 of the Code.

however, are subject to U.S. tax when distributed as dividends to U.S. shareholders over whom the worldwide jurisdiction is asserted.³¹ The effect of this combination of basic jurisdictional rules is usually referred to in international tax circles as "tax deferral". That is because the United States tax on foreign source income earned by foreign corporations is deferred (i.e. postponed) until the foreign corporation pays dividends to its U.S. shareholders.³² This aspect of the U.S. tax system illustrates the two independent jurisdictional contexts mentioned earlier, namely, the status of the taxpayer (the foreign corporation), and the source of its income (U.S. sources).

A corporation organized under the laws of a foreign country is treated as a foreign corporation and is therefore taxable only on income derived from activity within the United States. An entity is treated as a foreign corporation even if it is wholly owned by U.S. shareholders and even if it is managed or controlled from within the United States.³³ It is because of these rules that the U.S. tax on foreign income of foreign subsidiaries of U.S. corporations is deferred until dividends are

31. Section 243(b)(1) and (5) of the Code.

32. J. Kaczmarek, "Tax Saving Incentives to Foreign Trade", 47 Georgia Law Journal 88 (1958) and O. Oldman, "United States Tax Laws and Treaties Affecting Private Foreign Investment", 19 Federal Bar Journal 342 (1942).

33. Section 7701(a)(5) of the Code.

paid to the U.S. shareholders. At that time, the income becomes taxable since we now know the United States asserts jurisdiction over the global income of the U.S. corporate recipient of the dividend.³⁴ At this early point, then, we can see a very basic element in the U.S. tax system as it related to foreign income of U.S. corporations which is generated by those U.S. corporations through the means of foreign subsidiaries corporations which they organize and control.

It is important to note at this stage that the United States is somewhat unique in placing such a heavy emphasis on the place of incorporation of a corporate entity for the purposes of determining whether it is domestic or foreign.³⁵ Given this rather rigid definitional boundary, a U.S. based corporation is free to organize foreign corporate subsidiaries and defer U.S. taxation on the income of those subsidiaries until the parent decides to have dividends declared out of the foreign subsidiary and subjected to U.S. taxation. Furthermore, while these foreign source dividends are ultimately subject to a full U.S. tax when

34. Section 11 and 61 of the Code.

35. Implications of Multinational Firms for World Trade and Investments for U.S. Trade and Labor, Report to the Committee on Finance of the United States Senate and its Subcommittee on International Trade on Investigation No. 332-69 under Section 332 of the Tariff Act of 1930, Committee on Finance, United States Senate, 93rd Congress 1st Session, Volume 1, pp. 68-73.

received by domestic corporations, we shall see later in our study that a credit against U.S. tax is given to the domestic corporation for foreign income taxes incurred by their foreign subsidiaries attributable to the earnings out of which the dividend was declared.³⁶

A major point to note, at this point, is that this deferral of U.S. tax is not counterbalanced by a loss of the right to claim credit for the foreign taxes. For purposes of the foreign tax credit, we will see that the total corporate tax structure of the domestic parent and its foreign subsidiaries is treated as a single taxpayer operating on a global scale, with the exception that foreign subsidiary losses may not be utilized to reduce the taxable income of the U.S. parent.³⁷ As a result in foreign countries where the tax rate is lower than the U.S. corporate rate - a result that we will see is true from the analysis of our empirical data in later chapters - operations conducted through foreign corporations permit the use of funds abroad for reinvestment and expansion of foreign operations which would have been paid in taxes in the United States if the business had not been carried on by foreign subsidiaries of U.S.

36. Section 902(a) of the Code.

37. E. A. Owens, The Foreign Tax Credit, (Harvard Law School International Program in Taxation, Cambridge, Massachusetts, 1961) pp. 2, 9-12.

corporations. The lower rate of foreign taxation, the greater advantage of deferral, since it is the difference between the amount of foreign tax and the amount of the U.S. tax which is deferred.

3. Current Taxation of Income of Controlled Foreign Corporations

We have just seen that, as a general rule, the foreign source income of foreign corporations controlled by U.S. corporations is not subject to United States tax until it is distributed as dividends. As with all general rules, there are exceptions. To curb tax avoidance, the Revenue Act of 1962 contained certain provisions which sought to eliminate this deferral of U.S. tax in certain cases by imposing a tax on U.S. shareholders with respect to their share of undistributed profits of controlled foreign corporations.³⁸ In substance, the income which is to be subjected to current tax is treated as a constructive dividend. These tax provisions were intended to apply chiefly to the income of so-called tax haven corporations.³⁹ These are corporations

38. M. Norr, "Jurisdiction to Tax and International Income", 17 Tax Law Review 431 (1962).

39. President's Tax Message Along With Principle Statement, Detailed Explanation and Supporting Exhibits and Documents, 87th Congress, 1st Session (1961). See also, Hearings Before the Senate Committee on Finance on H. R. 10650, 87th Congress, 2nd Session 98-103, pp. 173-242.

incorporated in foreign countries which impose little or no income tax on income derived from foreign sources.⁴⁰ They have been used by U.S. corporations to take advantage of U.S. and foreign tax laws or tax treaties in order to defer U.S. tax and reduce foreign taxes by serving as buffer companies between foreign source income and the taxation of the U.S. shareholders. Thus, they immunize foreign income from immediate U.S. taxation.⁴¹

In essence, these provisions sought to eliminate deferral of U.S. tax on tax haven type earnings generated by U.S. controlled foreign corporations from insurance of U.S. risks, base company sales and service operations and holding company activities.⁴² Whether income becomes taxable under these so-called Subpart F provisions, and thereby provides an exception to the normal rules on deferral of U.S. tax on foreign income, is determined by several factors. This taxation of a U.S. shareholder on undistributed income of a foreign corporation not only depends on the control of the corporation by U.S. persons, but also requires

40. For a description of these tax saving operations and background for the legislation, see Doing Business Abroad, Henry London (Ed.), (Practicing Law Institute, New York, 1962), pp. 533-581.

41. W. J. Gibbons, Tax Factors in Basing International Business Abroad, (Harvard Law School, International Program in Taxation, Cambridge, Massachusetts, 1957), pp. 17-38.

42. R. W. Wales, "Tax Policy in Relation to Foreign Business Income - The Revenue Act of 1962", 40 Taxes 961 (1962).

the ownership of a substantial amount of stock in the foreign corporation by a U.S. shareholder,⁴³ the existence of tax haven characteristics of the foreign corporation's income,⁴⁴ and the use to which the income will be put.⁴⁵

While these provisions are extremely complex and are a subject unto themselves, the significance of these provisions for purposes of our study is to highlight the fact that not all foreign earnings of all foreign subsidiaries of U.S. corporations are deferred from U.S. taxation. Putting these provisions in perspective, however, it should be noted that they have not resulted in the imputation to U.S. corporate shareholders of a major portion of the earnings of foreign subsidiaries.⁴⁶ This seems to be due to the fact that, at the time these provisions were enacted in 1962, a number of relief provisions were also enacted.⁴⁷ These relief provisions have enabled many U.S. corporations to buffer themselves from the potentially harmful effects

43. Section 957 of the Code.

44. Section 951 and 954 of the Code.

45. Section 951 and 956 of the Code.

46. Supplemental Statistics of Income 1964, 1965 and 1966. Foreign Income and Taxes - Corporation Income Tax Returns, Department of the Treasury, Internal Revenue Service, Publication 479 (4-73), (U.S. Government Printing Office, Washington, D.C., 1973), pp. 245-253.

47. Section 954(b), 963 of the Code.

of this legislation.⁴⁸ However, since the Tax Reduction Act of 1975 did contain provisions that removed several of these relief provisions for taxable years beginning in 1976, these Subpart F provisions may impact more heavily on U.S. based corporations in the future.⁴⁹ Because of the foregoing developments, the deferral concept in the U.S. tax law is an extremely important one. It provides a basic means whereby earnings of foreign subsidiaries of U.S. based corporations are shielded from U.S. taxation until such time as the U.S. parent corporation decides to receive the earnings in the form of taxable dividends. We will see, when analyzing actual empirical data, that this deferral concept has a significant bearing on the impact that foreign tax burdens make on U.S. corporations; which is an important aspect of our study.

4. U.S. Taxation on Ultimate Repatriation

A further factor which is important for an appreciation of the U.S. tax system as it relates to the earnings of foreign subsidiaries of U.S. based corporations is the manner in which the earnings of foreign subsidiaries of U.S. corporations are taxed to U.S. shareholders when the profits are ultimately realized, not by the payment of dividends, but by the

48. J. Harris, "Foreign Base Companies Under the 1962 Act: Relief Provisions and Areas for Tax Planning", University of Southern California Tax Institute (1964), p. 287.

49. Tax Reduction Act of 1975, Section 602.

taxable sale or exchange of the stock of the corporate entity. Prior to the Revenue Act of 1962, U.S. corporate shareholders could effectively realize the profits of a foreign subsidiary at capital gains rate by liquidating the corporation or by selling or exchanging its stock.⁵⁰ While this is true of domestic corporations, several Code provisions prevent domestic corporations from accumulating excessive profits to avoid the tax on dividends, and the earnings of domestic corporations are, in any event, subject to full U.S. tax as they are earned.⁵¹ Since, for most types of businesses, it is possible to insulate foreign income as earned from the reach of U.S. tax jurisdiction by incorporating a foreign subsidiary, a great deal of foreign operations of U.S. persons are carried on through foreign corporations. Prior to the Revenue Act of 1962, there was little in the Code to discourage the use of foreign corporations. The only obstacles or restrictions were the foreign personal holding company provisions and Code sections 367 and 1491 - 1492, which had a relatively limited scope.⁵²

50. W. H. Horne, Jr., "Foreign Tax Planning - Company, Branch, or Independent Organization, 17 NYU Tax Institute 349 (1959).

51. Section 531 of the Code.

52. S. Z. Siegal, "Section 367 of the Internal Revenue Code and Its Relationship to the Taxation of Certain Transactions Involving Foreign Corporations", 22 Federal Bar Journal 109 (1962) and J. H. Alexander, "Foreign Personal Holding Companies and Foreign Corporations that are Personal Holding Companies", 67 Yale Law Journal 1173 (1958).

The Revenue Act of 1962 by introducing Section 1248 imposed a tax at ordinary income rates - rather than the lower capital gains rate previously applicable - on some or all of the gain realized and recognized by U.S. shareholders from the sale or exchange of stock in a controlled foreign corporation. In essence, the gain is taxed as a dividend to the extent of the earnings and profits of the foreign corporation attributable to the stock whenever a sale or exchange of the stock, or a liquidation, of a controlled foreign corporation takes place and gain is recognized.⁵³ Section 1248 is designed to assure that accumulated earnings of controlled foreign corporations that are realized by U.S. shareholders through a liquidation or a sale or exchange of stock will eventually bear the full U.S. corporate tax at the same rate as if the earnings were distributed as dividends. The gain on the sale or exchange of stock is treated as dividend income and is taxed at the ordinary income rates only to the extent of the corporation's earnings and profits accumulated after 1962. To the extent that the amount of gain exceeds the earnings and profits, the excess is taxable at capital gains rates.⁵⁴

Inasmuch as undistributed earnings of controlled

53. Section 1248(a) of the Code.

54. A. G. Choate, "Federal Tax Policy for Foreign Income and Foreign Tax Burdens - History, Analysis and Prospects", Temple Law Quarterly, Volume 44, No. 4, (1971), pp. 471-473.

foreign corporations are subject to tax as if they were dividends under Section 1248, domestic corporate shareholders are entitled to a deemed paid foreign tax credit for foreign income taxes incurred on those earnings.⁵⁵ In the next section of this chapter, we will see exactly the significance of this deemed paid foreign tax credit. At this point, however, it is important to note that a deemed paid foreign tax credit would not normally be allowable on corporate liquidations or on the sale of the stock.⁵⁶ Therefore, it should be noted that the treatment of corporate shareholders under Section 1248 may be more favorable to the taxpayer in some cases than under prior law. This would generally be the case where the effective foreign tax rate at the subsidiary level is substantially close to the U.S. corporate tax rate. In such an instance, the foreign tax credit will eliminate most, if not all, of the U.S. tax on the gain whereas if the capital gains tax applied, a substantial U.S. tax would be incurred. That is because the treatment as a dividend would result in U.S. tax being incurred only after giving effect to the foreign tax credit deemed paid whereas capital gains taxation would be applied without recognition for any underlying foreign taxes incurred by the subsidiary.

55. Section 1248(a) and Section 902(a) of the Code.

56. Associated Telephone and Telegraph Company, 306 F. 2d. 824 (2nd Cir. 1962).

An important aspect of the rules dealing with U.S. taxation of foreign subsidiary earnings for purposes of our study is that such tax is generally deferred until the earnings are actually distributed. Furthermore, where those earnings are not distributed, but are realized by means of liquidation of the foreign corporation or a taxable sale or exchange of the stock, U.S. shareholders must still include the gain on such disposition in income as a dividend to the extent of the earnings of the subsidiary attributable to the gain. However, the impact is modified since the indirect foreign tax credit may be utilized to offset the U.S. tax on the dividend. In essence, then, we see the deferral concept postpones U.S. taxation of earnings of foreign subsidiaries until such time as the U.S. shareholders require that those earnings be realized through the form of dividends or disposition of the shares. Even in these latter situations, however, the foreign tax burdens incurred by the foreign subsidiary provide a hidden reservoir of tax credits to be used in the future to offset the U.S. taxation.

B. The Role of the Foreign Tax Credit in the U.S. Taxation of Foreign Income of U.S. Corporations

Up to this point, we have seen that the United States imposes a worldwide jurisdiction in the taxation of earnings of U.S. corporations. Furthermore, selecting the criterion of place

of incorporation for its definition of a domestic corporation produces a wide range of corporate entities over which worldwide jurisdiction is imposed. With the exception of certain specific types of U.S. corporations that receive preferential treatment, such as Western Hemisphere Trade Corporations, Possessions Corporations, and Domestic International Trade Corporations, this worldwide principle pulls into the U.S. tax system the global income of most U.S. corporate entities. However, we also now know that a major exception to this worldwide jurisdiction exists in the case of foreign subsidiaries of U.S. corporations. Because of the reliance on place of incorporation for determining domesticity, U.S. corporations are able to conduct foreign operations by means of subsidiaries incorporated outside the United States and defer U.S. taxation on the earnings of those subsidiaries. We have further seen that when the earnings of those subsidiaries are repatriated (an event under the control of the U.S. corporation), either by means of dividends or by means of disposition of the stock of the corporation, a foreign tax credit is available for offsetting U.S. tax on those earnings. At this point then, we have gained familiarity with the basic U.S. tax rules dealing with the international aspects of U.S. corporations conducting foreign operations. We must now examine the role whereby foreign tax burdens incurred by U.S. based corporations in their foreign

operations are utilized within the U.S. tax system to offset the U.S. tax liabilities of those U.S. based corporations.

Given the tax policy established in the United States tax law with regard to taxing the worldwide income of U.S. incorporated entities, the next most important aspect of the U.S. tax system as it relates to the foreign income of U.S. corporations is the manner in which the United States addresses itself to the problem of relief from double taxation. As we proceed, we will see that the United States has adopted the foreign tax credit as the mechanism to be available to U.S. corporations to deal with the absorption of foreign tax burdens in the U.S. tax system. However, in order to put the U.S. foreign tax credit system in proper perspective for our study, we must first gain an appreciation of exactly what double taxation involves and the unilateral relief measures that have been considered on an international scale to meet this problem. It is these points to which we now turn our attention since, as we will see later in the examination of empirical data, they form an essential conceptual background for any evaluation of the impact of the actual foreign tax burdens incurred by U.S. based corporations and the manner in which they are actually being absorbed in the U.S. tax system.

1. The Basic Concept of Double Taxation

To establish an appreciation of the concept of

double taxation, it is important that we understand the principles involved in the basic systems of taxation as they relate to international transactions. To set the stage, we must at once realize that no rules of international law exist to limit the extent of any countries tax jurisdiction. Similarly, no rules exist to require a country to grant relief from international double taxation. As of now, such rules exist only to the extent they may be provided by tax treaty in any particular case. Moreover, only in a few countries are there any local constitutional limitations on its jurisdiction. Within its own legal and fiscal framework, a country is free to adopt whatever rules of tax jurisdiction it chooses. This is true no matter how broad may be the reach of the resulting tax net.⁵⁷ Furthermore, there is nothing immutable about the rules of tax jurisdiction, the extent of relief from international double taxation, or the methods of providing such relief which a particular country may apply at any particular time. These are grounded in a country's economic, political, and fiscal status at home and abroad. As that status changes from generation to generation, change in these rules and

57. Bruins, Einaudi, Seligman and Stamp, League of Nations Report on Double Taxation, Finance Committee, Economic and Financial Commission, League of Nations, Berne, (1923) and Stanley S. Surrey, "Current Issues in the Taxation of Foreign Corporate Investment", 56 Columbia Law Review 815 (1956).

methods may be necessary as well.⁵⁸

This freedom of choice available to nations and their choice of jurisdictional rules, the different economic conditions with which they must deal, the resulting diversity in tax structures, all combine to make for the potential of international double taxation. Tax jurisdiction in practice however is a different matter from tax jurisdiction in theory. However, lawful an assertion of tax jurisdiction may be, the power to make that assertion effective is nevertheless required.⁵⁹ To be effective, such jurisdiction requires some nexus or minimum connection between the country asserting the jurisdiction and the taxpayer or the income sought to be taxed. It is in this very choice of the minimum connection necessary to permit the effective application of jurisdiction that tax patterns begin to appear.

One major type of income tax system is the global or unitary system. This is the system found in the United States.⁶⁰

58. J. T. Lang, The Common Market and Common Law, American Bar Foundation Study, (University of Chicago Press, Chicago and London, 1966), pp. 239-252.

59. Klimowsky, "Unilateral Measures for the Avoidance of Double Taxation, Especially as Regards Fiscal Aspects of the Relationship Between Capital Exporting Countries and Countries in the Process of Development", 43 Cahiers de Droit Fiscal International, No. 7 (1961), pp. 13-14.

60. R. P. Baker, Jr., "Taxation of Foreign Income and Foreign Business in Europe, Taxation of Foreign Income, (Tax Institute of America, Princeton, New Jersey 1966), pp. 3-29.

It uses a broad concept of income and within that concept every kind of income is taxed more or less the same way. The jurisdictional connection is the personal status of the taxpayer rather than the source of its income. If the taxpayer is a resident of the country (however defined), the country asserts jurisdiction to tax its entire income from all sources. Having jurisdiction over the person, the country is in a position to make that assertion effective. The significant result of such a system is that income from foreign sources is taxed along with domestic source income.⁶¹

The other major category of income tax systems is the so-called schedular system.⁶² The essence of this system is the concept that there are qualitative differences in different kinds of income. As a result, each different kind is taxed under different rules and at different rates. The jurisdictional connection is the source of the income not the personal status of the taxpayer. A significant result of such a source jurisdiction pattern is that the country of residence does not

61. Peggy B. Musgrave, "International Tax Base Division and Multinational Corporations", 27 Public Finance No. 4 (1972), pp. 394-413.

62. Richard Goode, "Reconstruction of Foreign Tax Systems", Readings on Taxation in Developing Countries, (The Johns Hopkins Press, Baltimore, 1964), pp. 169-179.

assert jurisdiction to tax income for foreign sources.⁶³

Within these broad jurisdictional frameworks, we can now view international double taxation. By international double taxation is meant the taxation by two or more taxing jurisdictions of the same income of the same taxpayer. This may arise in one of two ways. Either the jurisdictional connections used by different countries may overlap or the taxpayer, or his income, may have connections with more than one country. The taxpayer, for example, may be a resident of a country which taxes all its income wherever it arises (e.g. United States). If some of that income arises in another country, it will be taxed there as well. Although no rules of international law forbid international double taxation, the fact that no principles of international or even constitutional law require relief to be given does not mean that relief is generally denied. The necessities of commercial and fiscal coexistence - often grounded in considerations of their administrative convenience - have lead many nations of the world to voluntarily limit the scope of their tax jurisdiction. Some of these restrictions are unilateral,

63. Francisco Forte, "Comment on Schedule and Global Income Taxes", Readings on Taxation in Developing Countries, (The Johns Hopkins Press, Baltimore, 1964), pp. 185-187.

some are bilateral, and some are multilateral.⁶⁴

Based on these considerations of the basic systems of taxation from an international standpoint and the manner in which they can give rise to double taxation, we are now in a position to more closely examine the way in which these tax systems lead to unilateral relief from the problems of double taxation.

2. Unilateral Relief from Double Taxation

Given the existence of the two major types of taxing systems available to countries around the world - as well as the potential for the creation of international double taxation - it has become fairly common in practice for countries to adopt unilateral relief measures from double taxation. Most countries now have some accommodations in their internal law to take account of the tax liabilities borne by their taxpayers in countries in which their foreign source income originates.⁶⁵ Such unilateral methods of relief generally fall into either of two classes depending largely on whether the tax system is schedular or unitary.

64. J. T. Lang, "Unilateral Relief from Double Taxation", The Common Market and Common Law, American Bar Foundation Study, (University of Chicago Press, Chicago and London, 1966), p. 283.

65. L. Mills and H. J. Gumpel, "Taxation of Foreign Source Income by Other Countries", Federal Tax Treatment of Foreign Income, (The Brookings Institution, Washington, D.C., 1964), pp. 112-137.

For the most part, countries that now have or formerly had a schedular system followed the exemption method.⁶⁶ France, for example, exempts the income earned by its corporations from permanent establishments located abroad. Whether the foreign income is actually subject to tax abroad is immaterial.⁶⁷ Australia by contrast applies an exemption to all foreign income other than dividends but only if the income has been subject to tax in the country of source.⁶⁸

In those countries using the unitary system of taxation, on the other hand, the tax credit method is the more typical method of unilateral relief.⁶⁹ There are influential forces in the tax field who prefer the exemption method of unilateral relief with its outright exemption of foreign income - regardless of the extent, if any, to which the income is taxed abroad - to the subtle complexities of the foreign tax credit.⁷⁰

66. C. Cosciani, "Fiscal Problems of the Common Market", Joint Tax Program Inter-American Development Bank, Economic Commission for Latin America on Fiscal Policy for Growth in Latin America, (The Johns Hopkins Press, Baltimore, 1965), pp. 359-382.
67. "Taxation of Foreign Income in Europe - France", Guide to European Taxation, (International Bureau of Fiscal Documentation, Amsterdam, the Netherlands, 1973), p. 5.03.
68. Section 23(q) Income Tax and Social Services Contributions Act of Australia.
69. Peggy B. Musgrave, United States Taxation of Foreign Investment Income, (Harvard Law School, International Tax Law Program, Cambridge, Massachusetts, 1969), pp. 71-76.
70. P. Richman, Taxation of Foreign Investment Income, (The Johns Hopkins Press, Baltimore, 1966), pp. 173-183.

The tax credit method has the advantage of assuring that one tax or the other, the foreign or the domestic, must be paid. For that reason, despite some dissent, the exemption method is generally being regarded as increasingly inappropriate for modern economic activity. The adoption of the foreign tax credit system by Germany, a dominant power in the tax thinking of the Common Market, and its use by such developing countries as India, Pakistan, and Israel suggest that the tax credit system will not be readily abandoned.⁷¹

Another method of unilateral relief from international double taxation is the reduction method. By this is meant income realized abroad is taxed at preferential rates. In Belgium, for example, a leading exponent of this method, the rate is one-fifth the normal rate for some income taxes.⁷² A further method of unilateral relief arises out of the treatment which certain countries apply to foreign subsidiaries. In some countries, it has generally been the jurisdictional tax rule that the earnings of a foreign subsidiary are not subject to tax until remitted to the parent corporation as dividends. We have seen that, as

71. J. T. Lang, The Common Market and Common Law, American Bar Foundation Study, (University of Chicago Press, Chicago and London, 1966), pp. 284-293.

72. "Taxation of Foreign Income in Europe - Belgium", (International Bureau of Fiscal Documentation, Amsterdam, The Netherlands, 1973), p. 2.03.

a general rule, this is the system adopted in the United States.⁷³ Unless and until dividends are paid, there is no problem of double taxation and relief is complete. The availability of tax deferral on the income of foreign subsidiaries has provided some countries the most useful tax encouragement which can be given. Sweden, for example, a most active overseas investor, has operated quite successfully abroad without a foreign tax credit. Its major source of unilateral relief is the recognition which Sweden gives to the form of foreign subsidiaries.⁷⁴

Up to this point, we see that there are several main methods of preventing double taxation on foreign source income: exempting foreign income from local tax, crediting the amount of the foreign tax against local tax, reducing the local rate of tax on the foreign income, and deferring the local rate of tax on foreign income. Finally, there is the availability of deducting the foreign tax in computing the local taxable income base. The first two of these methods are the principal ones, the two which are recommended by the OEEC-OECD Fiscal Committee.⁷⁵

73. E. R. Barlow, and I. T. Wender, Foreign Investment and Taxation (Prentice-Hall, Englewood Cliffs, New Jersey 1955), pp. 102-117

74. Taxation in Sweden - World Tax Series, Harvard Law School, International Program in Taxation, (Little Brown & Co., Boston, Toronto, 1959), pp. 454-459.

75. Exemplified in Articles XXIII and XXIV of the OEEC Fiscal Committee's Draft Model Taxation Convention and Article XXIIIA and XXIIIB of the OECD Fiscal Committee - Draft Double Taxation Convention on Income and Capital (1963).

Deducting foreign tax from taxable income does not reduce the total rate of tax to the higher of the two national rates, therefore, it is generally considered inadequate as double taxation relief. On the other hand, reducing the tax rate on foreign source income may be inadequate or excessive relief depending on the rates of foreign tax involved and the extent of the reduction. Some feel the tax credit system is inappropriate if the foreign tax is partly or wholly shifted by the taxpayer. Since the exemption method does not depend on the amount of foreign tax paid or borne, the same objection cannot be made against it, but it does not purport to achieve tax equality between taxpayers on an international basis.⁷⁶

To more precisely evaluate the system, one must determine whether the ordinary tax credit or full tax credit system is used. If only one country taxes the income in question, an enterprise is, to that extent, in the same competitive position as other enterprises in that country even though it is resident or its income is not from sources in that country. Whether this result is advantageous depends upon the respective tax rates.

76. The deduction method appears most appropriate for dealing with taxes which are passed on since gross income is increased by the extent to which the tax is shifted. See Richman, "Taxation of Foreign Investment Income", 32 Economic Analysis 132 (1963).

Where the ordinary tax credit is used - namely, granting a credit for foreign taxes paid only up to the amount of local taxes attributable to the foreign income in question - the enterprise is in the position of an enterprise in the country with the higher of the two tax rates. However, if the full tax credit is given - namely, a credit for all foreign tax burdens without limitation - it is in the position of an enterprise in the country of residence. The use of the ordinary tax credit does not always result in tax equality and therefore equal conditions of competition between residents of the same country. If the ordinary tax credit is given and the tax rate is higher in the country of source, the company in question is presumably at a competitive disadvantage in comparison with other companies selling the same commodity in the country of residence but not in comparison with other companies operating in the country of source.⁷⁷

Whichever type of credit is given, the higher rate of tax is paid on the income subject to double taxation where the country of source taxes the income at a lower rate. This means that enterprises of the country of residence are at a disadvantage in the country of source in comparison with the residents of that country and probably also in comparison

77. O. Oldman, "U.S. Tax Law and Treaties Affecting Private Foreign Investment", 19 Federal Bar Journal, pp. 342-347 (1959).

with residents of third countries trading in the country of source. Residents of the country of source would have a tax rate different from that of residents of third countries unless the third countries exempted foreign source income from tax.⁷⁸

The special effect of the full tax credit, when the tax rate is higher in the country of source, is a waiver by the country of residence of some of the tax on local income which it otherwise would have received, since the rate on all income is the lower national tax rate. The full credit system, therefore, gives to the taxpayer a subsidy which may or may not be justified from the point of view of the country of residence by the favorable effect of the foreign operations on its balance of payments position or some other reason. Relief against double taxation thus discriminates by giving the full tax credit in cases where a subsidy is justified and ordinary credit where it is not.⁷⁹

In some instances, it is considered more important

78. The competitive disadvantage suffered by the United States in Latin America and elsewhere was the main reason given by United States industry for demanding the introduction of the tax credit system in the United States in 1918. It replaced the system in which foreign tax was only a deduction. See Revenue Act of 1918, Section 322-238, 240(c).

79. C. K. Sullivan, The Search For Tax Principles in the European Economic Community, (Harvard Law School, International Program on Taxation, Cambridge, Massachusetts, 1963), pp. 66-69.

that conditions of competition for a foreign enterprise be the same as those for local enterprises in the state of source. Only the use of the tax exemption method in the country of residence is sure to achieve this result. No method of giving relief can place the enterprise simultaneously in the same competitive position as enterprises in both countries. However, unless the effective tax rates in all countries are similar, a very unlikely result, a choice is therefore necessary.⁸⁰

What has been said up to this point reveals the essential factors for double taxation relief which applies to taxpayers operating a branch operation in the country of source. The situation is different if the operations in the country of source are carried out through a subsidiary and if the tax law of the country of residence of the parent company permits deferral of the tax payable on the profits of the foreign operation until repatriation. In such a case, the subsidiary is taxed in the same way as other similar companies in the country of source. Its foreign ownership does not normally affect its effective tax rate. As long as the subsidiary is taxable only in the country of source, no question of double taxation arises until repatriation

80. "Tax Law of Selected Foreign Countries", The Taxation of Business Income from Foreign Operations - Studies in U.S., Foreign and International Tax Law, (American Management Association, Inc., Report No. 2, 1958), pp. 57-122.

of profits in the form of dividends.⁸¹

An important question, then, arises as to the extent to which the law of the country of residence of the parent company allows a credit to the parent for foreign tax. To equalize competitive conditions, should the country of residence of the parent company treat the foreign source dividends in the same way as the foreign source profits of a branch or as the local source profits of a subsidiary? Countries adopt different policies on economic double taxation of dividends as well as on relief from juridical double taxation. Equal treatment for the profits of a foreign subsidiary and a foreign branch is attractive to some because it looks at the substance rather than the corporate form. However, since a subsidiary is taxed in the country of source in the same way as its competitors, it could be argued that by using the exemption principle, the branch should be treated like a foreign subsidiary.⁸²

As can be seen from the above analysis, the matter of the nature and extent of unilateral relief from double taxation as practiced in various countries is an extremely varied

81. U. Anschutz, "Harmonization of Direct Taxes in European Economic Community", 13 Harvard International Law Journal (Winter - 1972), pp. 1-58.

82. T. Georgakopoulos, "Tax Harmonization and International Income Distribution", 25 National Tax Journal, (December 1972), pp. 541-555.

and complex one. It ranges from those countries which feel that a corporation acting abroad acts at its own peril and must bear the tax consequences of that activity to those countries which subsidize income from abroad by permitting any amount of foreign taxation it incurs to offset the tax liability in the country of residence. The foregoing discussion is important because it now enables us to put in perspective the following exposition of the manner in which the United States has adapted its tax system to this question of unilateral relief from double taxation. The system in the United States, as we will see, borrows from many of the concepts discussed in this section and provides U.S. based corporations with a significant degree of latitude in achieving relief from the foreign tax burdens they incur.

3. The Foreign Tax Credit as Employed in the United States

We now know that under the income tax law of the United States, domestic corporations are taxed on their world-wide income, regardless of its geographic source. When income is derived from sources outside the United States, it will usually be taxed in the countries in which it originates. Consequently, the potential for international double taxation which we have just examined will arise. As we have also seen, there are many possible approaches which a country may take if it wishes to minimize the high rate of taxation caused by the

simultaneous imposition of its tax as the country of residence or nationality of the taxpayer and of the tax of another country as the country of the source of the income. While some other devices are used by the United States, it relies primarily upon its unilateral treatment of foreign taxes to relieve the effects of international double taxation of income.⁸³

Foreign taxes of all types except gift and inheritance taxes are deductible from gross income in computing United States taxable income, just as state taxes are deductible.⁸⁴ By far, the most important relief, however, is that provided by the foreign tax credit. Under these provisions, domestic corporations may at their option credit rather than deduct foreign income taxes.⁸⁵ This treatment of foreign income taxes as a direct offset against the United States income tax instead of as a deduction from gross income can be very beneficial to taxpayers. Assume, for example, that the United States tax rate applicable to a U.S. corporation is 50 percent, foreign source taxable income before foreign tax is \$100, and the foreign tax paid is \$30.00. If the foreign tax is used as a deduction, taxable income becomes

83. E. Owens, "United States Income Tax Treaties - Their Role in Relieving Double Taxation", 17 Rutgers Law Review 428-430, (1963).

84. Section 164 of the Code.

85. Section 901 of the Code.

\$70.00 and the U.S. tax would be \$35.00, giving a total of \$65.00 in taxes. When the foreign tax is used as a credit, taxable income is \$100 on which the U.S. tax before credit is \$50.00. After the foreign tax of \$30.00 is credited against this \$50.00, however, only \$20.00 need be paid to the United States. This gives a total of \$50.00 in taxes as compared to \$65.00 if the foreign tax were deducted.

The effect of the foreign tax credit when the foreign tax rate is lower than the U.S. rate as in the above example, is that a tax is paid to the United States at a rate equal to the excess of the U.S. rate over the foreign rate. When the foreign rate equals or exceeds the U.S. rate, the credit cancels the U.S. tax liability completely. In short, the credit generally operates to reduce the effective overall rate of tax to the higher of the foreign or the U.S. tax rate. Double taxation is eliminated because, in effect, tax is paid at the higher of the two rates. When the foreign rate is higher, only the foreign tax is paid; when the foreign rate is lower, the effective overall rate of tax is the U.S. rate even though both foreign and U.S. tax are paid. Consequently, the results for the U.S. taxpayer is the same as if he had paid only the U.S. tax. In this sense, the United States appears to have adopted the

ordinary tax credit and not the full tax credit; but let us examine the U.S. system more closely.⁸⁶

In general, the U.S. income tax system stresses ability to pay and taxable capacity is based on the principle that taxpayers with an equal taxable capacity should bear an equal U.S. tax burden.⁸⁷ Therefore, the source and nature of income from a foreign or domestic source is largely immaterial in the basic tax structure. It is also in accordance with this principle to provide relief from international double taxation by granting a credit for foreign income taxes paid. The credit accommodates the U.S. income tax system to the problem presented by the imposition of foreign taxes on foreign source income while at the same time this principle of tax equality is maintained.⁸⁸ In other words, insofar as unilateral action by the United States can be effective, the results of the operation of the credit is that U.S. corporations with the same amount of income bear an equal total tax burden on income whether or not they are subjected to foreign income taxation. An essential ingredient to be borne in mind for our future analyses involving empirical data is that

86. T. Lang, The Common Market and Common Law, American Bar Foundation Study (University of Chicago Press, Chicago and London, 1966), pp. 313-322.

87. S. Surrey and W. C. Warren, "The Income Tax Project of the American Law Institute", 66 Harvard Law Review 761 (1953).

88. E. Owens, Foreign Tax Credit, (Harvard Law School Program in International Taxation, Cambridge, Massachusetts, 1961), p. 358.

the U.S. foreign tax credit system is not intended to be a full credit as discussed earlier; namely, a credit for all foreign taxes regardless of limitation. Rather, it is intended to use the tax credit in its ordinary capacity; namely, to offset U.S. taxation on foreign source income. This will become important as we review the manner in which U.S. corporations actually utilize foreign tax burdens to offset U.S. taxation. Because the U.S. foreign tax credit system affects so dramatically the manner in which foreign tax burdens impact on U.S. corporations, we must establish a good working knowledge of the important elements of the foreign tax credit system as it is used in the United States before proceeding further.

a) Deduction Versus Credit for Foreign Taxes

The first aspect of the U.S. tax system as it relates to the treatment of foreign tax burdens suffered by U.S. corporations is that the U.S. corporation has the choice of using its foreign income taxes as a deduction in arriving at its taxable income base or may elect to claim them as a credit. This election may be made each year and is not binding for future years thereby giving the U.S. corporation maximum flexibility on an annual basis.⁸⁹ If a taxpayer elects to credit foreign taxes in any year, all eligible taxes paid to foreign countries

89. Treas. Reg. Sec. 1.901-1(a).

or possessions of the United States must be credited and none may be deducted.⁹⁰ When an election is made to credit eligible foreign taxes, however, non-creditable foreign taxes may still be deducted.

b) Parties Entitled to Claim Benefits of Foreign Tax Credit

Under the U.S. tax system, a taxpayer may credit foreign taxes only if it comes within the eligible category of taxpayers, and only if the foreign tax for which a credit is sought was imposed on him.⁹¹ Eligible taxpayers are U.S. citizens, U.S. residents, domestic corporations and U.S. trusts and estates. Foreign corporations, non-resident aliens and foreign trusts and estates are only entitled to claim foreign tax credits under limited circumstances.⁹² Thus, as a general rule, U.S. corporations are entitled to elect to claim foreign taxes as a credit. There are exceptions, however, in the case of Possessions Corporations and Domestic International Sales Corporations discussed earlier. This is due to the fact that the former is not subject to U.S. taxation on any of its foreign source income. Since its foreign income is exempt from taxation,

90. Treas. Regs. Sec. 1.901-1(c), Rev. Rul. 57-106, 1957-1 CB 242.

91. E. Owens, The Foreign Tax Credit, (Harvard Law School Program in International Taxation, Cambridge, Massachusetts, 1961), pp. 358-360.

92. Section 901(b)(4) of the Code.

no foreign tax credit is needed to eliminate double taxation.⁹³

In the case of the Domestic International Sales Corporation, since it is not subject to U.S. taxation at all under Section 991, it has no need for a foreign tax credit.⁹⁴

In general, a credit may be claimed only by the person upon whom the foreign tax was legally imposed. The legal incidence of a foreign tax determines who the taxpayer of that tax is for purposes of the credit.⁹⁵ The right to the credit cannot be shifted from one eligible taxpayer to another by contract nor is the economic incidence of the foreign tax material. In this connection, United States standards for deciding the legal incidence of the foreign tax and not foreign standards are applicable. This concept will become important in later segments of our study because of the manner in which foreign taxes are imposed by certain foreign countries and the manner in which U.S. corporations tend to influence the incidence of taxation where one party may be able to use the foreign taxes as a credit while another cannot.

93. Section 901(d)(1) of the Code.

94. Section 901(d) of the Code.

95. E. Owens, The Foreign Tax Credit, (Harvard Law School, International Program in Taxation, Cambridge, Massachusetts, 1961), p. 360. See also Biddle 302 U.S. 573 (1938).

c) Types of Foreign Taxes Eligible for Foreign Tax Credit Treatment

Under the U.S. foreign tax credit system, not all levies imposed by foreign governments are eligible for foreign tax credit treatment.⁹⁶ Basically, two kinds of foreign taxes are creditable, income taxes (including war profits and excess profits taxes) and taxes paid in lieu of taxes on income.⁹⁷ In order to qualify as a creditable income tax of the first category, the tax must be an income tax according to U.S. standards. The foreign characterization or classification of a tax is not controlling.⁹⁸ The principal test for identifying a foreign income tax is that the character of its tax base be the same as or approximate to income as defined in the United States tax law. Any foreign corporate tax which is substantially the same kind of tax as the comparable U.S. tax will qualify under this test. Similarity to the U.S. tax in terms of identical deductions, exemptions and other items is not necessary.⁹⁹ Taxes imposed on separate items of income such as dividends, interest, wages, royalties and rentals are also creditable if levied on the recipients of these items.¹⁰⁰ Estimated income taxes collected

96. Treas. Regs. Sec. 1.901-2(a).

97. Section 903 of the Code.

98. E. Owens, Foreign Tax Credit, (Harvard Law School Program in International Taxation, Cambridge, Massachusetts, 1961), pp. 29-31.

99. Treas. Regs. Sec. 1.903-1(a).

100. See Lanman and Kemp-Barclay and Company of Columbia, 6 TC 942 (1956).

under foreign laws which permit foreign taxpayers to estimate their net income have also qualified for foreign tax credit treatment.¹⁰¹ However, production, sales, turnover and export taxes do not generally qualify for the credit nor do taxes whose tax base is not income under the U.S. law, such as taxes based on legacies, imputed rent, or capital.¹⁰²

A recent modification of the U.S. tax law regarding the eligibility of foreign taxes for U.S. tax purposes relates to payments to a foreign country in connection with the purchase or sale of oil or gas extracted in that country. Based on the concern of some in the U.S. Congress as to whether some of these payments were taxes or, in reality, merely disguised royalties, the new law provides that these payments will not be considered a tax if the taxpayer has no economic interest in the oil or gas and either the purchase or sale is made at so-called "posted" prices.¹⁰³ Since this provision is only effective starting in 1975, its impact cannot yet be assessed. However, it is important for our consideration at this early stage of our

101. American Metal Co. vs. Commissioner, 221 F 2d 134 (2nd Circuit 1955), cert. den. 350 U.S. 829 (1959).

102. Keasby and Mattison Co. vs. Rothensies, 133 F 2d 894 (3rd Circuit 1943) cert. den. 320 U.S. 7 1939 (1943), Seatrains Lines, Inc., 46 BTA 1076 (1942) and I. T. 3768, 1945 CB 204.

103. Tax Reduction Act of 1975, Section 601(b).

study, since it illustrates the closeness with which these particular foreign levies are being scrutinized to assure their eligibility as foreign tax credits.

In order to qualify as a creditable "in lieu" tax, the foreign tax must be a substitute for a qualifying income tax. That is, it must replace or partially replace an income tax which would be imposed on the taxpayer if it were not subjected to the "in lieu" of taxes.¹⁰⁴

The credit is granted for qualifying taxes paid or accrued to a foreign country or to any possession of the United States. Taxes paid to a foreign country include those paid to subdivisions of the foreign country such as provinces, states, cantons, cities, as well as taxes paid to national government. Possessions of the United States for purposes of this credit would be Puerto Rico, the Virgin Islands and Guam.¹⁰⁵

The foregoing outline of the taxes which are eligible for foreign tax credit treatment provides important groundwork for our study because of the discussion in recent years of whether the amounts imposed by certain oil-producing countries as taxes on U.S. oil companies are in the nature of foreign income

104. E. Owens, Foreign Tax Credit, (Harvard Law School Program in International Taxation, Cambridge, Massachusetts, 1961), pp. 28-29.

105. Treas. Regs. Sec. 1.901-2(c).

taxes which should be eligible for foreign tax credit treatment or are, in reality, not qualified because they do not meet the standards set forth above.¹⁰⁶ As we have just seen, this is a current topic of interest because of the recent change in the U.S. tax law on this very subject. Admittedly, the distinctions here are quite complex. But the basic rules underlying this significant aspect of the foreign tax credit system in the United States will be important for our later considerations of specific empirical data in this area.

d) Levels of Foreign Taxation for Which U.S. Corporations Can Claim a Foreign Tax Credit

We have seen in an earlier portion of this chapter that the United States imposes a worldwide jurisdiction on the taxation of income of U.S. corporations. We have also seen, however, that there is a deferral of U.S. taxation as it relates to foreign earnings of U.S. corporations generated through the use of foreign subsidiary structures. We will now see how this worldwide jurisdiction principle is applied in terms of the manner in which the foreign tax credit system works with regard to the repatriation of earnings of foreign subsidiaries to U.S. corporate shareholders.

106. Analysis on Tax Data on Seven Major Oil Companies prepared for Senate Permanent Subcommittee on Investigations and Released by Chairman H. M. Jackson (D-Wash.) December 1, 1974.

Under the U.S. foreign tax credit system, a U.S. corporation is deemed to have paid qualifying taxes imposed upon its foreign subsidiaries and sub-subsidiaries.¹⁰⁷ The taxes thereby become creditable by the U.S. corporation under Section 901. This so-called indirect or deemed paid credit is granted to domestic corporations with regard to taxes paid or accrued by foreign corporations in which they have a certain equity interest. Under the U.S. tax system, the deemed paid credit is not available to individual shareholders in foreign corporations.¹⁰⁸ Under U.S. tax concepts, individuals are not considered to have borne the burden of a corporate income tax. Corporate shareholders in the United States, on the other hand, are granted relief from double imposition of the United States corporate income tax and, under Section 902, comparable relief from international double taxation is afforded.¹⁰⁹

In 1918 when the foreign tax credit was first adopted in the United States, a domestic corporation was permitted a credit for foreign taxes paid by a majority-owned foreign subsidiary (first tier foreign corporation) on earnings which were distributed to the domestic corporation.¹¹⁰ The required

107. Section 902(a) of the Code.

108. Treas. Regs. Sec. 1.902-1(a).

109. Sections 243-246 of the Code.

110. Revenue Act of 1918, Chapter 18, Section 238, 240(c).

ownership for first tier companies was reduced from 50 to 10 percent in 1951.¹¹¹ In 1942, the credit was extended to second tier foreign corporations which were 100 percent owned by a first tier foreign corporation.¹¹² This 100 percent ownership requirement of a second tier foreign corporation was lowered to 50 percent in 1951.¹¹³ In 1971, Congress made two important changes in this area. One change reduces the required ownership between a first tier and second tier corporation from 50 percent to 10 percent. The other change extended the credit to foreign income taxes paid by a third tier foreign corporation in which a second tier foreign corporation has at least a 10 percent ownership interest.¹¹⁴

We now find the situation in U.S. tax law whereby an indirect foreign tax credit is allowed for foreign taxes paid by a second tier foreign corporation which is only 10 percent owned by the first tier foreign corporation, where its earnings are distributed through the first tier corporation as dividends to the domestic corporation. The percentage of ownership prior to 1971 was at least 50 percent of the second tier corporation's voting power. Similarly, since 1971, an

111. Revenue Act of 1951, Sections 332(a) and 332(b).

112. Revenue Act of 1942, Section 158(e).

113. Revenue Act of 1951, Section 332(b).

114. Public Law 91-684 modifying Section 902(b) of the Code.

indirect foreign tax credit is allowed for foreign taxes paid by a third tier foreign subsidiary in which the second tier foreign subsidiary has at least a 10 percent interest. In each instance, the indirect credit is allowed only if the domestic corporation has an indirect ownership of at least 5 percent in both the second and third tier foreign corporation.¹¹⁵

From this, it can be seen that there is a significant degree of latitude, not only in terms of the levels from which foreign tax credits can flow to U.S. corporations and offset their U.S. tax liabilities, but also in terms of the percentage ownership which they need have. The U.S. corporation need not have a controlling interest in foreign corporations at any level of the chain of foreign corporations in order to claim the foreign tax credit. The overall requirement is only that there be at least a 10 percent ownership at the first tier level and at least a 5 percent ownership at the second and third tier level.

This deemed paid credit for taxes paid by a foreign subsidiary is computed as follows: Assume that a dividend of \$1,000 is received by a U.S. parent corporation in January 1975 from a wholly-owned foreign subsidiary. The foreign corporation

¹¹⁵. Section 902(b)(3) of the Code.

is on a calendar year basis and its total profits in 1974 were \$1,500, on which it paid or on which is accrued a creditable foreign income tax of \$600 leaving net profits of \$900 available for distribution. Its total profits in the year 1973 were \$1200 on which it incurred a creditable foreign income tax of \$480, leaving \$720 net profits available for distribution. Since dividends are deemed to be paid out of the most recently accumulated profits, in this example, they are first ascribed to the \$900 net profits of 1974 and then to the \$720 net profits of 1973 to the extent necessary to account for the remainder of the \$1,000 dividend.¹¹⁶ The amount of credit is calculated separately for the foreign creditable taxes paid on each year's profits distributed. The amount of the foreign tax creditable for each year is that part of the tax which bears the same relationship to the total tax paid as the amount of the dividends attributable to a given year's net profit and received by the domestic corporation bears to the total net profits of that year. Consequently, in this example, the amount of Section 902 credit which may be claimed by the domestic parent corporation in 1975 when the dividend is received is \$667 computed as follows:

116. General Foods Corporation, 4 TC 209 (1944).

$$\begin{array}{r} \$600 \text{ (1974 Foreign Tax)} \times \frac{\$900}{\$900} \text{ (Dividend Related to 1974)} \\ \text{ } \quad \quad \quad \text{ } \quad \quad \quad \text{ } \quad \quad \quad \text{ } \quad \quad \text{ (1974 Net Profits)} \end{array}$$

$$= \$600$$

$$\begin{array}{r} \$480 \text{ (1973 Foreign Tax)} \times \frac{\$100}{\$720} \text{ (Dividend Related to 1973)} \\ \text{ } \quad \quad \quad \text{ } \quad \quad \quad \text{ } \quad \quad \quad \text{ } \quad \quad \text{ (1973 Net Profits)} \end{array}$$

$$= 67$$

Total taxes paid by subsidiary which are deemed
by parent corporation \$667

The credit for taxes paid by second and third tier foreign subsidiaries would be calculated according to the same principle. However, several additional steps are involved. First, it would be necessary to compute the portion of the taxes paid by the third tier subsidiary which will be deemed to have been paid by the second tier subsidiary. Then it will be necessary to compute the portion of the total taxes paid and deemed paid by the second tier subsidiary which will be deemed to have been paid by the first tier subsidiary. The credit is taken at the point when the first tier subsidiary distributes a dividend to the domestic corporation from the profits of those years in which it received dividends from the second and, indirectly, third tier subsidiaries. At that time, the parent

may claim a credit for the amount of the subsidiary's foreign taxes deemed paid using the same computation as for foreign taxes actually paid by the first tier subsidiary.¹¹⁷

For purposes of our study, it is also important to know that the deemed paid credit is further complicated in the U.S. tax system because of the so-called "gross-up" provisions. In order to prevent the allowance of a deduction as well as a credit for foreign taxes, the amount of dividend actually received is grossed up for the amount of the foreign tax credited.¹¹⁸ Thus, under the facts shown in the above example, the United States tax against which the credit is taken is computed by applying the tax rate to \$1,667 - that is, the \$1,000 dividend received plus the \$667 credit. This method of calculation - which permits a credit and no deductions for foreign creditable taxes - is not used when the dividends are received from a foreign corporation which qualifies as a less developed country corporation.¹¹⁹ Prior to the Revenue Act of 1962, the dividend giving rise to a Section 902 credit was not grossed up by the amount of foreign taxes credited, so that in effect the domestic corporation also received a deduction for the foreign taxes paid by its subsidiaries. At the same time, the entire

117. Section 902(b)(1) and 902(b)(2).

118. Section 78 of the Code.

119. Section 902(a)(2) of the Code.

foreign tax could not be credited, but rather only that portion attributable to the net profits distributed. At the present time, gross-up is not required of dividends from less developed country corporations. Using the same figures as in the above example, this credit is computed as shown below:

$$\begin{aligned} \$600 \text{ (1974 Foreign Tax)} \times \frac{\$900 \text{ (Dividend Related to 1974)}}{\$1500 \text{ (Pre-tax 1974 Profits)}} \\ = \$360 \end{aligned}$$

$$\begin{aligned} \$480 \text{ (1973 Foreign Tax)} \times \frac{\$100 \text{ (Dividend Related to 1973)}}{\$1200 \text{ (Pre-tax 1973 Profits)}} \\ = 40 \end{aligned}$$

$$\begin{aligned} \text{Total taxes paid by subsidiary which are deemed paid} \\ \text{by parent corporation} \\ = \underline{\underline{\$400}} \end{aligned}$$

Thus, it can be seen that, by using pre-tax profits rather than net profits after foreign tax in the denominator of the fraction, credit is disallowed for that portion of the foreign tax attributable to those profits paid over in taxes to the foreign government and, hence, not included in U.S. taxable income.

This calculation was changed under the Revenue Act of 1962 on the theory it could produce a lower aggregate tax rate for foreign source income than for U.S. source income or

for foreign source income derived by branches of U.S. corporations. This method was retained, however, with respect to income from less developed country corporations in order to encourage investment in the economically less-advanced countries.¹²⁰

Whether this advantageous method of calculation may be used depends upon whether the first tier foreign corporation is a less developed country corporation. On the other hand, if the first tier foreign corporation is not a less developed country corporation, the gross-up formula applies with the status of the lower tier subsidiaries being immaterial.¹²¹ Consequently, it can be seen that vastly different results can be produced in the computation of the deemed paid credits depending on whether the first tier foreign corporation is a less developed country corporation. Under certain tax reform proposals currently being discussed in the United States, the advantage to be given less developed countries under this deemed paid credit calculation would be removed. The proposal would be to have all companies compute their deemed paid credit using the gross-up concept thereby

120. Revenue Act of 1962, Report of the Committee on Finance of the United States Senate to Accompany H. R. 10650, 87th Congress, 2d Session, Rep. No. 1881 (U.S. Government Printing Office, Washington, D.C. 1962), p. 67.

121. Section 902(a)(2) of the Code.

bringing the treatment of income at the foreign corporation level in line with the treatment of foreign taxes earned on income at a branch level.¹²²

One final point which is important for our study in connection with the deemed paid credit is the manner in which the earnings of foreign subsidiaries are to be computed. In calculating the Section 902 credit, the figures used for the net profits of a foreign subsidiary at the first, second, or third tier must be computed under U.S. tax law.¹²³ Taxable income of a foreign corporation under foreign tax law or its profits under foreign tax or accounting standards are not relevant. This aspect is important because of the fact that, as we will see in our analysis of empirical data, one of the significant reasons for disparities in the treatment of foreign tax burdens of U.S. based corporations and the generation of excess foreign tax credits is the fact that the United States relates the foreign tax burdens to income computed under U.S. standards of taxation, whereas the foreign governments actually levying the tax, compute it on the basis of taxable income using their standards. This aspect of the U.S. tax system is important

122. See, for example, The Energy Tax and Individual Relief Bill of 1974, H. R. 17488.

123. Treas. Regs. Sec. 1.902-3(c)(5).

since it is one of the foundation stones accounting for differences between the foreign statutory rates of taxation and the effective rate of taxation for the foreign country as computed in the United States.

e) Limitation of the Use of Foreign Tax Credits to U.S. Tax Attributable to Foreign Source Income

Perhaps the most important background portion of the U.S. foreign tax credit system for purposes of our study of the foreign tax burdens of U.S. based corporations is the limitation which is placed by the U.S. tax system on the extent to which foreign taxes may be utilized as a credit. We saw in an earlier section of this study the difference between the ordinary foreign tax credit and the full foreign tax credit as those concepts were employed in international tax circles generally. The United States has formally opted away from the full foreign tax credit system and thus does not permit all U.S. corporations to use all amounts of foreign income tax that they incur, as a direct offset to U.S. taxation.¹²⁴ A limitation is placed on the amount of credit based on the theory that the role of the foreign tax credit is merely to prevent international double

¹²⁴. E. Owens, Foreign Tax Credit (Harvard Law School Program in International Taxation, Cambridge, Massachusetts 1961), pp. 282, 284.

taxation and, to achieve that role, it need only offset U.S. tax attributable to the foreign source income. Thus, the ordinary tax credit system is basically the one adopted in the United States. However, as we shall see later in our study, the U.S. rules of operation provide for such significant flexibility to U.S. corporations in this area that some authorities question whether the full credit system is actually in effect.

The amount of foreign tax which a U.S. corporation may use as a credit in any year may be reduced by the application of the limitation system imposed by the Code.¹²⁵ This limitation may be computed either on a "per country" basis or an "overall" basis as a general rule.¹²⁶ At the outset, it should be noted that it is the taxpayer's decision as to whether it chooses to compute the limitation on its foreign tax credit by either the per country or the overall method. Thus, at the outset, it can be seen that the taxpayer has control over the manner in which it will be limited.¹²⁷

The amount of the per country limitation is

125. Under the Tax Reduction Act of 1975, the amount of payments of foreign taxes on foreign oil extraction income that can be treated as creditable taxes is limited to 52.8 percent of taxable income from foreign oil extraction in taxable years ending in 1975. This percentage limit will drop to 50.4 percent for 1976 and to 50 percent for later years. See Section 907(a)(2) of the Code.

126. Section 904(a)(1) and (a)(2) of the Code.

127. Section 902(b)(1) of the Code.

basically the U.S. tax attributable to a taxpayer's income from sources in that particular foreign country. This is computed by multiplying the U.S. income tax (before credit for any taxes) by a fraction, the numerator of which is its taxable income from sources within the foreign country and the denominator of which is total taxable income from all sources.¹²⁸ For this purpose, it should be noted that its taxable income from sources within the foreign country is computed by subtracting from the foreign source gross income from that country, those deductions of the U.S. taxpayer attributable directly or indirectly to that gross income. The per country limitation is computed for each country to which creditable taxes are paid and establishes a ceiling on the maximum amount of credit which may be claimed by the U.S. taxpayer for qualifying taxes paid either directly or indirectly to each foreign country.¹²⁹

If the taxpayer chooses not to use the per country method for computing his limitation, the overall limitation is available.¹³⁰ The taxpayer may choose whichever method gives the better result. The amount of the overall limitation is the U.S. tax attributable to the aggregate foreign source

128. Treas. Regs. Sec. 1.904-1(1).

129. E. Owens, Foreign Tax Credit (Harvard Law School Program in International Taxation, Cambridge, Massachusetts, 1961), p. 203.

130. Treas. Regs. Sec. 1.904-1(d)(1).

income. It is computed by multiplying the U.S. income tax (before credit for any taxes) by a fraction, the numerator of which is taxable income from all foreign sources and the denominator of which is total taxable income from all sources. The amount of credit which may be claimed under the overall limitation is the lesser of the aggregate amount of all foreign creditable taxes or the amount of the computed overall limitation.

The goal of either form of limitation is to preserve to the United States, the full amount of its tax on U.S. source income. The per country limitation, in addition, is supposed to preserve to the United States its tax on income from each foreign country in the amount by which it exceeds the creditable taxes paid to each country.¹³¹

The per country limitation is applicable until a taxpayer exercises its option to use the overall limitation in a given year. However, once this option is exercised, the overall limitation must be used by the taxpayer in all subsequent years, unless the consent of the Secretary of the Treasury or his delegate is obtained to use the per country limitation in a particular year.¹³² In practice, this consent is not often

131. E. Owens, Foreign Tax Credit (Harvard Law School Program in International Taxation, Cambridge, Massachusetts, 1961), p. 215.

132. Treas. Regs. Sec. 1.904-1(d).

given so that, as a practical matter, once a taxpayer has opted to use the overall limitation method, he must stay on that method.

In computing either form of limitation, the quantities used and the applicable fractions are computed under U.S. tax standards. "Total taxable income" in the denominator of the fraction equals the taxpayer's tax base for the U.S. tax against which the credit will be taken. The amount of taxable income derived from a particular foreign country (for the per country limitation) or the amount of total taxable income from sources outside the United States (for the overall limitation) used in the numerator of the fraction is a portion of this total tax base and is computed under U.S. rules for determining the geographical source of income.¹³³ As indicated earlier, the individual country taxable income or the total foreign taxable income is computed by subtracting from the country gross income or foreign gross income those deductions deemed attributable to the gross income using U.S. standards.¹³⁴ This particular aspect of the U.S. foreign tax credit system is extremely important. As we will see in our examination of the empirical data, the computation of the limitation using U.S. standards of gross income

133. Section 861-863 of the Code.

134. Treas. Regs. Sec. 1.861-8.

and deductions is a significant element in the foreign tax credit system. This is because it is basically at variance with the foreign countries' basis for computing the foreign tax. Consequently, this produces disparities between the tax bases to which the foreign tax has to be related. The importance of this will be seen in later chapters of this study.

The effect of the per country limitation is that combined U.S. and foreign taxes are paid on income from each foreign country at the higher of the U.S. tax rate or the effective tax rate in that particular country. The limitation may operate in determining the amount of credit because the foreign statutory rate is higher than the U.S. statutory rate; or because the foreign concept of taxable income is more inclusive than the U.S. concept, thus raising the effective foreign rate above the U.S. rate; or because the foreign country's tax is imposed on income not deemed to be from sources in that country under U.S. source rules. The effect of the overall limitation is that combined taxes are paid on aggregate foreign source income at the higher of the average of all the effective tax rates or the U.S. rate. Use of the overall limitation is therefore more advantageous than the per country limitation in those situations in which a taxpayer pays foreign income taxes to one or more

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foreign countries at effective tax rates higher than the U.S. rate and to one or more foreign countries at effective tax rates lower than the U.S. rate. Because the overall limitation permits foreign taxes to be averaged, it generally prevents a loss of credit to a particular taxpayer which would occur under the per country limitation, if the taxpayer paid taxes to one or more of the foreign countries at a rate higher than the U.S. rate. The use of the overall limitation, therefore, provides a means for offsetting foreign taxes incurred in certain countries against the U.S. tax on income from other countries. Use of the overall limitation, on the other hand, may be less advantageous than the use of the per country limitation when the taxpayer suffers a loss in one or more foreign countries and derives taxable income from another foreign country or foreign countries. A loss in one foreign country does not reduce the amount of the per country limitation applicable to foreign taxes paid to another foreign country, if the loss is equal to or less than the U.S. source income. Given the same facts, the amount of the overall limitation will be reduced by reason of the foreign loss and may operate to reduce the amount of credit allowed.¹³⁵ It is for this reason that the per country method is not permitted

135. Foreign Tax Credit, Foreign Income Portfolio No. 5 - 2d (Tax Management, Inc., Washington, D.C.), pp. 7-11.

for computing the limitation on foreign oil related income. Under the Tax Reduction Act of 1975, the overall method must be used for taxable years ending in 1976 and later years.¹³⁶

One further element in connection with the limitation on the foreign tax credit under the U.S. system that has arisen in recent years is the series of separate limitations based on certain types of foreign income generated by U.S. taxpayers. We have already seen some of the specific limitations geared to the oil and gas industry by the Tax Reduction Act of 1975. Because of the flexibility of the overall limitation, Congress had already reduced the flexibility for using income generated from certain foreign sources to absorb excess foreign tax credits from other areas.¹³⁷ As we noted above, the overall limitation permits the offsetting of foreign tax against U.S. tax that would ordinarily be due on other types of income. In these special limitations under the foreign tax credit system, Congress has made in-roads into the flexibility of the overall limitation to some extent.

The first such special limitation of significance for our study has to do with interest income.¹³⁸ Before

136. Tax Reduction Act of 1975 Section 601(a) and 601(d) adding Section 907(b) to the Code.

137. Section 904(f) and 901(e) of the Code.

138. Section 904(f)(1)(a) of the Code.

this particular provision was enacted, Congress found that certain U.S. taxpayers were using interest income generated in certain foreign countries to absorb potential foreign excess tax credits from other countries because of the fact that the interest income could be received at a very low foreign tax rate (or at a zero tax rate) due to the unilateral tax rate in some foreign countries or because of the tax treaty privileges which the United States had enacted with other foreign countries.¹³⁹ As a result, the limitation on the foreign tax credit now has to be applied separately and on a per country basis with respect to interest income, although major exceptions to this rule do exist in connection with (a) interest income from a transaction which is directly related to the active conduct of a trade or business by the U.S. taxpayer, (b) interest income derived from the conduct of a banking, financing or similar business, and (c) interest income received from a foreign corporation in which the U.S. taxpayer owns at least a 10 percent interest.¹⁴⁰ The general import

139. Revenue Act of 1962, Report of the Committee on Finance of the United States Senate to Accompany H. R. 10650, 87th Congress, 2d Session Rep. No. 1881, (U.S. Government Printing Office, Washington, D.C.), pp. 72-74.

140. Revenue Act of 1962, Report of the Committee on Finance of the United States Senate to Accompany H. R. 10650, 87th Congress, 2d Session Rep. No. 1881, (U.S. Government Printing Office, Washington, D.C.), pp. 76-81.

of all three exceptions is to exclude from the interest income subject to a separate computation, interest income arising in the normal course of business as distinguished from passive interest income arising from investment.

A second special foreign tax credit limitation exists for foreign mineral income.¹⁴¹ In this regard, a U.S. corporation may no longer claim a foreign tax credit for foreign taxes imposed on foreign mineral income to the extent that the foreign tax is attributable to the percentage depreciable allowance granted by the United States. In other words, excess foreign tax credits resulting from the allowance by the United States of percentage depletion on foreign mineral income will not be available to reduce U.S. tax imposed on other foreign income. Under this limitation, foreign income taxes paid or accrued to a foreign country or a U.S. possession on foreign mineral income from sources within the country or the possession will be reduced, for foreign tax credit purposes, to the extent that the foreign taxes exceed the amount of U.S. tax on such income. As in the case of the special limitation for interest income, this special limitation for foreign mineral income is computed on a country-by-country basis, and is in addition to the limitation

¹⁴¹. Section 901(e)(1) of the Code.

previously discussed relating to foreign oil extraction income.¹⁴²

The third special rule for foreign tax credit limitation deals with DISC income.¹⁴³ Under the Revenue Act of 1971, a DISC shareholder which has elected the overall limitation on the foreign tax credit may not use its excess credits on non-DISC foreign income to offset U.S. taxes on DISC dividends. This is done by providing that there must be a separate computation of the limitation of the foreign tax credit for taxes deemed paid by the DISC shareholder on DISC dividends and by prohibiting the shareholder from using the overall limitation with respect to DISC dividends. If a shareholder elects the per country limitation and receives dividends from more than one DISC, the limitation is applied to the total of such dividends.¹⁴⁴

It should be noted in connection with these limitations that they are generally applied on a per country basis. Therefore, if a taxpayer has been using the overall limitation, that limitation will continue to apply on all income other than these special types of income. Moreover, the special limitations will be applied separately for the special income

¹⁴². Treas. Regs. Sec. 1.901-3(c)(1).

¹⁴³. Section 904(f)(1)(b) of the Code.

¹⁴⁴. Revenue Act of 1971, Report of The Committee on Finance of the United States Senate to Accompany P. L. 91-684, 92nd Congress, 1st Session (U.S. Government Printing Office, Washington, D.C. 1971).

derived from each foreign country.¹⁴⁵ If the taxpayer uses the per country limitation as a general rule, he will continue to use this basis, but will have to apply the limitation separately for the special income as opposed to other income derived from each country.¹⁴⁶ In essence then, these special limitations are geared to changing the basic concept of the overall limitation in the U.S. tax system. They remove from the averaging process that the overall limitation implies the ability of offsetting excess foreign tax credits in one area against U.S. tax on foreign income from a different area. That is, it is not possible to use excess credits in general, against interest income or DISC income, notwithstanding the objectives of the overall limitation. As our study proceeds, we will see that this departure from the basic concept of the overall limitation is an important aspect of the trend in which the U.S. foreign tax credit system is moving.

(f) Timing Considerations for Carryback and Carryforward of Excess Foreign Tax Credits

One final consideration required in order to give our study a firm foundation of the understanding of the unilateral means for avoiding double taxation deals with the

¹⁴⁵. Foreign Tax Credit, Foreign Income Portfolio No. 5.2(d), Tax Management, Inc., Washington, D.C.), pp. 12-17.

¹⁴⁶. Foreign Tax Credit, Foreign Income Portfolio No. 5.2(d), Tax Management, Inc., Washington, D.C.), pp. 18-21.

timing aspect of the foreign tax credit. Up to this point, we have considered the important elements of the U.S. foreign tax credit system as it relates to a particular year. The U.S. tax system, however, has much more flexibility built into it than a year by year tax credit. In certain countries, the basic choice in the utilization of the foreign tax credit system is simply a matter of considering the facts for any one year.¹⁴⁷ However, the allowance in the U.S. tax system of a carryover of U.S. tax credits makes the U.S. system much more complicated. In effect, the carryover mechanism allows an averaging of foreign tax rates over time, just as the overall limitation allows an averaging of foreign tax rates among countries. Consequently, the differences between the per country and the overall method of limitation in a particular year may tend to disappear over time when the whole carryover period is taken into account.

The basic rules for carryovers in the U.S. tax system is that the excess tax may be carried back two years and may be carried forward five years, and used as a credit to the extent that there is an excess limitation in any of these

147. See, for example, the Foreign Tax Credit System as used in the United Kingdom, Canada, and Germany in Canadian Tax Reporter, (Commerce Clearing House, Canadian Limited, Toronto 1974) Vol. 1A and Taxation in Western Europe, (Confederation of British Industry, London, 1974), pp. 144-147, 356-362.

years.¹⁴⁸ This carryover process can be applied regardless of which form of limitation is used. However, excess tax cannot be carried over from a taxable year in which the per country limitation is used to a taxable year in which the overall limitation is used or vice versa.¹⁴⁹ When the overall limitation is used, excess tax consists of the amount by which aggregate creditable taxes in a given year exceed the overall limitation in that year. The computations are the same when the per country limitation is used, except that they are made on a country-by-country basis. This carryover of excess credits prevents or at least mitigates, a possible loss of credit which may arise out of timing maladjustment as, for example, where the same income is taxable in different years in the foreign country and in the United States. Where, in an earlier year, the taxpayer has used a deduction for foreign taxes paid instead of a credit, any unused foreign taxes of the current year carried back to the deduction year, are to be considered as used in the deduction year.¹⁵⁰ However, no tax benefit will result either as a deduction or as a credit for the taxes carried to the deduction year unless the taxpayer reverses his choice of deduction of taxes and claims the taxes as a credit

instead.¹⁵¹

¹⁴⁸. Section 904(e) of the Code.

¹⁴⁹. Section 904(e)(2) of the Code.

¹⁵⁰. Treas. Regs. Sec. 1.904-2(b).

¹⁵¹. Treas. Regs. Sec. 1.904-2(d)(1) and (2).

At this point of our study, we are now in a position to summarize how the U.S. foreign tax credit system operates. We see at the outset an extremely flexible adaptation of that method of providing unilateral relief for double taxation. In the United States, the system is one which gives the U.S. corporation the choice to claim foreign taxes as a deduction or a credit whichever proves more advantageous to him in any given year. Furthermore, the foreign tax credit system as utilized in the United States is one which is available to U.S. corporate entities on a broad scale since it permits U.S. corporations to not only claim credits for foreign taxes incurred directly by them, but also for foreign taxes which they are deemed to have paid as a result of the foreign burden incurred by foreign corporations in which they have an equity interest. In this regard, we have seen that the interest need not be a controlling one and, in fact, may be a rather small minority interest in actual fact. This deemed paid credit - coupled with the deferral aspect of the U.S. tax system as it deals with the earnings of foreign corporations in which U.S. corporations have an interest - provides a great deal of timing flexibility to U.S. corporations. The U.S. tax credit system is also flexible enough to permit a U.S. corporation to claim foreign taxes paid in lieu

of foreign income taxes as creditable foreign taxes. The broad scope of how those taxes are determined gives U.S. corporations a fair amount of latitude in this area. The system is also one which provides a limitation on the amount of foreign taxes that can be claimed as a credit. However, there are two basic limitation methods which a U.S. corporation can select based on whichever it feels will be of greater benefit to it in the long run. In addition, there are several specific provisions in the Code dealing with particular limitations on the foreign tax credit which are outside the basic methods. However, these special limitations are a fairly recent addition to the U.S. tax system and do not account for a major portion of the U.S. tax credit limitation. Finally, we have seen that the foreign tax credit system in the United States has a significant degree of timing latitude from the standpoint of the utilization of the credit. The two-year carryback and five-year carryover provisions provide an eight-year span of time over which U.S. corporations may utilize their foreign taxes as credits where they cannot be completely absorbed in a given year. This carryover system provides an averaging process on the basis of time and the overall limitation provides an averaging process on the basis of rates of foreign tax.

C. U.S. Tax Treaty Network as it Affects U.S. Taxation of Foreign Income of U.S. Corporations

We have just seen that the U.S. internal tax system has provided a very expansive means for U.S. corporations to avoid double taxation via the foreign tax credit. Notwithstanding this unilateral means of providing double taxation relief, the United States has embarked on a system of tax treaties with numerous foreign countries which have as their overall purpose the providing of double taxation relief.¹⁵² Tax treaties are intended to provide bilateral relief in terms of U.S. corporations doing business abroad as well as foreign corporations doing business in the United States. For purposes of our study, the question arises as to what function the U.S. tax treaty system provides for U.S. corporations operating abroad given the existence of the foreign tax credit system in our law. Later sections of this study dealing with the examination of empirical data delve more precisely into the manner in which tax treaties actually operate in connection with the foreign tax burdens of U.S.

152. United States presently has income tax treaties in effect with the following countries: Australia, Austria, Barbados, Belgium, Canada, Denmark, Finland, France, Germany, Greece, Ireland, Italy, Jamaica, Japan, Luxembourg, Netherlands, New Zealand, Nigeria, Norway, Pakistan, Sweden, Switzerland, Trinidad, Tobago, Republic of South Africa and the United Kingdom. See Tax Treaties (Commerce Clearing House, Inc., Chicago).

corporations. To put that discussion in proper focus, we must examine the background of the U.S. tax treaty system in order to establish a firm foundation to appreciate the research discussed later in the study.

1. The Concept of Bilateral Relief from Double Taxation

The first aspect to which we should direct our attention is the bilateral approach to relief from double taxation. The bilateral relief afforded by tax treaties is, for many countries, a major method of lifting the burdens of international double taxation. This is especially the case in those countries which do not provide generous unilateral relief.¹⁵³ Like unilateral relief measures, bilateral treaty relief typically takes one of two forms. The treaty may adopt the exemption method whereby tax jurisdiction over specified categories of income is assigned exclusively to one of the contracting nations while the other exempts that category of income from tax. For example, under the exemption method, the country of source in which a permanent establishment is located is assigned exclusive jurisdiction to tax the profits of the establishment and the country of residence (the country in which the owner of the establishment

153. Y. Hadari, "Tax Treaties and Their Role in Financial Planning of Multinational Enterprises," 20 American Journal of Comparative Law (Winter 1972), pp. 111-145.

resides) agrees in turn to refrain from exercising its jurisdiction to tax the owner of these profits.¹⁵⁴

Alternatively, the tax treaty may provide relief from international double taxation by reducing the tax ordinarily due when one or both of the contracting nations seek to tax the income. For example, the country which is the source of a dividend may agree to reduce the withholding rate normally applicable to dividends paid to non-residents, while the country of residence agrees to give a tax credit for the tax paid to the country of source.¹⁵⁵ In such a case, both countries exercise jurisdiction to tax while mutually agreeing to adjustments which either eliminate or at least reduce the burden of international double taxation on the income in question.

A confusing element in the treaty picture is that many treaties combine both methods of relief. This is especially true of the treaties between a country which uses a tax credit system as its unilateral method of relief and a country which

154. T. Aoki, "Recent Double Taxation Conventions of Japan", 25 Bulletin For International Fiscal Documentation (October 1971), pp. 374-385.

155. Mitchell B. Carroll, "OECD, IMF, U.S. Treasury and IFA International Tax Project 1972", 26 Bulletin for International Documentation (April 1972), pp. 139-143.

does not. A typical example is the U.S. tax treaty with Sweden.¹⁵⁶ In form and on its face, that treaty appears to follow the exemption method, allocating income from particular sources to one country or the other for tax purposes. Income from real property is said to be taxable only in a country in which the property is located. For example, all interest is taxable only in the country in which the recipient resides. But after these and similar provisions allocate particular items of income to one country or the other, a key article of the treaty provides that, in computing the income of its citizens, residents and corporations, the United States may still take into account income from all sources, including income allocated to Sweden by the treaty, "as though this convention had not come into effect," Then the United States provides relief by application of its foreign tax credit in the usual course.¹⁵⁷ Sweden, on the other hand, provides relief by unilaterally exempting from tax certain income deemed by the treaty to have a U.S. source.¹⁵⁸

Because of this so-called "savings clause" on the United States side, it becomes difficult to see what relief

156. Legislative History of United States Tax Conventions prepared by the Staff of the Joint Committee on Internal Revenue, Vol. 2 to Sec. 21, pp. 23-65.

157. U.S. - Sweden Tax Treaty, Article XIV.

158. U.S. - Sweden Tax Treaty, Article XIV-B.

such a treaty gives to U.S. taxpayers that is not already available to them under the foreign tax credit system. In fact, some parties feel this may have some effect in limiting the U.S. bargaining power in the treaty negotiation field. That is, the existence of broad, unilateral double tax relief in the United States may limit the desire of other contracting nations to give much relief to U.S. taxpayers.

At the outset, then, it can be seen that the rationale for a tax treaty in the abstract is to provide relief from double taxation where the internal law of the countries in question may not provide satisfactory double taxation relief in the first instance. However, even though the foreign countries grant some type of unilateral relief, something more can be added to relief from double taxation as a result of tax treaty negotiations. This is an important point to keep in mind as we now compare the general context in which double taxation agreements are negotiated with that which exists in the United States, particularly as it relates to U.S. entities conducting operations abroad. With this in mind, we will now examine the manner in which the bilateral tax treaty has been adapted to United States usage in order to obtain a foundation for examining the manner in which it affects the foreign tax burdens of U.S. corporations.

2. The Background of U.S. Bilateral Tax Treaties

As in the case of other industrialized countries, the United States has found it useful to enter into income tax treaties for the purpose of eliminating some of the troublesome tax problems that arise out of various types of international transactions. These problems arise, for example, when sales take place between an enterprise in one country and an enterprise in another, or when individuals from one country travel for business or cultural purposes to another country. They may also arise when income is generated in one country as a result of investments made by individuals or corporations of another country or as a result of services rendered by residents of one country to persons in another. The resulting problems of double taxation exist for all countries and particularly industrialized ones. These transactions cause potential international tax problems, since each of the two or more countries involved in the transaction may lay claim to an income tax on the profits produced by the transaction. Conflict may therefore be inevitable.

Most of the industrialized countries have found it appropriate to include unilateral measures in their tax laws to cope with these double taxation problems. As we have seen regarding the United States, principle reliance in meeting these

problems is placed in the foreign tax credit mechanism. But even though the industrialized countries employ various unilateral measures to cope with these problems, virtually all have found it necessary to supplement these measures by entering into a network of tax treaties with their principal commercial partners and other countries with whom their taxpayers are concerned in trade or investment. There are a number of factors responsible for this. There are to begin with, differences among countries concerning the scope of their income tax. If the United States is to give credit for taxes imposed by a foreign country, some feel it must be only for taxes imposed on income which the former considers as sourced outside the United States. But if the U.S. concept of source differs from other countries, the credit mechanism will not be adequate to the problem. The other country will tax the income, the United States will not allow the credit, and the income involved will bear a tax considerably higher than either country alone would impose.¹⁵⁹

There are other tax issues which are often best resolved through one of the countries granting complete exemption from tax through the tax treaty. One such tax difficulty facing

159. Taxation in the United States - World Tax Series, Harvard Law School Program in International Taxation (Commerce Clearing House, Inc., Chicago 1963) Section 11/5.3, pp. 154-155.

international business which the U.S. unilateral tax credit mechanism does not solve relates to various types of fees and royalties. It is common for a country to levy tax on a gross basis on outgoing payments, such as royalties, rents or technical fees. In the United States, a tax of 30 percent is levied on the gross amount of such payments made to foreign parties. A foreign tax at that rate on a royalty paid to a U.S. licensor of a patent may be considerably higher than our 48 percent corporate tax on the net income earned by a licensor after taking account of the costs incurred in earning that royalty. It may represent the equivalent of a 55 - 60 percent tax on the net income from the royalty. The excess of foreign tax over U.S. tax in such a case would not be absorbed through the U.S. unilateral tax credit mechanism. However, a reduction in the foreign tax withholding rate could bring the effective foreign tax rate on the net income down to a level which could be absorbed by the U.S. tax credit mechanism. Alternatively, the difficulty could be met by having the foreign tax apply on a net income basis, rather than on gross income. As we will soon see, these are approaches used in some U.S. tax treaties.¹⁶⁰

160. See, for example, Article XIII A of the U.S. - Canadian Tax Treaty and Article IX of the U.S. - United Kingdom Tax Treaty.

A somewhat similar problem relates to the determination by a foreign country of the amount of income earned therein by a branch of a U.S. enterprise. In some countries, the costs allowed as a deduction in arriving at the taxable income of a branch of a foreign owned enterprise are limited to those incurred within the foreign country itself.¹⁶¹ Thus, overhead costs incurred within the United States which are applicable to the activities of the branch may not be allowed as a deduction in computing taxable profit. The result is that the tax is really imposed on gross income rather than net income. Here, again, tax treaties can generally meet the problem by obligating a country to allow costs incurred abroad but applicable to the branch within its borders as a deduction for purposes of its tax.¹⁶²

If, for example, a foreign country considers the earnings from the rendition of services by a U.S. company to have its source where the enterprise paying for the services is located, while the United States considers the source to be where the services are rendered, then the U.S. unilateral credit

161. This is the rule, for example, in many Latin American countries, such as Mexico, Argentina, Brazil and Venezuela. See Carl Shoup, The Fiscal System of Venezuela (The Johns Hopkins Press, Baltimore, 1959), pp. 87-89.

162. Article III of the U.S. - Japan Tax Treaty.

mechanism will ~~not eliminate~~ double taxation, since no credit will be allowed for the foreign tax. To illustrate further, one country may regard the source of income from a sales transaction to be the place where the order is accepted. The United States considers the source to be the place where title to the property passes. Again, the tax credit mechanism may not provide appropriate relief from double taxation. Still another example, more important perhaps than the others, arises when two countries utilize different methods for determining the amount of income applicable to each country from transactions between related enterprises, such as a parent corporation in one country and a subsidiary in the other. The result may be that a segment of income is taxed in both countries with neither giving any recognition to the tax imposed by the other. Tax treaties deal with these problems by trying to reach mutually acceptable rules regarding the source of income and allocations of income.¹⁶³

A further aspect of the background of the U.S. tax treaty system involves a situation which has a combination of problems. A U.S. firm seeking to enter a market in another country

¹⁶³. This provision is similar to that in Section 482 of the Internal Revenue Code and is found in such tax treaty articles as Article IV of the U.S. - Australian Tax Treaty.

may not only be confronted with the difficulties in complying with unfamiliar tax laws, but it may also be confronted with a foreign tax burden that is unrelieved by the foreign tax credit provision in our laws because of differing tax concepts. The so-called permanent establishment provision of U.S. tax treaties seeks to cope with such cases. It describes certain types of activities which, when carried on in a foreign country by a U.S. firm, are regarded as not constituting a permanent establishment within that country. As a result, any profits earned through such activity are not taxable in that country. Under this form of relief, a firm in one country may send out salesmen to another in an effort to penetrate a particular market without becoming subject to the tax laws of that country.¹⁶⁴

Another situation where the unilateral U.S. foreign tax credit is inadequate to deal with international tax problems is the relatively simple one where foreign tax rates are higher than U.S. tax on the same income. The problem arises most frequently where direct foreign investment is involved. Like the United States, many foreign countries impose not only a corporation tax on profits but in addition, they also levy a withholding tax on the dividends paid to the shareholders whether

¹⁶⁴. Legislative History of the U.S. Tax Conventions prepared by the Staff of the Joint Committee on Internal Revenue (U.S. Government Printing Office, Washington, D.C. 1962) Vol. 1, p. 15.

resident at home or abroad. Ordinarily, no distinction is drawn between types of dividend recipients abroad. One recipient may be a parent corporation owning all or a major part of the company paying the dividends, another may be an individual or corporation owning only a few shares in the company. The statutory withholding tax on both is likely to be the same rate. Under these circumstances, the total tax payable with respect to the profits earned through direct investment and transmitted to the United States through the form of dividends may be considerably above the 48 percent rate imposed by the United States.¹⁶⁵ To solve this difficulty, U.S. tax treaties seek to arrive at mutually acceptable adjustments in the withholding tax rates on dividends paid by the companies in each country to those in the other country. The U.S. tries to secure reciprocal withholding tax rates on dividends which differentiate between a parent corporation and portfolio investors. The United States has taken the position that withholding tax rates paid to parent companies should be reduced to the point where the total tax imposed on the profits earned in the foreign country and remitted to the

165. For example, if one assumes a 50 percent U.S. tax rate on net profits and a ratio of expenses to gross income of approximately 70 percent, a withholding tax of more than 15 percent on gross income would result in a higher tax rate than the 50 percent tax rate on net income.

United States do not exceed the U.S. tax on corporate income generally.¹⁶⁶

It is also important for this background discussion to note the U.S. tax treaty system seeks to assure non-discrimination in tax treatment of a U.S. citizen and business ventures abroad. It is not uncommon for nationals of one country to find themselves subjected to higher withholding taxes by the foreign country in which they are residing than the nationals of that country. Through tax conventions, the United States seeks to secure commitments from other countries that U.S. nationals will get the same treatment as nationals of the country in which they are living. The same concept, in general, applies to corporate entities.¹⁶⁷

One of the important contributions of U.S. tax treaties to international trade and investment is that they open the door to consultations between the tax authorities of the signatories.¹⁶⁸ The creation of this consultative machinery offers the enterprises of a country some assurance that, where

166. Legislative History of the U.S. Tax Conventions prepared by the Staff of the Joint Committee on Internal Revenue (U.S. Government Printing Office, Washington, D.C. 1962) Vol. 1, p. 16.

167. E. P. Chang, "Fiscal Cooperation in Tax Treaties", 26 Taxes 889 (1948).

168. D. T. Smith, "The Functions of Tax Treaties", 12 National Tax Journal 317 (1959).

appropriate, there can be official discussions on a technical level with the authorities of the other country to secure a reasonable determination of taxable income. This provides relief that no unilateral provision of the U.S. tax law can afford U.S. based corporations.

Based on the foregoing discussion of the background of the U.S. tax treaty system and, in particular, the nature of the extent to which it can provide relief which is not wholly available through the unilateral foreign tax credit system, we are now able to formulate ideas on the overall objectives of the U.S. tax treaty network and how these objectives are approached via specific provisions in U.S. treaties.

3. Objectives of the U.S. Tax Treaty Network

In examining the conventions to which the United States is a party, it is important to note that they basically affect U.S. taxation of its own citizens, residents or corporations via the credit for foreign taxes incurred. Accordingly, the tax conventions are directed to the basic goals of (a) exemption from or reduction in rate of U.S. tax, as such tax applies to residents or business enterprises of the particular foreign country in which the taxation is in force, and (b) exemption from or reduction in rate of tax imposed by the other

foreign country as it applies to residents and business enterprises of the United States. The specific objectives of such agreements may therefore be summarized as follows:

1. Avoidance of double taxation
2. Stimulus to foreign trade and investment
3. Fiscal cooperation between the respective

revenue services for establishment of a forum for discussion and solution of taxation problems at the administrative level of common interest of both countries.

The relevance of these objectives for purposes of our study lies primarily in the substantive rules which are contained in the first two objectives. In fact, the stimulus objective provided by foreign tax treaties to foreign trade and investment can be looked at primarily from the standpoint of the extent to which it succeeds in avoiding double taxation. Consequently, the major substantive tax objective of the tax treaties with which the United States is a party is the role of the avoidance of double taxation. Given this as the primary objective of the U.S. tax treaty as it relates to U.S. based corporations, it then becomes important for purposes of our study, to see exactly how the U.S. tax treaties seek to meet these objectives with specific provisions.

4. Specific Provisions of U.S. Tax Treaties to Meet the U.S. Objectives

To achieve the objectives of the U.S. tax treaty network, treaties pursue several different approaches. One approach is to lay down conditions under which only one of the two signatories to a treaty will impose tax.¹⁶⁹ The country that gives up tax ordinarily is the one which has the more tenuous claim to tax either because the activities within its border are marginal or because they are more or less temporary in nature.¹⁷⁰ Another approach is to reduce the tax rate normally collected at source on income leaving a country. Such a reduction makes it possible to tolerate the imperfections that may exist in determining the taxable income from sources within the foreign country for purposes of arriving at the maximum credit against U.S. tax.¹⁷¹ A further device used in U.S. treaties is to lay down rules for determining the amount of taxable income that is realized from a given type of transaction. This technique for handling international

169. K. E. Lachmann, "International Tax Treaties and Their Effect on Double Taxation", The Taxation of Business Income from Foreign Operations, (American Management Association, New York 1958), pp. 183-187.

170. A. Dean, "Some Brief Suggestions For Improvements of International Treaties to Avoid Double Taxation", paper submitted at the International Bar Association Oslo Conference (1956).

171. R. R. Dailey, "The Concept of the Source of Income", 15 Tax Law Review 415 (1960).

tax problems is being used in U.S. tax conventions of later vintage. It is hoped that substantial progress will be made in the future in developing appropriate rules particularly in transactions between related parties.¹⁷² Given this overview, we will now examine those specific provisions contained in U.S. tax treaties that seek to achieve the objectives outlined earlier.

As we have seen, tax treaties do not provide any additional relief from double taxation for U.S. corporate taxpayers under U.S. tax law beyond the foreign tax credit device which is already provided for in the Code. The foreign country generally grants relief from its own tax for its residents by affording to them the benefits of a foreign tax credit or some comparable relief. In contrast to the double taxation relief under U.S. internal law, however, in several cases the foreign country adopts the foreign tax credit for the first time in the treaty.¹⁷³

United States income tax treaties do have one major element that reduces the tax on income from sources in one country flowing to residents of the other country. Double

172. Klimowsky, "Unilateral Measures for the Avoidance of Double Taxation, Especially as Regards Fiscal Aspects of the Relationship Between Capital Exporting Countries and Countries in the Process of Development", 43 Cahiers de Droit Fiscal International 1961, pp. 7, 13-15.

173. A. Broches, "Convention on the Settlement of Investment Disputes: Some Observations of Jurisdiction", 5 Columbia Journal of Transnational Law 263 (1966).

taxation is mitigated chiefly by the mutual relinquishment of tax revenues from non-residents on income arising from sources in the other contracting state. Thus, the pattern of U.S. treaty relief is a restriction by each country on the scope of its source jurisdiction exerted over non-residents plus a foreign tax credit or similar benefit for the residents of each country for foreign taxes which, despite this restriction, are collected by the country of source.

Another of the specific provisions which the U.S. tax treaty network contains is the description of the taxes covered. The U.S. tax treaty provisions generally apply only to the federal income tax in the United States. Foreign taxes covered by treaties are identified by name and are usually national income taxes similar to the U.S. income tax. The significance of these provisions in connection with meeting the objectives of the U.S. tax treaty system is to define those levies by both countries which are the subject matter of the convention. However, tax treaties do not in general identify foreign taxes as those which are eligible for foreign tax credit in the United States. This is a basic deficiency of U.S. tax treaties which remains to be rectified.¹⁷⁴

¹⁷⁴. E. Owens, "United States Income Tax Treaties: Their Role in Relieving Double Taxation", 17 Rutgers Law Review 428 (1963).

As we saw in the background analysis, U.S. tax treaties generally contain a savings clause reserving to the United States the right to tax its own citizens, residents and corporations, as if the treaty had not come into effect. Thus, regardless of any other provisions of these treaties, the United States may continue to tax these taxpayers on global income as it did in the absence of the treaties. This savings clause is crucial in the interpretation of the U.S. income tax treaties. For example, in certain treaties, a provision may state that income from real estate will be taxable only in the country where the real estate is situated. On its face, it would appear to be an extremely clear provision and a significant departure from the U.S. internal law. Read in conjunction with the savings clause, it applies with respect to the United States tax only to persons who are not U.S. citizens or U.S. corporations. This savings clause thus serves to complicate the objective of avoiding double taxation by having the United States continue to tax U.S. corporations even though another provision of the tax treaty would indicate that the United States will exempt income from U.S. taxation.¹⁷⁵

175. E. Owens, "United States Income Tax Treaties: Their Role in Relieving Double Taxation," 17 Rutgers Law Review 433 (1963).

Some of the U.S. treaties contain source rules on one or more types of income. However, by and large, the source rules contained in treaties are those used in the United States. The specific provisions of tax treaties to which the United States is a party are deficient in terms of source of income definition and to an extent do not greatly aid in the resolution of the problem of double taxation.¹⁷⁶

Specific provisions of U.S. treaties dealing with industrial and commercial profits aid significantly in meeting the objective of the avoidance of double taxation because they generally exempt such profits from taxation in each country unless the entity generating such income has a permanent establishment within the state. This particular provision provides a complete exemption from certain types of taxation that takes place in a foreign country and, in so doing, serves to meet the objective.¹⁷⁷

In the area of investment income, U.S. treaties generally provide for reduction in the tax rate at the source or even for exemption. This enables the entity generating the

176. O. Oldman, "United States Tax Laws and Treaties Affecting Private Foreign Investment", 19 Federal Bar Journal 342 (1959).

177. J. N. Proomkin and I. T. Wender, "Revenue Implications of United States Income Tax Treaties", 7 National Tax Journal 177 (1954).

income to avoid double taxation by either not bearing any tax in the country of source on the investment income or by having the amount of tax levied kept within the absorbable level for foreign tax credit purposes.¹⁷⁸

The foregoing illustrations of specific provisions of the U.S. tax treaty network provides us with insights regarding the manner in which the overall objective of avoidance of double taxation is met through specific provisions of the treaty network. At this point, we have a clear picture of the manner in which the specific provisions dealing with (a) definition of taxes, (b) the permanent establishment concept, (c) exemption of taxation of industrial and commercial profits, (d) the exemption or reduction of rates on investment income, and (e) the definition of the source of income rules, all play toward meeting the stated objectives which we have seen exist for the U.S. tax treaty network. In order to round out this exposition of U.S. tax treaties, it now remains for us to look at how these particular provisions relate particularly to U.S. based corporations.

178. H. S. Bloch and C. E. Heilemann, "International Tax Relations" 55 Yale Law Journal 1158 (1946).

5. The Role of U.S. Tax Treaties as They Relate to U.S. Based Corporations

Since the objective of our study is to examine the role that foreign tax burdens have on U.S. based corporations, it becomes important for us to appreciate the function which U.S. tax treaties are supposed to perform specifically for U.S. corporations. We have seen that the objectives of tax treaties are two-fold in nature relating to U.S. corporations conducting overseas operations as well as foreign corporations conducting U.S. operations. For purposes of our discussion, we are interested only in the former type of activity in that it is the U.S. corporation generating income from abroad which will be subjected to the foreign taxes that we are interested in evaluating. Since we have just seen how specific provisions of U.S. tax treaties are constructed to meet the overall objectives of the treaties, we now look at the way in which they relate specifically to U.S. based corporations.

The savings clause which we have just reviewed prevents the tax treaties from directly affecting U.S. taxation of its own corporations. Thus, from the very outset, the savings clause in tax treaties serve to reinstate the worldwide taxing jurisdiction which the United States asserts under the Code. As such, the tax treaty provisions which would exempt

from U.S. taxation certain types of foreign income generated by U.S. corporations will not be operative in most cases and as a result, the tax treaties in this respect are ineffective.¹⁷⁹

In its treaties, the United States agrees to apply the Code foreign tax credit provisions for the income taxes of the foreign signatory country. The foreign tax credit clause is the only clause under which the United States agrees to apply its internal law as of the effective date of the treaty rather than as it changes from time to time. By thus freezing the application of the Code credit provisions, the tax treaty does have an effect on U.S. based corporations by means of avoiding complications concerning the effect of subsequently enacted amendments to the foreign tax credit provisions of the Code.¹⁸⁰

A further area in which the tax treaties impact on U.S. based corporations is in the source rules for applying the foreign tax credit. The provisions dealing with the definition of source of income are, however, not as comprehensive as they might be. As a result, the tax treaties in this regard do not

179. E. Owens, "United States Income Tax Treaties: Their Role in Relieving Double Taxation", 17 Rutgers Law Review 435 (1963).

180. Joseph, "Income Tax Treaties - A comparison of Basic Provisions", 12 NYU Tax Institute 787 (1954).

impact significantly on the U.S. based corporation. These corporations rely primarily on the Code definitions of source in determining the limitation on their foreign tax credit for all practical purposes.¹⁸¹

Some provisions of U.S. tax treaties impact on U.S. based corporations by defining which foreign taxes may be claimed as a foreign tax credit. There are specific provisions in individual treaties but they are not of broad application. For that reason, the types of foreign taxes that are available as a credit as well as the level on which they are considered to be borne are generally determined under the Code sections and not under the treaties.¹⁸²

One of the major areas in which the foreign tax treaties do effect U.S. based corporations is in the exemption or reduction in tax rate which the foreign country provides the U.S. corporation generating foreign income. In many instances, the reduction of foreign tax by the foreign country provides a real benefit to U.S. based corporations because it provides the U.S. corporation with the ability to claim these taxes as foreign

181. Joseph, "Income Tax Treaties - A Comparison of Basic Provisions", 12 NYU Tax Institute 793 (1954).

182. Taxation in the United States - World Tax Series, Harvard Law School Program in International Taxation, (Commerce Clearing House, Inc., Chicago, 1965), pp. 1150-1151.

tax credits without exceeding the limitations imposed by the Code. As we have seen in an earlier portion of this chapter, the Code does provide limitations on the amount of foreign taxes that can be utilized as a credit. To the extent that tax treaties reduce that burden, they provide a most significant contribution to the impact the treaties have on U.S. corporations. Consequently, whether it be through the industrial and commercial profits exemption because of the lack of permanent establishment or because of the reduced withholding rates on dividends, interests, royalties, and other types of income, the tax treaty impact on U.S. corporations is significant at this level.¹⁸³

To this point of our study, we have examined the international tax concepts relevant to the interplay of foreign tax burdens incurred by U.S. based corporations and the U.S. tax system. This exposition is now complete insofar as it relates to the results of transactions as reported by the taxpayer. However, since international trade and investment involve a significant amount of cross-border dealings between related parties, there exists the potential for shifting of income and expenses within a family of corporations engaged in international operations. Because of this potential, the U.S. tax law contains rules

183. E. Owens, "United States Income Tax Treaties: Their Role in Relieving Double Taxation", 17 Rutgers Law Review 431 (1963).

requiring taxpayers to deal with related parties on an arm's length basis. If the taxpayer does not act in this manner, the Internal Revenue Service is empowered to reallocate income and expenses to place the taxpayer where it would have been if it had originally dealt at arm's length. Because the application of these rules to the international area raises significant problems of excessive foreign tax burdens on foreign income of U.S. taxpayers, with resulting double taxation, we will now establish an awareness of these requirements so that the later empirical research is placed on a firm conceptual basis.

D. Role of Tax Allocations Under Section 482 as They Affect U.S. Taxation of Foreign Income

All of the foregoing sections of our study describe the U.S. tax concepts underlying the taxation of foreign income of U.S. corporations as the income, deductions, credits and allowances are reported by the taxpayer. However, there is a major tool available to the U.S. tax administration to insure that the taxpayer deals with its foreign subsidiaries on an arm's length basis and does not intentionally or inadvertently shift profits abroad so as to avoid U.S. taxation under the deferral concept. This is Section 482 of the Code and an understanding

of it is essential to our study.¹⁸⁴

1. Background to Section 482 Application

Section 482 of the Code authorizes the Internal Revenue Service to allocate income or expenses among related companies, when this is necessary not only to prevent tax evasion but also to clearly reflect the income of each. Although it was written into the tax code long before international business became important to many U.S. corporations, it has been applied increasingly to international transactions as U.S. firms have established subsidiaries and affiliates overseas.

The language of Section 482 has not changed substantially since it was first enacted as Section 45 of the Revenue Act of 1928. At the time the section became law, few U.S. companies were heavily involved in international business and even fewer had extensive networks of subsidiaries and affiliates

184. Section 482 reads as follows:

"In any case of 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, the Secretary or his delegate may distribute, apportion, or allocate gross income, deductions, credits, or allowances between or among such organizations, trades, or businesses, if he determines that such distribution, apportionment, or allocation is necessary in order to prevent evasion of taxes or clearly to reflect the income of any such organizations, trades, or businesses."

overseas. In the first 20 years of its life, the section was not applied extensively to international business transactions.¹⁸⁵

After World War II, U.S. companies increased their international business activities substantially. With the industrial economies of Western Europe and Japan severely damaged, many U.S. firms that had confined their operations to the domestic market found that they could export profitably. During the 1950's, rapid economic growth abroad made international business more attractive. The formation of the European Common Market in 1957 and the resurgence of Europe and Japan during the early 1960's - both as markets and as competitors - encouraged U.S. firms to establish manufacturing and marketing subsidiaries overseas.¹⁸⁶

One effect of the establishment of U.S. subsidiaries overseas was to place these manufacturing and marketing operations outside U.S. tax jurisdiction. When a foreign subsidiary paid dividends or royalties or fees to its U.S. parent, these payments were taxable to the parent; but until these payments were made, the subsidiary's income was not taxable in the United States.

185. S. Ekman, "Warning Signals Under Section 45 and 129", New York University 12th Institute on Federal Taxation (1954), p. 693.

186. S. Pizer and F. Cutler, "United States Assets and Investments Abroad", U.S. Department of Commerce, 46 Survey of Current Business (No. 9) 30 (1966).

During the late 1950's and early 1960's, parts of the academic community and organized labor became increasingly concerned with other possible effects of foreign direct investment. Did it aggravate the balance of payments problem? Did it displace domestic investment and thereby retard U.S. economic growth? Was it responsible for rising unemployment in the United States? The answers to these questions were elusive, but the questions themselves were enough to raise the suspicion that U.S. firms, in establishing subsidiaries overseas, might be acting in opposition to the national interest.

This concern was aggravated by the fact that many U.S. owned subsidiaries in foreign countries were paying their local income taxes at very low rates. Some foreign governments offered tax incentives to attract investments to areas in need of industrial development. Others collected income taxes at a lower effective rate than the United States as a matter of policy, relying more heavily on sales taxes and other levies for their needed revenue. A few set their tax rates low to encourage the establishment of financial, sales, and holding companies in their countries.¹⁸⁷

187. W. Brudno, "The Practical Aspects of Incorporating and Doing Business Abroad", University of Southern California Tax Institute (1962), p. 345.

Between 1957 and 1962, hundreds of U.S. companies established "tax haven" subsidiaries in Switzerland, Panama, the Bahamas, and other countries. Some of these tax haven companies performed substantial functions, such as selling and sales promotion, follow-up service, financial coordination, and regional marketing management for their U.S. parent companies as well as for manufacturing subsidiaries, national sales companies, independent licensees, and independent distributors. Others had no more substance than a letter box and a name plate on a lawyer's office.¹⁸⁸

With the change of administrations in the United States in 1961, concern about foreign investment exerted increasing influence on U.S. government policy. The Kennedy Administration's first tax reform bill sought to give the U.S. Treasury the authority to tax all income of foreign subsidiaries when it was earned, rather than when it was remitted to the United States. It also sought a revision of Section 482, to make it more specifically applicable to transactions between U.S. companies and their foreign affiliates.¹⁸⁹

188. J. Guttentag, "Tax Aspects of Foreign Operations," 10 Wayne Law Review (1964), p. 529.

189. J. Hewitt, "Section 482 - Allocation of Income and Deductions Among Related Parties", New York University 20th Institute on Federal Taxation (1962), p. 463.

The Revenue Act of 1962, as it was finally passed into law, fell short of the Administration's proposals for the taxation of foreign income. Through its Subpart F provisions discussed earlier in this chapter, it authorized the Treasury to tax certain income of foreign sales and service subsidiaries when it was earned, but it did not extend the Treasury's reach to include foreign manufacturing subsidiaries. Although the Congressional Joint Conference Committee recommended that the Treasury write new regulations interpreting the application of Section 482 to international transactions, the language of Section 482 itself was left intact.

The Treasury favored the taxation of income of foreign manufacturing subsidiaries by the United States when the income was earned, whether or not it was remitted to the U.S. parent. The law passed by Congress did not authorize this. The law did authorize current taxation of certain kinds of income of tax haven companies, whether or not they performed a function other than tax avoidance; but this did not apply to prior years. Since audits by the IRS are usually carried on several years after the fact, the IRS faced a large backlog of prior year audits involving tax haven subsidiaries that could not be touched by the new provisions of the 1962 Act, even though both the

Administration and the Congress had spoken forcefully against them.¹⁹⁰

Furthermore, Congress had passed to the Treasury the responsibility for interpreting the broad language of Section 482 to clarify its application to international business transactions between related parties. Under the circumstances, it is understandable that the Treasury used Section 482 freely during the 1960's to increase the amount of tax it could collect from U.S. manufacturers having foreign subsidiaries.

2. The Section 482 Regulations

Prior to the Joint Committee's recommendation in 1962, the regulations themselves were not very explicit. Revisions since then have added much more detail in an effort to lay down specific rules to be applied to the various kinds of transactions between related parties.

The old regulations established the arm's length standard as the basis for clearly reflecting the income of related parties. When organizations under common control did business with each other, the regulations specified that their dealings with each other should be treated for tax purposes as

¹⁹⁰. D. Bacon, "Compliance Problems in Taxation of International Operations" Taxation of Foreign Income by United States and Other Countries (Tax Institute of America, Inc., Princeton, 1966), p. 160

if they were not members of the same corporate family. In the words of the regulation:

"The purpose of Section 482 is to place a controlled taxpayer on a tax parity with an uncontrolled taxpayer, by determining, according to the standard of an uncontrolled taxpayer, the true taxable income from the property and business of a controlled taxpayer The standard to be applied in every case is that of an uncontrolled taxpayer dealing at arm's length with another uncontrolled taxpayer."¹⁹¹

The new regulations promulgated in the 1960's attempted to prescribe methods for determining more precisely the arm's length price. Special guidelines for pricing intercompany sales involving Puerto Rican affiliates were published in January 1963. Detailed Treasury regulations covering intercompany loans, service payments, and leasing were first proposed in April 1965, and revised in August 1966. Regulations covering intercompany transfer pricing and royalties for intangibles were also proposed in August 1966. Final regulations applicable to all types of intercompany transactions were adopted in April 1968 with additional provisions covering service payments added nine months later.

Given the existence of these new rules, it is

¹⁹¹. Treas. Reg. Sec. 1.482-1(b)(1).

important for our study to examine the manner in which they have been working in practice. Doing so sheds further light on the subject matter of our study; namely, the foreign tax burdens imposed on foreign income of U.S. based corporations as that income is ultimately determined by the rules of arm's length dealing.

3. Experience With Intercompany Dealings by Taxpayer

During 1969 and 1970, the National Industrial Conference Board received grants from 46 U.S. companies to support a comprehensive study of corporate experience with international allocations under Section 482. The study, which was carried out in 1970 and 1971, included a survey of 512 companies and 90 personal interviews.¹⁹²

In reviewing the Conference Board study, one sees that companies cooperating in the study indicated that international allocations of income were common in the 1960's. Of the 521 companies that responded to the questionnaire, more than half (271) report that they experienced allocations during the past ten years; 241 companies report that they did not. Of the 241 reporting no allocation experience, however, just over half (129) say that transactions with related parties were not of significant

192. M. Duerr, Tax Allocations and International Business, (The Conference Board, New York, 1972), pp. 7-17.

importance to their international business. Among the cooperating companies whose business with related parties abroad was considered to be of significant importance, two out of three (66%) said that they experienced allocations.

Many companies reported that their allocation covered several tax years and several kinds of transaction. Eleven companies reported that ten tax years or more had been subject to allocations during the ten year period; and the mean frequency among the 271 companies that experienced allocations was between four and five tax years out of the ten. Sixteen companies experienced an allocation in one year only, 11 of them in the most recent year examined by the IRS.

Many of the companies that had experienced allocations indicated that they involved more than one kind of transaction. One hundred forty-one companies reported that their allocations involved only one kind of transaction - pricing of tangible goods, service payments, loans, royalties, transfer of intangibles, use of tangible goods, or foreign tax credit limitation allocations - while 130 companies reported allocations involving more than one kind of transaction. No attempt was made to determine exactly how many issues were raised in each company in each tax year, but the data suggested that the total number of allocation issues raised by the IRS during the 1960's was substantial.

Responses also indicated that a substantial proportion of the reported allocations involved transactions with affiliates whose tax rates were lower than the normal U.S. rate. Of the 271 companies reporting that they have experienced allocations, half (135) stated that the allocation or allocations involved a foreign affiliate that was taxed at substantially below U.S. rates. In 69 companies, allocations involved a Western Hemisphere Trading Corporation. In 14, allocations involved a Possessions Corporation.

Despite the higher incidence of allocations involving related units that might be considered tax haven corporations, interviewed executives said that many allocations involve foreign affiliates whose effective rate of tax is about the same as the U.S. rate. According to the survey findings, 88 companies experienced allocations involving only foreign affiliates that were taxed at close to the U.S. tax rate; and 37 companies reported experience with allocations involving both affiliates taxed at close to the U.S. rate and those taxed at a lower rate. These survey results lent support to an objection raised frequently in the interviews: that IRS sometimes allocates income from a foreign tax jurisdiction into its own jurisdiction even though the U.S. parent company has nothing to gain by shifting income

to its foreign subsidiary, since the subsidiary's income is taxed at approximately the same rate as the parent's, and occasionally at a higher rate.

The survey also revealed that the vast majority of allocation cases were settled out of court, most of them in negotiations between the company and the IRS agent. As the interviews showed, these settlements were usually informal and had little value as precedents. Out of 220 companies reporting allocation cases that had been settled, 133 (about 60%) said that settlement was reached at the agent level. Twenty-one were settled at a District Conference; and 63 were settled by the IRS's Appellate Division. Only three companies reported that their cases were settled in the courts.

In addition, 124 companies reported that they had unsettled allocation cases outstanding when they participated in the survey. The levels at which these outstanding cases were being considered showed a different profile.. Although about one-third (44) said that these unsettled cases were pending negotiations with the agent, the other two-thirds had been referred up the Appellate chain - 13 of them before the courts.

The most commonly reported basis for Section 482 allocations seemed to be the pricing of goods sold between related

parties. Of the 271 companies with allocation experience, just under half (134) reported allocations based on intercompany pricing. Almost as many (121) reported allocations based on charges for services performed for related parties. Typically, these involve an allocation of head office costs to overseas units or a service fee calculated as a percentage of the foreign unit's sales. Just under one-third of the companies (86) said that they had been challenged for interest chargeable on loans or advances to related parties, or on accounts receivable outstanding longer than six months. Some of these cases involved interest-free loans from the U.S. parent to the foreign subsidiary; others, subsidiary-to-subsidary loans which IRS deemed to have flowed through the U.S. parent.

Less common in the study were allocations involving royalty payments, the transfer of intangible property (patents, trademarks, etc.), leasing, and allocations affecting the foreign tax credit.

Based on the results of this study, it can be seen that the status of taxpayer income and tax burdens in the foreign area is unsettled at best. From transfer pricing to technological transfers and from movement of financial capital to services by U.S. parents for foreign subsidiaries, there has

been a constant scrutiny and challenge by the U.S. tax authorities of U.S. taxpayers' attempts to shift profits abroad. Having seen this story from the taxpayers' standpoint as expressed in the Conference Board study, we should also examine the results of a Treasury Department study dealing with Section 482 experiences to fully appreciate the import for purposes of our study.

4. Experiences with Intercompany Dealings
By the U.S. Treasury

In January of 1973, the Treasury Department released a report on international tax cases involving Section 482.¹⁹³

The purpose of this study was to obtain data concerning the administration by the Internal Revenue Service of the regulations under Section 482 of the Code as applied to international transactions and arrangements.

Included in this study were all international cases in which the examining agent considered making one or more Section 482 adjustments and in which the revenue agent's report of examination was completed in calendar year 1968 or calendar year 1969. The data contained in this study are based

193. See "Summary Study of International Cases Involving Section 482 of the Internal Revenue Code", U.S. Department of the Treasury, January 8, 1973.

entirely on the revenue agent's report of examination in each case. Information concerning the disposition of each case after the filing of the revenue agent's report was not examined.

A total of 871 international cases were identified in which examining agents considered making one or more Section 482 adjustments. Where a taxpayer's returns were audited for more than one year, or where an entity related to the U.S. taxpayer also filed a U.S. tax return, all returns were treated as one case.

At the outset, it is important to note that adjustments were actually made in slightly more than half of the 871 cases in which one or more adjustments involving Section 482 were considered by the examining agent (458 cases out of 871). Similarly, out of a total of 1,706 potential adjustments that were considered in the 871 cases, slightly more than half (886 adjustments) were actually made. The aggregate dollar amount of all the 886 adjustments made totalled more than \$662 million.

Of the total \$662,101,000 of adjustments made in all cases, pricing adjustments totalled \$312,526,000, or almost half of the total dollar amount of all adjustments made. The total dollar amount of service adjustments - \$75,936,000 - was the third largest.

Data concerning three of the four most frequent types of adjustments - pricing adjustments, service adjustments, and adjustments involving intangibles - were analyzed in detail by the Treasury Department to determine the reason that the agent did or did not make a particular adjustment.

The pricing regulations provide for three methods of determining an arm's length price for the sale of tangible property between related entities. In order of priority, they are called the comparable uncontrolled price method, the resale price method, and the cost plus method. Under the regulations, other unspecified methods can be used to determine an arm's length price if none of the specified methods may reasonably be applied, or if some other method is clearly more appropriate.¹⁹⁴

Of the 174 pricing adjustments made in the study, 20.7 percent were based on the comparable uncontrolled price method, 10.9 percent were based on the resale price method, 27.6 percent were based on the cost plus method, and 40.8 percent were based on an improvised fourth method. Where a pricing adjustment was not made, however, the comparable uncontrolled price method was applied in 56.1 percent of the cases (234 cases out of 417 in which a pricing adjustment was considered but not made),

¹⁹⁴. Treas. Reg. Sec. 1.482-2(e)(1)

usually on the basis of evidence of sales to third parties offered by the taxpayer. A fourth method was applied in 27.6 percent of the cases in which a pricing adjustment was not made (115 out of 417 cases).

Where one entity renders services for the benefit of a related entity, the regulations provide that an arm's length charge for the services may ordinarily be determined on the basis of the costs incurred by the entity rendering the services. If the services are an "integral part" of the business activity of either entity, however, an arm's length charge must be based on the amount that an unrelated third party would have paid.¹⁹⁵

Of the 288 potential service adjustments that were considered, 150 (52.1 percent of the total) were actually made. Approximately 60 percent of the service adjustments were made either on the basis of the taxpayer's costs or on the basis of third party transactions. Approximately 40 percent of the service adjustments were made by application of a hybrid method.

Where intangible property (such as patents or know-how) is transferred or made available by one entity to a related entity, the regulations provide that an arm's length consideration must be received. Where the property has been developed jointly by the related parties pursuant to a bona fide

¹⁹⁵. Treas. Reg. Sec. 1.482-2(b)(2).

cost-sharing arrangement, however, each entity will be permitted to use the property free of charge to the extent that it shared in the costs of development. Where an arm's length consideration must be determined, the standard to be applied is the consideration that would have been received from an unrelated third party for the intangible property under the same circumstances. Where similar transactions with third parties cannot be found, the regulations set forth twelve factors that may be examined in determining an arm's length consideration.¹⁹⁶

Of the 188 potential adjustments involving intangibles that were considered, 100 (53.2 percent of the total) were actually made. Of the 100 adjustments made, no consideration had been received in 73 instances. In 6 instances where no consideration had been received, the parties had shared the research and development costs under a cost-sharing arrangement which the agent determined had not properly reflected the costs and risks of the parties to the arrangement. Accordingly, in those cases, the agent reallocated the development costs in order to properly reflect such costs and risks, instead of imputing an arm's length consideration from one entity to another. The remaining 93 adjustments were made by imputing an arm's length

¹⁹⁶. Treas. Reg. Sec. 1.482-2(d)(2).

consideration to the entity that had transferred or made available the intangible property to the related entity. The consideration received by the taxpayer from unrelated third parties was used as the basis for 54 of these adjustments, while the various other methods prescribed in the regulations were applied in making 24 of these adjustments.

Of the 88 potential adjustments involving the transfer of intangibles that were considered but not made, the existence of a cost-sharing arrangement among the related entities was the basis for not making an adjustment for only 9.1 percent of the adjustments not made. The consideration received by the taxpayer from unrelated third parties was relied upon as the basis for not making an adjustment in 23.9 percent of these cases, while the various methods prescribed in the regulations were relied upon as the basis for not making an adjustment in 35.2 percent of these cases.

From the foregoing examination of the great variety and magnitude of adjustments to income of U.S. taxpayers in the international area, we can now appreciate the fact that there has been considerable scrutiny of the shifting of income from U.S. based corporations to their foreign subsidiaries and among foreign subsidiaries of U.S. corporations. This insight forms

a valuable input for our study of the foreign tax burdens incurred by U.S. based multinational corporations and the manner in which these burdens and incomes have been managed by the U.S. corporations. We must remember throughout our study that U.S. corporations have latitude for adjusting their foreign income and tax burdens in addition to all the other techniques available, but that the Internal Revenue Service has the authority - and exercises it - to reallocate the foreign income to more clearly reflect arm's length dealing. Both of these elements produce a cross-current of activity which has great significance for U.S. based corporations.

Up to this point of our study, we have examined the manner in which the United States tax system seeks to impact on U.S. based corporations with regard to their foreign income and foreign taxes incurred. Essentially, it is a system which draws all worldwide income into the tax net and taxes it basically the same way in terms of inclusion in the income base. The Code - recognizing a worldwide principle of jurisdiction provides the potential for substantial international double taxation for a capital exporting country like the United States - contains a foreign tax credit mechanism which is very broad and flexible in its construction. The U.S. foreign tax credit system is the

basic way in which the United States tax system accommodates itself to foreign tax burdens suffered by U.S. corporations. The United States also has a tax treaty network which has as its objective the avoidance of double taxation as a basic principle. The particular provisions contained in the U.S. tax treaty system for the achievement of this objective are geared more to the exemption or reduced taxation by foreign countries of the income generated by U.S. corporations. The savings clause in the U.S. tax treaty network preserves for the United States the right to tax worldwide profits of its corporation notwithstanding any other provision of the treaties. In essence, the U.S. tax treaty system impacts on U.S. based corporations by assisting in a more efficient absorption of foreign tax burdens by U.S. corporations against the U.S. tax under the foreign tax credit system. Finally, the U.S. tax system, as it relates to the international sphere, contains a much used provision for reallocating the income and expenses of U.S. corporations engaged in transactions with foreign affiliates. In so doing, there is an air of uncertainty involved in the intercompany dealings of U.S. based corporations abroad with a resultant double taxation overhang of importance to our study. With this overall conceptual framework established, we are now in a position to analyze the manner in

which U.S. based corporations are actually affected by foreign tax burdens.

CHAPTER II

EXAMINATION OF THE IMPACT OF FOREIGN TAX BURDENS ON U.S. CORPORATIONS CONDUCTING INTERNATIONAL OPERATIONS

In the foregoing chapter, we examined the U.S. tax system from the standpoint of the manner in which the underlying U.S. tax policies on foreign income of U.S. corporations have been translated into specific taxing provisions both in the internal law and in tax treaties. From it, we extracted the framework which the United States has adopted in dealing with the taxation of foreign income of U.S. corporations, and in particular, the manner in which foreign taxes that U.S. corporations incur are to be absorbed within the U.S. tax system. As we have seen, the tax rules were adopted within the framework of U.S. tax policy considerations based on a worldwide jurisdictional principle as to the taxation of income of U.S. corporations. They were also tailored around the objective of granting double taxation relief to U.S. corporations through the unilateral adoption of the foreign tax credit mechanism in the Code. Furthermore, we saw that the bilateral tax treaty system which the United

States has constructed provides a companion to the foreign tax credit system as it relates to U.S. corporations specifically in that it provides a means whereby foreign tax burdens can be accommodated more efficiently into the U.S. taxing system. With that conceptual framework behind us, we can now begin to examine the manner in which U.S. corporations actually incur foreign taxes and the extent to which these taxes impact on them.

A. Basic Objectives of this Study

1. Determination of the Extent to Which U.S. Corporations Incur Foreign Taxes Based on Empirical Data

From the foregoing conceptual discussions of the U.S. tax system as it relates to the foreign investments and foreign income generated by U.S. based corporations, one can see that the U.S. tax policies are founded on some assumptions as to the imposition of foreign taxes on the foreign earnings generated by those U.S. corporations. These assumptions include certain basic economic evaluations of the relationship of the tax factor to the decision to invest abroad as well as the impact that the tax factor makes on the decision to retain earnings abroad or repatriate them.¹⁹⁷

197. G. M. Brannon, "Objectives of United States Tax Policy", Proceedings of the 66th Annual Conference of the Taxation National Tax Association - Tax Institute of America, September 1973, pp. 9-11.

This latter aspect is, in turn, affected by the fact that earnings of foreign subsidiaries of U.S. companies are deferred from U.S. taxation, as a general rule, until they are repatriated to the United States in the form of dividends. Coupled with this impact of the tax factor on the decision to invest abroad and retain earnings abroad, the tax factor also has an impact on the foreign competitive environment.¹⁹⁸ This raises the question as to whether the U.S. tax on foreign earnings of U.S. corporations should be neutral vis-a-vis other U.S. corporations or foreign competition. In this regard, differentials in domestic and foreign tax rates are a significant factor that must be looked at in approaching any evaluations of this subject. For these fundamental tax policy purposes, then, one has to gain a true insight into the extent to which U.S. corporations actually incur foreign taxes.

In order to make a true inquiry into the foreign tax burdens of U.S. based corporations, the starting point adopted for our study was to ascertain the extent to which U.S. corporations were actually incurring foreign taxes in their day-to-day operations. Therefore, the first objective of this study was to

198. Ibid., p. 15.

make such a determination in order to be able to appreciate from the outset the relative importance of foreign tax burdens incurred by U.S. based corporations.

2. Examination of the Manner in Which U.S. Corporations Utilize Foreign Taxes Incurred Against Their U.S. Tax Burdens

Because of the nature in which the U.S. tax law is structured with regard to providing unilateral and bilateral relief from double taxation, the next objective of the study was to determine the manner in which U.S. corporations utilize the foreign taxes that they actually incur to offset U.S. tax burdens that they would otherwise have incurred on those earnings. Because of the intricate interrelationship of the foreign tax credit mechanism in the United States - with its per country and overall alternatives - and the bilateral tax treaty network the United States has constructed, a significant interplay of U.S. and foreign tax liabilities was found. It was not sufficient for purposes of the study to look solely at the quantum of foreign taxes incurred by U.S. corporations conducting international operations. One also had to relate that factor to the offsetting of those burdens by U.S. companies against their U.S. tax liabilities.¹⁹⁹

199. P. Musgrave, "International Tax Based Division of Multi-National Corporations", 27 Public Finance, No. 4 (1972), pp. 394-413.

This was important if we were ultimately to relate the actual experience of U.S. companies in their foreign operations from a tax standpoint to the tax policy decisions the U.S. government has made to date as reflected in the tax system dealing with foreign tax burdens.

3. Comparison of the Foreign Tax Burdens Incurred by U.S. Corporations and Reported for Tax Purposes With the Tax Rates Reported by Such Corporations for Accounting Purposes

Our examination of the impact of foreign tax burdens on U.S. corporations conducting international operations could have restricted itself solely to the pure tax results produced by the imposition of foreign tax burdens and their utilization as offsets against U.S. tax liabilities. However, to provide an even more meaningful evaluation of the impact of the foreign tax burden, an additional basis for comparison was utilized in the study. Because of the disparity between accounting income and taxable income on an international scale, there existed a logical basis for comparison of the foreign tax burdens. The research, therefore, sought as a further objective a meaningful comparative analysis of foreign tax burdens on U.S. corporations from both a tax and financial accounting standpoint. In so doing, worthwhile bases for conclusions on the impact of foreign tax burdens on U.S. corporations from an interdisciplinary

approach could be made.

Since the foreign subsidiary operations of U.S. corporations are generally consolidated for financial statement purposes and the results of these corporations are reported to its shareholders, it was felt that, for purposes of this research, significant analyses could be performed by comparing the tax burdens incurred by U.S. corporations and reported for tax purposes with the tax burden as reported by such companies for accounting purposes.²⁰⁰ The objective here was to provide a basis for evaluating - against a different basis of measurement - the impact of tax burdens, both U.S. and foreign, on foreign earnings.

4. Analysis of the Techniques Employed by U.S. Corporations in Tax Planning for Foreign Taxation Incurred on an Individual Corporation Basis

After having examined the extent to which foreign tax burdens were incurred by U.S. based corporations and the manner in which they were utilized under various circumstances to offset U.S. tax burdens, it then behooved us to ascertain the specific means by which U.S. corporations are able to achieve their results of accommodating their overall tax planning to foreign tax burdens. Therefore, the next objective of our research was

²⁰⁰. Professional Accounting in 25 Countries (American Institute of Certified Public Accountants - Committee on International Relations, New York, 1964), p. 22.

to take the statistical data made available by our studies and examine the manner in which the incurrence of foreign and U.S. taxation on overseas earnings by U.S. corporations affect the decision making process by those companies with regard to foreign operations. As the quantitative data of the research was developed, certain trends in the techniques used by U.S. corporations were disclosed. Our research sought to develop these quantitative trends toward insights into qualitative decision making results. This objective was sought in order that our research would not only provide an evaluation of the quantitative manner in which U.S. corporations react to the imposition of U.S. and foreign tax burdens on their international operations, but also to see how these corporations anticipate the imposition of those burdens and utilize the foreign taxes in their ongoing planning.

5. Conclusions as to the Manner in Which Foreign Taxes Actually Impact on U.S. Corporations

Once having examined the manner in which U.S. corporations actually incur foreign and U.S. taxation on their foreign earnings and compared those burdens from a tax and financial reporting standpoint, our study was able to relate these effects to the impact they have on the decision making process of U.S. corporations and the techniques utilized for planning

for foreign taxes incurred abroad. With these results available, our research then enabled us to achieve the objective of drawing conclusions as to how the incurrence of U.S. and foreign tax on foreign earnings by U.S. corporations in the real world interrelate with the U.S. tax policies as expressed in the U.S. tax system.

6. Formulate Recommendations to Modify U.S. Tax Policies Relating to Foreign Income of U.S. Corporations and to Conform the U.S. Tax Rules to Those Modified Policies

Based on the conclusions reached as a result of our research, we were then able to meet the objective of formulating recommendations for modifying U.S. tax policies so that they would be more in line with, and reflective of, the actual incurrence of taxation on the foreign earnings of U.S. corporations. In addition, the modification of these tax policies gave rise to recommendations for modification of the U.S. internal tax law and U.S. tax treaties so that the unilateral and bilateral tax rules conform to the modified tax policies suggested by the recommendations of this research.

B. Structure of the Study

In order to meet the objectives stated above, our research had to be so organized as to provide sufficient empirical data with which to generate the answers needed to meet those

objectives. This requirement for empirical data necessitated the assemblage of a data base which was not available in published form. This segment of the chapter outlines the nature of the empirical data base required and the profile of the data base actually assembled for our study.

1. Nature of the Empirical Data Base

To meet the objectives of our study, it was necessary to have access to data as to the amount of foreign taxes actually incurred by U.S. corporations on their foreign income, the amount of foreign income being generated, the amount of U.S. tax burdens on that income, as well as the amount of U.S. taxable income related to those earnings.

The information required had to be accumulated in such a form as to enable us to analyze it, not only on an aggregate basis by total U.S. corporations with foreign operations, but also by such sub-categories as type of industry in the United States and abroad incurring those foreign tax burdens and the size of U.S. corporations conducting operations abroad. Furthermore, in order to provide a meaningful basis for analysis, the data had to be in a form capable of being analyzed by country of source so that the interplay of foreign income tax laws and tax treaties could be appropriately evaluated. In addition, the data had to be segmented by country so that our research

could compare the effective rates of foreign tax with the statutory rates imposed by foreign countries. The data had to be in sufficient detail to enable analysis by type of income within foreign countries. This was due to the varying tax treatments, both in the United States and abroad, on different types of income being earned by U.S. corporations from foreign sources.

A significant degree of U.S. operations abroad are conducted in the form of foreign corporate subsidiaries. Because of this fact, there are variations in tax liabilities on income earned directly abroad by U.S. corporations and that earned by their foreign subsidiaries. Consequently, the data base had to be assembled so that it could be evaluated in that context during the course of our research.

The data base also had to be segmented between tax treaty countries and non-tax treaty countries so that comparisons could be made between the two types of countries and the foreign tax burdens that ensued therefrom. In addition to actual tax burdens, our research computed foreign tax burdens on the basis of assumptions that tax treaties do not exist in order to isolate their impact.

A further factor in our study was that the ability of U.S. corporations to utilize foreign taxes as tax

credits in the United States is a function of several variables from the U.S. tax standpoint; namely, foreign gross income, deductions attributable to the foreign gross income, foreign taxable income and the U.S. effective tax rate. The data base therefore had to be accumulated so as to be able to provide this information for an in-depth evaluation of foreign tax credits.

From an overall standpoint, the data had to be capable of sufficient recomputation so as to yield analyses as to the manner in which taxes in certain foreign countries can be utilized against U.S. tax on income from other countries. This was needed so that the impact of foreign tax burdens on decision making processes of U.S. corporations could be evaluated from a tax standpoint.

Finally, the data base had to be structured in such a manner as to enable us to compare the data for the U.S. corporations from a tax standpoint with the data for financial statement purposes. This was necessary in order to make a comparative analysis of the impact that foreign taxes make on U.S. companies from a tax as well as an accounting standpoint. This required the assembly of the financial information U.S. corporations present for reporting to their shareholders with the data presented for tax purposes so that a comparison could

be made of not only their overall tax burdens but also the burdens related to their foreign operations.

These various analyses required of our research, in order to meet the objectives of our study, could not be obtained from published data. Although the U.S. Department of Commerce publishes information on foreign direct investment by U.S. corporations and operations abroad as well as flows of foreign income to U.S. corporations, this information was not specific enough nor provided in sufficient detail in order to be responsive to the needs of our study.²⁰¹ Similarly, the U.S. Treasury Department produces tabulations of aggregate statistics of foreign income and foreign taxes reported on corporate income tax returns of U.S. corporations. However, such data is basically out of date and is not in sufficient detail to provide the basis for in-depth research of the type required by our study.²⁰² Our research did draw to a limited extent from these sources, but is based primarily on private empirical data which enabled us to obtain more in-depth insights into the manner in which foreign tax burdens are actually incurred by U.S.

201. See, for example, data produced by U.S. Department of Commerce, Survey of Current Business, September 1973, pp. 63-68.

202. See, for example, U.S. Treasury Department Supplemental Statistics of Income 1964 - 1966 Foreign Income and Taxes, Corporation Income Tax Returns, Publication 479 (4-73), (U.S. Government Printing Office, Washington, D.C. 1975), pp. 16-23.

corporations. This empirical data formed the basis for comparison with the information available from the Securities and Exchange Commission dealing with accounting treatment given by U.S. corporations to tax burdens and income from foreign operations in their published financial statements.²⁰³ The financial reporting on these matters did provide empirical data for purposes of our comparison of accounting and tax treatment on overseas earnings of U.S. based corporations.

2. Profile of the Data Base

Because of the deficiencies in the available published information, steps were taken to assemble information required for our detailed analyses from private sources. The research used as its basis for the required empirical data, information compiled from clients of an international accounting firm with a wide dispersion of clients in the international area. Because of the confidential nature of the relationship between client and accounting firm, the data was analyzed without identifying specific companies with specific data, thereby respecting this confidentiality. Without identifying particular companies, the data was assembled so that meaningful

203. Securities and Exchange Commission Release No. 149 amending Rules 3-16(o) of Regulation S-X, 38 F.R. 33282, November 28, 1973.

trends could be researched and evaluated.²⁰⁴ The procedures and protocol for utilizing the data is set forth in Exhibit A.

The data was assembled by requesting the offices in the United States of the accounting firm to provide the data on the clients in their office which had reported income from foreign earnings either on a direct basis or from foreign subsidiaries on their most recent tax return. The inquiry requested all data pertaining to the foreign tax burdens of the corporations including information on the computation of the foreign tax credit, the amount of foreign taxes and the countries in which the taxes were incurred, the foreign income by country, the amount of deemed paid credits from foreign subsidiaries, carryovers of excess foreign tax credits from prior years, the U.S. tax burden on the foreign income for foreign tax credit limitation purposes, and the information dealing with the foreign subsidiaries of these U.S. corporations as reflected on their U.S. tax returns.

As a result of this inquiry, the data base compiled consisted of some 407 U.S. companies' information being assembled, all of whom claimed foreign tax credits on their tax

204. The accounting firm is Peat, Marwick, Mitchell & Co. See T. Wise, "The Very Private World of Peat, Marwick, Mitchell", Fortune Magazine (July 1966).

PEAT MARWICK MITCHELL & CO
CERTIFIED PUBLIC ACCOUNTANTS
345 PARK AVENUE
NEW YORK, NEW YORK 10022

MEMORANDUM OF PROCEDURE AND PROTOCOL FOR RESEARCH

Subject: An Inquiry Into the Foreign Tax Burdens of U. S.-based
Multinational Corporations

The purpose of this memorandum is to set forth the procedures and protocol used in connection with the assembly of the data for purposes of making an examination of the foreign tax burdens incurred by U. S. corporations and the understanding as to how this data was to be utilized by the writer.

The initial stage in connection with the assembly of the data was an approach by me to the major offices of the firm, requesting that they forward to me the tax return data for their clients which had claimed a foreign tax credit on their tax returns for the year 1972 or fiscal period ending in 1972.

The data requested was a copy of the corporation's tax return filed on Form 1120 with the attachments dealing with the foreign taxes incurred by corporations related to Form 1118. The information regarding foreign taxes included computation of the foreign taxes directly incurred by the U. S. corporations, the amount of foreign taxes which the U. S. corporations were deemed to have paid by reason of dividends received from foreign affiliates and foreign taxes which were carried over to the current year from prior years in which they could not be utilized.

In addition to the information on foreign taxes actually incurred in the current

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year, a request was made for the information returns filed by the U.S. corporations with regard to the foreign corporations which they controlled. Such information was available on Form 2952 and Form 3646 required to be appended to the corporation income tax return of the corporations responding. The copy of all of these Forms is appended to this memorandum for reference purposes.

As a second stage, a data base was compiled which consisted of some 407 U.S. companies' information being assembled. All these companies claimed a foreign tax credit on their tax returns for the taxable year 1972 or the fiscal period ended therein. I searched the 407 companies in the data base and found that 117 had requirements for filing Form 10K with the Securities & Exchange Commission for the year 1972 or some period ending therein.

The request for data was responded to by 32 offices of the firm and, while the data base represents a significant number of companies for purposes of research, it does not represent all the clients of the firm.

In addition to the data collected based on tax returns of the corporations as filed, I also collected the Form 10K's filed by corporations in the data base with the Securities & Exchange Commission for the period of time comparable to that on which they file their tax returns. This information was based on that available from published sources at the Securities & Exchange Commission.

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The understanding on which the materials assembled were to be used, was that they could be utilized for compiling statistical data regarding the foreign tax burdens of U. S. corporations for purposes of preparing the study on that subject. The results of that study could be made available outside the firm, but due to the confidentiality of the data, the materials could not be displayed so as to identify any specific company in the data base, either directly or indirectly. Consequently, compilations on the basis of size of corporation, industrial classification and types of income, as well as country, were considered appropriate, including such analyses based on foreign subsidiary earnings as well as the direct foreign earnings of U. S. corporations.

In addition, comparisons with published financial data were also considered appropriate so long as the confidentiality of particular client information was respected.

Walter F. O'Connor

MS

Information Return with Respect to Controlled Foreign Corporations

(Under Section 6038 of the Internal Revenue Code)

For calendar year 19____, or other taxable year beginning 19____ and ending 19____

Name of United States person

Identifying number (social security number, or employer identification number if other than individual)

Address

The following information must be submitted on a separate Form 2952 for each Controlled Foreign Corporation (see instruction A). Amounts must be stated in U.S. dollars and all information must be in the English language.

1 (a) Name and address of foreign corporation

(b) Employer identification number of army

2 Name and address of statutory or resident agent in country of incorporation

3 (a) Name and address of branch or agent in the U.S.

(b) Identifying number

4. Name and address of custodian of books and records and location of books and records if different from such address

5 (a) Principal business activity

(b) Business code number

(c) Principal cities and countries where business is conducted

6 Date of incorporation

7 Information furnished for the foreign corporation's period—
beginning . . . 19 . . . ending . . . 19

8 Country under whose laws incorporated

9 (a) Description of each class of stock

(b) Number of shares of each class outstanding—	
at the beginning of the annual accounting period	at the end of the annual accounting period
Common	
Preferred	
Other	

10 (a) Total percentage of voting stock of the foreign corporation owned by you at the end of the annual accounting period

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(b) The following information must be submitted for each U.S. person who is a shareholder owning at any time during the foreign corporation's annual accounting period 5% or more in value of any class of outstanding stock.

[illegible]

11 (a) Current earnings and profits (see sections 902 and 961(a) and the regulations thereunder) *

(b) Current foreign income, war profits, and excess profits taxes paid or accrued (exclude amounts withheld on distributions)

(c) Distributions out of current earnings and profits

(d) Distributions out of accumulated earnings and profits for prior years (see instruction 1—attach schedule)

(e) Distributions out of other than earnings and profits (see instruction 4—attach schedule)

*If no entry is made on line 11(a) or if the amount entered on line 11(b) is larger than the amount entered on line 11(a) attach an explanation reconciling lines 11(a) and 11(b).

12 *Complete the following summary showing the total amount of each of the following types of transactions that took place during the annual accounting period of the foreign corporation between the foreign corporation (column (1)) and the persons described in columns (2) through (6).

(1) Transactions of controlled foreign corporation	(2) U.S. person filing return	(3) Any domestic corporation controlled by U.S. person filing return	(4) Any foreign corporation controlled by U.S. person filing return	(5) 10% or more U.S. shareholder of controlled foreign corporation (other than controlling shareholder)	(6) 10% or more U.S. shareholder of domestic corporation filing this return
(a) Sales of stock in trade (except in the ordinary course of business where neither party to the transaction is a U.S. person)					
(b) Sales of property rights (e.g., patents, trademarks, secret formulas, etc.)					
(c) Compensation received for technical, managerial, engineering, construction, scientific, or like services					
(d) Commissions received					
(e) Rents and royalties received					
(f) Amounts borrowed (other than open accounts which arise and are collected in the ordinary course of business)					
(g) Dividends received					
(h) Interest received					
(i) Premiums received for insurance or reinsurance					
Total (lines (a) through (i))					
(j) Purchases of stock in trade (except in the ordinary course of business where neither party to the transaction is a U.S. person)					
(k) Purchases of tangible property other than stock in trade (except where neither party to the transaction is a U.S. person)					
(l) Purchases of property rights (e.g., patents, trademarks, secret formulas, etc.)					
(m) Compensation paid for technical, managerial, engineering, construction, scientific, or like services					
(n) Commissions paid					
(o) Rents and royalties paid					
(p) Amounts loaned (other than open accounts which arise and are collected in the ordinary course of business)					
(q) Dividends paid					
(r) Interest paid					
Total (lines (j) through (r))					

If an entry would be made in the above schedule except for the fact that no compensation was paid, indicate the categories in which this has occurred.

*If the U.S. person is a bank, as described in section 581, or is controlled within the meaning of section 368(c) by a bank, the term "transactions" must not, as to a corporation with respect to which a return is filed, include banking transactions entered into on behalf of customers. However, deposits in accounts between a foreign corporation controlled by a U.S. person, and a bank, and withdrawals from accounts must be summarized by reporting end of month balances.

13 (a) The following financial statements for the annual accounting period of the foreign corporation must be filed with and made a part of this return: (1) profit and loss statement for the period; (2) balance sheet as of the end of the period; and, (3) analysis of changes in surplus accounts (include both opening and closing balance). These statements must be filed in conformity with generally accepted accounting principles, and in such form and detail as is customary for the corporation's accounting records.

(b) Enter gross receipts or gross sales (less returns and allowances) from the profit and loss statement required in item 13(a)(1)

(c) Enter total assets (net) from the balance sheet required in item 13(a)(2)

14 Exchange rate used (if more than one rate is used, attach statement) ▶

15 Complete the following for persons with whom this return is jointly filed or on whose behalf it is filed:

Name	Address

Instructions

(References are to the Internal Revenue Code.)

A. Requirement of Return.—Every U.S. person must make a separate annual information return on Form 2952 with respect to each annual accounting period of each foreign corporation that person controls for an uninterrupted period of 30 days or more during such annual accounting period.

B. Nature of Business.—See page 7 of the instructions to Form 1120 for list of principal business activities and business activity code numbers.

C. Principal Cities and Countries where Business is Conducted.—List those places of business from which the largest portion of gross receipts shown in line 13(b) is derived.

D. U.S. Person.—The term "U.S. person" means:

- (1) a citizen or resident of the United States;
- (2) a domestic partnership;
- (3) a domestic corporation; and
- (4) any estate or trust other than a foreign estate or foreign trust within the meaning of section 7701(a)(31).

Enter all transactions of an affiliated group which filed a consolidated return in column 2 of item 12. Enter transactions of domestic subsidiaries with which a consolidated return was NOT filed in column 3 of item 12.

See section 1.6038-2(d) of the regulations for exception of certain residents of U.S. possessions.

E. Control.—A person will be deemed to be in control of a foreign corporation if he owns stock possessing more than 50% of the total combined voting power of all classes of stock entitled to vote, or more than 50% of the total value of shares of all classes of stock of the foreign corporation. A person in control of a corporation which, in turn, owns more than 50% of the combined voting power, or of the value, of all classes of stock of another corporation is also treated as being in control of such other corporation.

Example.—Corporation A owns 51% of the voting stock in Corporation B. Corporation B owns 51% of the voting stock in Corporation C. Corporation C in turn owns 51% of the voting stock in Corporation D. Corporation D is controlled by Corporation A.

F. Attribution Rules.—For the purpose of determining control of domestic or foreign corporations, the constructive ownership rules of section 318(a) apply, except that:

(1) Stock owned by or for a partner or a beneficiary of an estate or trust will not be considered owned by the partnership, estate, or trust when the effect is to consider a U.S. person as owning stock owned by a person who is not a U.S. person.

(2) A corporation will not be considered as owning stock owned by or for a 50% or more shareholder when the effect is to consider a U.S. person as owning stock owned by a person who is not a U.S. person.

(3) If 10% or more in value of the stock in a corporation is owned, directly or indirectly, by or for any person, section 318(a)(1)(C) will apply.

G. Period Covered by Return.—The information required by this return must be furnished for the annual accounting period of the foreign corporation ending with or within the U.S. person's taxable year.

H. Time and Place for Filing Return.—Returns on Form 2952 must be filed with the U.S. person's income tax return. An application for an extension of time for filing a return of income is also considered as an application for an extension of time for filing Form 2952.

I. Distributions Out of Accumulated Earnings and Profits.—If any distributions are made by the foreign corporation to shareholders with respect to their stock out of accumulated earnings and profits for prior years, enter in item 11(d) the total amount of such distributions and attach a schedule showing the years during which the earnings and profits were accumulated. (The distributions are deemed to be made out of the most recent prior years' accumulated earnings and profits, working backwards.)

J. Distributions Out of Other Than Earnings and Profits.—To the extent that distributions made by the foreign corporation to shareholders with respect to their stock exceed the current and prior years' accumulated earnings and profits, enter in item 11(e) the total amount of other distributions. Attach a schedule showing the amount that is applied against the shareholders' basis, and the amount that is treated by the shareholders as capital gain distributions.

Also, include in the schedule the amount of any distributions by the con-

trolled foreign corporation which are made to shareholders in redemption of stock, or in partial or complete liquidation.

K. Two or More Persons Required to Submit the Same Information.—If two or more persons are required to furnish information with respect to the same foreign corporation for the same period, the persons may, instead of making separate returns, jointly make one return. The joint return must be filed with the income tax return of any one of the persons making such joint return.

L. Persons Exempted from Furnishing Information.—Any person required to furnish information under section 6038 with respect to a foreign corporation need not furnish that information if all of the following conditions are met:

(1) The person does not directly own an interest in the foreign corporation;

(2) The person is required to furnish the information solely by reason of attribution of stock ownership from a U.S. person; and

(3) The person from whom the stock ownership is attributed furnishes all of the information required of the person to whom the stock ownership is attributed.

M. Statement Required.—Any person who is required to file this return but does not do so because the information will be furnished by another person must file a statement with his return indicating that such liability will be satisfied and identify the return with which the information will be filed and the place of filing. The statement below may be used for this purpose.

N. Penalties.—The information required by section 6038 must be furnished even though there are no foreign taxes which would be reduced. For criminal penalties for failure to file a return and filing a false or fraudulent return, see sections 7203, 7206, and 7207.

O. Effect on Tax Credit.—Failure to furnish any information required by section 6038 will result in a reduction in the foreign taxes which are taken into account when figuring the credit under sections 901, 902, and 960 as provided in detail in paragraph (l) of section 1.6038-2 of the regulations.

Statement in Regard to Filing Requirement of Form 2952

I have not filed Form 2952 because (check applicable box):

☐ I am exempted from filing and information will be furnished by the person from whom the stock ownership is attributable.

☐ A joint return has or will be filed.

Person filing this statement		The information required to be furnished on Form 2952 will be filed by	
Name		Name	
Address		Address	
Identifying number	Year	Internal Revenue Service Center	Identifying number

Income from Controlled Foreign Corporation

(Under Sections 951 through 972 of the Internal Revenue Code)

► Attach to your tax return.

A. Name and address as shown on your income tax return

B. Taxable year ending

The following information relates to the controlled foreign corporation. A separate Form 3646 must be filed for each controlled foreign corporation. See instruction E.

C. Name, address, and employer identification number, if any, of controlled foreign corporation

D. Taxable year ending

E. Nature of business

F. Country under whose laws incorporated

G. Date of incorporation

H. Country in which principal place of business is located

Yes No

I. Has a minimum distribution election been made with respect to your total interest in the controlled foreign corporation (section 963)?
If "Yes," omit Schedules D, C, and F, and line 1 of Schedule A.

J. Did the controlled foreign corporation have foreign base company income (as determined for purposes of section 954(b)(3)(A)) constituting 30 percent or more of its gross income?

If "No," omit Schedule C and check if amounts were excluded under: (a) section 954(b)(2) ☐ and/or (b) section 954(b)(4) ☐.
(If amounts were excluded under section 954(b)(4), attach statement showing amounts excluded and reasons for claiming the exclusion.)

K. Did the controlled foreign corporation receive premiums and other consideration from the insurance of United States risks in excess of 5 percent of the premiums and consideration received from insurance of all risks (section 953)?
If "No," omit line 1 of Schedule B.

L. Has any amount ever been excluded from the foreign base company income of the controlled foreign corporation because of an increase in qualified investments in less developed countries?
If "Yes," complete Schedule E.

M. Has any amount ever been excluded from the subpart F income of the controlled foreign corporation because it qualified as an export trade corporation?
If "Yes," complete Schedule G.

N. Did the controlled foreign corporation hold any United States property at the close of its taxable year (other than property excluded under section 956(b)(2))?
If "Yes," complete Schedule D.

O. Is the controlled foreign corporation a foreign investment company or a foreign personal holding company?
If "Yes," see section 951(c) or (d) and the regulations thereunder.

SCHEDULE A—Summary

- 1 Pro rata share of subpart F income (Schedule B)
- 2 Pro rata share of increase in earnings invested in United States property (Schedule D)
- 3 Pro rata share of previously excluded subpart F income withdrawn from investment in less developed countries (Schedule E)
- 4 Pro rata share of previously excluded export trade income withdrawn from investment in export trade assets (Schedule G)
- 5 Total of lines 1 through 4. Enter here and on your tax return

SCHEDULE B—Pro Rata Share of Subpart F Income

- 1 Income derived from insurance of United States risks (section 953—attach schedule)
- 2 Foreign base company income (Schedule C)
- 3 Total of lines 1 and 2
- 4 Exclusion of net United States source income (section 952(b))
- 5 Line 3 less line 4
- 6 Pro rata share of line 5 (see reg. sec. 1.951-1(e))
- 7 Pro rata share of earnings and profits limitation (sections 952(c) and (d))
- 8 Line 6 or line 7, whichever is lesser
- 9 Pro rata share of reduction for export trade income (Schedule F)
- 10 Line 8 less line 9
- 11 Part of year corporation was a controlled foreign corporation over entire year times line 10, i.e. $\left(\frac{\text{days}}{365} \times \text{line 10}\right)$
- 12 Dividends paid to any other person with respect to your stock
- 13 Part of year you did not own such stock over entire year times line 10, i.e. $\left(\frac{\text{days}}{365} \times \text{line 10}\right)$
- 14 Line 12 or line 13, whichever is lesser
- 15 Pro rata share of subpart F income (line 11 less line 14). Enter here and on line 1, Schedule A

SCHEDULE C—Foreign Base Company Income

Show gross amounts before exclusions. If the entire gross income of the controlled foreign corporation is treated under section 954(b)(3)(B) as foreign base company income, omit lines 1 through 10 and enter such gross income on line 11.

1 Rents and royalties		
2 Less: (a) Rents and royalties derived in the active conduct of a trade or business and received from an unrelated person (section 954(c)(3)(A))		
(b) Rents and royalties received from a related person for the use of property in the country of incorporation of the controlled foreign corporation (section 954(c)(4)(C))		
3 Line 1 less line 2		
4 Dividends, interest, and net gains from the sale or exchange of stock or securities		
5 Less: Dividends, interest, and net gains described in sections 954(c)(3)(B), 954(c)(4)(A), and 954(c)(4)(B)		
6 Line 4 less line 5		
7 Other foreign personal holding company income		
8 Total foreign personal holding company income (sum of lines 3, 6, and 7)		
9 Foreign base company sales income (section 954(d))		
10 Foreign base company services income (section 954(e))		
11 Total of lines 8, 9, and 10		
12 Exclusion of certain gross amounts:		
(a) Shipping income described in section 954(b)(2)		
(b) Income described in section 954(b)(4). (Attach statement giving reason for the exclusion.)		
(c) Dividends described in section 959(b)		
13 Line 11 less line 12		
14 Deductions (including taxes) allocable to amounts included on line 13 (section 954(b)(5))		
15 Line 13 less line 14		
16 Exclusion of certain income described in section 954(b)(1):		
(a) Net amount of line 15 attributable to dividends, interest, and net gains from qualified investments in less developed countries.		
(b) Increase in qualified investments in less developed countries (see regs. sec. 1.954-5—attach computation)		
Check if an election is in effect for the taxable year under regs. sec. 1.955-3 ☐		
(c) Enter line 16(a) or line 16(b) whichever is lesser		
17 Foreign base company income (line 15 less line 16(c)). Enter here and on line 2, Schedule D		

SCHEDULE D—Pro Rata Share of Increase in Earnings Invested in United States Property

1 Amount of United States property (other than property excluded under section 956(b)(2)) held, directly or indirectly, by the controlled foreign corporation at the close of the taxable year	
2 If limitation applies, enter current and accumulated earnings and profits at the close of the taxable year (see regs. sec. 1.956-1(b))	
3 Amount of earnings invested in United States property at the close of the taxable year which would constitute a dividend if distributed on such date (line 1 or line 2, whichever is applicable)	
4 Amount of United States property (other than property excluded under section 956(b)(2)) held, directly or indirectly, by the controlled foreign corporation at the close of the preceding taxable year	
5 If limitation applies, enter current and accumulated earnings and profits at the close of the preceding taxable year (see regs. sec. 1.956-1(b))	
6 Amount of earnings invested in United States property at the close of the preceding taxable year which would constitute a dividend if distributed on such date (line 4 or line 5, whichever is applicable)	
7 Amounts paid during the preceding taxable year to which section 959(c)(1) applies	
8 Line 6 less line 7	
9 Pro rata share of line 3 (see regs. sec. 1.956-1(d))	
10 Pro rata share of line 8 (see regs. sec. 1.956-1(d))	
11 Line 9 less line 10	
12 Part of year corporation was a controlled foreign corporation over entire year times line 11, i.e. $\left(\frac{\text{days}}{365} \times \text{line 11}\right)$	
13 Amounts excludable under section 959(a)(2)	
14 Pro rata share of increase in earnings invested in United States property (line 12 less line 13). Enter here and on line 2, Schedule A	

SCHEDULE E—Pro Rata Share of Previously Excluded Subpart F Income Withdrawn From Investment in Less Developed Countries

- 1 Decrease in qualified investments in less developed countries (see regs. sec. 1.955-1(b)(1)—attach computation)
 Check if an election is in effect for the taxable year under regs. sec. 1.955-3 ☐
- 2 Limitation (see regs. sec. 1.955-1(b)(2)):
- (a) Sum of earnings and profits for the taxable year and earnings and profits accumulated for prior taxable years beginning after December 31, 1952
- (b) Sum of amounts excluded under section 954(b)(1) from foreign base company income for all prior taxable years, less sum of such amounts withdrawn under section 955(a) for such years (see regs. sec. 1.955-1(c)(2))
- 3 Enter line 2(a) or line 2(b), whichever is lesser
- 4 Previously excluded subpart F income withdrawn for the taxable year (line 1 or line 3, whichever is lesser)
- 5 Pro rata share of line 4 (see regs. sec. 1.955-1(c)(1))
- 6 Part of year corporation was a controlled foreign corporation over entire year times line 5, i.e. $\left(\frac{\text{days}}{365} \times \text{line 5}\right)$ Enter here and on line 3, Schedule A

SCHEDULE F—Pro Rata Share of Reduction for Export Trade Income

- 1 Total export trade income (section 971(b))
- 2 Amount of line 1 which constitutes foreign base company income included in line 17 of Schedule C
- 3 150 percent of export promotion expenses allocable to export trade income which constitutes foreign base company income (see regs. sec. 1.970-1(b)(2)(i)).
- 4 10 percent of gross receipts and gross amounts received or accrued which are attributable to export trade income which constitutes foreign base company income (see regs. sec. 1.970-1(b)(2)(ii))
- 5 Increase in investments in export trade assets (see regs. sec. 1.970-1(d)(2)—attach computation)
 Check if an election is in effect for the taxable year under regs. sec. 1.970-2(a)(2) ☐ and/or regs. sec. 1.970-2(a)(3) ☐
- 6 Line 5 times line 2 divided by line 1
- 7 Reduction for export trade income—enter the smallest of line 2, 3, 4, or 6
- 8 Pro rata share of line 7 (see regs. sec. 1.951-1(c)). Enter here and on line 9, Schedule B

SCHEDULE G—Pro Rata Share of Previously Excluded Export Trade Income Withdrawn From Investment in Export Trade Assets

- 1 Decrease in investments in export trade assets (see regs. sec. 1.970-1(d)(3)—attach computation)
 Check if an election is in effect for the taxable year under regs. sec. 1.970-2(a)(2) ☐ and/or regs. sec. 1.970-2(a)(3) ☐
- 2 Pro rata share of line 1
- 3 Pro rata share of the sum of earnings and profits for the taxable year and earnings and profits accumulated for prior taxable years beginning after December 31, 1952 (see regs. sec. 1.970-1(c)(2)(i))
- 4 Limitation under section 970(b) (see regs. sec. 1.970-1(c)(2)(ii)):
- (a) Pro rata share of the sum of the amounts by which subpart F income for prior taxable years was reduced under section 970(a)
- (b) Pro rata share of the sum of the amounts which were not included in subpart F income for prior taxable years by reason of section 972
- (c) Total of lines 4(a) and 4(b)
- (d) Less: Pro rata share of the sum of the amounts which were previously included in your gross income for prior taxable years under section 951(a)(1)(A)(ii) by reason of section 970(b)
- 5 Line 4(c) less line 4(d)
- 6 Enter the smallest of line 2, 3, or 5
- 7 Part of year corporation was a controlled foreign corporation over entire year times line 6, i.e. $\left(\frac{\text{days}}{365} \times \text{line 6}\right)$ Enter here and on line 4, Schedule A

SCHEDULE H—Reconciliation of Book Profits to Earnings and Profits (See instruction 1)

Indicate the section of the Code under which earnings and profits are being determined—

Section 902 ☐Section 963 ☐Section 964 ☐**1** Profit (loss) for the taxable year per books of account (before reduction for any income, war profits, and excess profits taxes)**2** Net adjustments to book profit in determining earnings and profits for U.S. tax purposes. Enter only a net addition or net subtraction for each item. No adjustment is required to be shown unless it is material in amount:

- (a) Capital gains or losses
- (b) Depreciation
- (c) Depletion
- (d) Investment or incentive allowance
- (e) Charges to statutory reserves
- (f) Inventory valuation adjustments
- (g) Other (exclude income, war profits, and excess profits taxes)

NET ADDITIONS	NET SUBTRACTIONS

3 Total net additions**4** Total net subtractions**5** Line 1 plus line 3 less line 4**6** Unrealized exchange gain (loss) under section 964(a) (omit if earnings and profits are not computed under section 964(a))**7** Earnings and profits for the taxable year (before reduction for any income, war profits, and excess profits taxes) (total of lines 5 and 6)**8** Total income, war profits, and excess profits taxes paid or accrued on or with respect to earnings and profits shown on line 7:

COUNTRY TO WHICH PAID	AMOUNT		
	Foreign currency	Exchange rate	U.S. dollars

Total.**9** Earnings and profits (after reduction for any income, war profits, and excess profits taxes) (line 7 less line 8)**10** If earnings and profits are computed other than under the rules of section 964(a), specify the exchange rate(s) used to convert amounts to U.S. dollars and the foreign currency so converted (attach schedule if necessary):

(a) Foreign currency

(b) Rate of exchange

11 Was the foreign corporation included in a minimum distribution election under section 963? ☐ Yes ☐ No.

If "No," omit (a) through (e):

(a) Amount of distributions received by such corporation from other corporations included in such election

(b) Amount of income, war profits, and excess profits taxes paid by such corporation by reason of the receipt of such distributions (excluding withholding taxes)

(c) Amount of withholding taxes borne by such corporation by reason of the receipt of such distributions

(d) Total of lines (b) and (c)

(e) Exchange rate(s) used for purposes of (a), (b), and (c)

returns for the taxable year 1972. In situations where a consolidated U.S. tax return was filed, it was only counted as one U.S. company. If all U.S. corporations in a consolidated tax return were counted, the number of U.S. corporations accounted for by the study would be substantially higher. Of the 407 companies in the data base, 117 had requirements for filing Form 10-K with the Security and Exchange Commission for the year 1972 or some period ending therein. These companies were used for the more detailed research in determining the relationships of financial and taxable income. The names of the U.S. companies that form the basis for this research are set forth in Exhibit B to our study, and indicate a substantial diversity from the standpoint of size of corporation, industrial classification and economic activity for purposes of this research.

The aggregate taxable income of all the U.S. corporations in the data base was \$4,012,206,000 for an average of \$9,858,000 per company. The aggregate total asset base of the companies represented by the study was \$39,164,576,000 for an average of \$96,227,000 per company. Furthermore, the companies in the data base had an aggregate of gross receipts of \$45,822,553,000 or an average of \$112,586,000 per company. While the average size of the corporations represented by this data base is not as large as some of the major oil companies engaged

LIST OF 407

U.S. CORPORATIONS FORMING DATA BASE FOR
RESEARCH ON THE IMPACT OF FOREIGN TAX BURDENS
OF U.S. BASED MULTINATIONAL CORPORATIONS

Adams, E. A. & Co. Inc.

AITS, Inc.

Alaska Interstate Company

Alberto-Culver Company

Allegheny Ludlum Industries, Inc.

Allen, R. C. Company, Inc.

American Broadcasting Companies, Inc.

American Cyanamid Company

American Flange & Mfg. Co.

American Independent Oil Company

American International Group, Inc.

American International Hardwood Corp.

American International Reinsurance Company

American Mail Line Limited

American President Lines, Limited

Amsinck Corporation

Anderson, Clayton & Co.

Ansor Corporation
Appleton-Century Crofts, Inc.
Armstrong Cork Company
Associated Transport, Inc.
Ataka America Inc.
Atlantic Container Lines
Auriema International Group, Inc.
Babcock Industries, Inc.
Badger Mutual Insurance Company
Baird-Atomic, Inc.
Baker Industries, Inc.
Bangor Punta Corporation
Bank of Hawaii
Bank of Tokyo Trust Company
Barclays Bank of New York
Bartlett Collins Company
Basic Leasing Corporation
Bass, H. W. & Sons, Inc.
Bates Manufacturing Company, Inc.
Beatrice Foods Co.
Beechnut, Inc.

Bentley Nevada Corporation

Big Drum, Inc.

Black & Veatch International Company

Blasius Industries, Inc.

Bobbie Brooks, Inc.

Bohack Corporation

Boorum & Pease Co.

Borg-Warner Corporation

Boston Insulated Wire and Cable Company

Bourns, Inc.

Bowaters (United States) Corporation

Bradford-White Corporation

Brewer, C. & Co., Ltd.

The Budd Company

Budget Industries, Inc.

Budget Rent-a-Car Corporation of America

Buffalo Viking Machine Tool Corporation

Bulova Watch Company, Inc.

Burlington Industries, Inc.

Business Men's Assurance Company of America

Butler Mfg. Company

Cadence Industries Corporation

Caemi International Corporation
Camargo Associates
Cannelton Industries, Inc.
The Cannon Group, Inc.
Cameron-Brown Company
Capital Investment of Hawaii, Inc.
Caribbean Barge Corporation
The Carter Group, Inc.
Carter-Wallace, Inc.
Carlisle Corporation
Cassette Cartridge Corporation
Celanese Corporation
Chadbourn, Inc.
Champion Spark Plug Company
The Charter Company
Charter New York Corporation
The Chase Manhattan Corporation
Chemetron Corporation
Chemical Barge Corporation
Chicago Molded Products Corporation
The Chinese American Bank
Chock Full o'Nuts

Christiana Mills, Inc.

Chromalloy American Corporation

Cinerama, Inc.

Cities Service Company

Citizens Utilities Company

Cobb Breeding Corporation

Combe Inc.

Combined Insurance Company of America

Comfax Communications Industries, Inc.

Commercial Credit Company

Comprehensive Designers, Inc.

Computer Exchange, Inc.

Computest Corporation

Concord Woodworking Company, Inc.

Conklin, T. E. Brass and Copper Company, Inc.

Construction Products, Inc.

Continental Air Lines, Inc.

The Continental Corporation

Control Data Corporation

Cook Industries, Inc.

Cooper Laboratories, Inc.

Corrigan Properties, Inc.

Crabtree, R. W. & Son, Inc.
Crane Packing Company
The Cross Company
Cunningham-Limp Co.
Dahlberg Electronics, Inc.
Danco Industries
Danly Machine Corporation
Dan River, Inc.
Delavan Mfg. Company
Delhi International Oil Corporation
The Delmark Company
Delta Drilling Company
Delta and Pineland Company of Mississippi
Denver Chemical Corporation
Designcraft Jewel Industries, Inc.
Detroit Bank and Trust Company
Devcon International Corporation
Diamondhead Corporation
Dillingham Corporation
Diversified Developments, Inc.
Dobbs House, Inc.
Domestic Air Express, Inc.
Donaldson, Lufkin & Jenrette, Inc.
Dover Corporation
Downe Communications Inc.

Dunham and Smith Agencies, Inc.
DWG Corporation
Eagle-Pitcher Industries, Inc.
Eastchester Savings Bank
East River Savings Bank
Eckard, Jack Corporation
Economy Forms Corporation
Edo Corporation
Emco Wheaton, Inc.
Emerson Electric Co.
Emmons Industries, Inc.
Employers Mutual Casualty Company
Engineered Specialties Corporation
Englehard Minerals & Chemicals Corporation
Ennar Securities Corporation
Essex International, Inc.
European American Banking Corporation
Ex-Cello-O Corporation
The Exolon Company
Faberge, Inc.
Farah Manufacturing Co., Inc.
Ferro Corporation

Fiduciary Trust Co. of New York
First Empire State Corporation
First Hawaiian Bank
First National Bank of Maryland
First National City Corporation
First Pennsylvania Corporation
Flagstaff Foods, Inc.
Florida Machine and Foundry Company
FMC Corporation
Forel Corporation
Forest Oil Company
Fram Corporation
Fuller, H. B. Company
Fuller, S. D. & Co.
Fullerton Lumber Company
Fusite Corporation
GAC Corporation
Gamble-Skogmo, Inc.
Gannett Company, Inc.
General Cable Corporation
The General Electric Company
General Signal Corporation

Genesco, Inc.

Gerber Scientific Instrument Company

Germaine Monteil Cosmetiques Corporation

The Gillette Company

Goliad Oil & Gas Company

Gotaas Larsen Inc.

Green Giant Company

The Griffith Laboratories, Inc.

Grolier, Inc.

Grosvenor, Inc.

Hambro American Corporation

Hamilton Brothers Petroleum Corporation

Harrell International Inc.

Hasbro Industries Inc.

The Hawaii Corporation

Hayes-Albion Corporation

Hein-Werner Corporation

Heinz, H. J. Company

Hers Apparel Industries, Inc.

Hilton Village, Inc.

Holophane Company

Home Insurance Company

Home Juice Company

The Home Savings Bank

HTR Corporation

Huber, J. M. Corporation

Hudson Bay Company Inc.

Hull, R. O. & Company, Inc., The

Hygrade Food Products Corporation

IDS Financial Corporation

Interco, Inc.

International Electronics Corporation

International Chemical & Nuclear Corporation

International Multifoods Corporation

International Packaging Corporation

International Utilities Corporation

Intrusion Prepakt, Incorporated

Iona Manufacturing Co.

Itel Corporation

Itoh, C. & Co. (America) Inc.

Johnson Matthey & Co., Inc.

Jones, J. A. Construction Company

"K" Lines New York, Inc.

Kansas City Life Insurance Company

Kem Manufacturing Corporation
Keystone Custodian Funds, Inc.
Knott Hotels Corporation
Komline-Sanderson Engineering Corporation
Lanvin-Charles of the Ritz, Inc.
Lawry's Foods, Inc.
Lipper, Arthur Corporation
The Londontown Manufacturing Company
Lucas, Joseph North America Inc.
Lydall Inc.
McLeod Young & Weir Inc.
McQuay-Perfex, Inc.
Macdermid, Inc.
Madison Throwing Company, Inc.
Mallory, P. R. & Company, Inc.
Management Assistance, Inc.
Manufacturers Hanover Corporation
Marwais Steel Corporation
Max Factor & Company
Mellon National Corporation
Melville Shoe Corporation
Meredith Corporation

Metallurgical Processing Corp.
Metromedia Inc.
The Miller Company
Mohasco Industries, Inc.
Montauk Machinery Co.
Moog, Inc.
Moran Towing Corporation
Morganite, Inc.
The Morris County Savings Bank
Morse Electric Company, Inc.
Morse Shoe, Inc.
Motor Finance Corporation
Motorola, Inc.
Multi-Resources International Inc.
Mundy, E. H. & Co.
Munsingwear, Inc.
The Nash Engineering Company
National Laboratories Manufacturing Co.
National Semiconductor Corporation
National-Standard Company
National Technical Schools
Nello L. Teer Company

Neptune Meter Company
New Birmingham Development Company
Northern Railway Company
Northrup King & Company
Northwest International Bank
Nuclide Corporation
NVF Company
Ocean Beauty Seafoods, Inc.
Ocean Data Equipment Corporation
Ocean Drilling & Exploration Co.
Oceanic Properties, Inc.
Odell Inc.
The Oil Gear Company
Olin Corporation
Oppenheimer United Company
Oremco, Inc.
Otis Elevator Company
Outdoor Supply Co., Inc.
Pacific Far East Line, Inc.
Pacific Gamble Robinson Co.
Page Airways, Inc.
Pan American Life Insurance Company

[Pan Handle Eastern Pipeline Company
Peabody Engineering Corporation
Peabody Gallion Corporation
Penn Columbia Corporation
Penney, J. C. Company
Pepper, Dr. Company
The Pittston Company
Point Clear Company
Polaroid Corporation
Polymer International Corporation
Potlatch Forrest, Inc.
Power Application and Manufacturing Company
The Power-Gas Corporation of America
Premier Industrial Corporation
Pubco Petroleum Corporation
Pueblo International, Inc.
Purolator, Inc.
Questor Corporation
Quigley Publishing Inc.
Rank Precision Industries
Rath & Strong, Inc.
Ratner Corporation

Raydon Technology

The Readers Digest Association, Inc.

Reeves Telecom Corporation

Refac Technology Development Corporation

Reichold Chemicals, Inc.

Republic National Bank of New York

Revere Corporation of America

Revlon Inc.

Rheem Manufacturing Co.

Riviana Foods, Inc.

Robinson, C. H. Company

Rockaway Corporation

Rohm & Haas Company

Roland International Corporation

Rosemount, Inc.

Rubbermaid, Incorporated

Rupert Manufacturing Co.

RUR Corporation

Safeway Stores, Inc.

Sandgate Corporation

Sandusky Foundry & Machine Co.

Sarco International Corporation

Schenectady Chemicals Inc.
Seaboard Allied Milling Corporation
Seaboard Shipping Corporation
Seattle-First International Corporation
Security Pacific National Bank
Sentry Insurance Company
Sharon Steel
S. I. Handling Systems, Inc.
Simmonds Precision Products, Inc.
The Singer Company
Smith Kline & French Laboratories
Snyder, H. P. Manufacturing Co.
Spalding, A. G. & Bros.
Spaulding & Spaulding, Inc.
Southern Union Gas Company
Stahmann Farms, Inc.
Standard Fruit & Steamship Co.
Standard Gage, Inc.
Standard Pressed Steel Co.
Standard Prudential Corporation
Standard Tool & Manufacturing Co.
Starkist Foods, Inc.

State Bank of Albany
States Marine International
The Superior Electric Company
Superior Optical Company, Inc.
Sweco, Inc.
Synercon Corporation
Sys tron-Donner Corporation
Taft Broadcasting Company
Tampax, Incorporated
Tauck Tours, Inc.
Tennant Company
Texas Eastern Transmission Corporation
Texas Gulf Sulphur Company
The Texstar Corporation
Thomas and Betts Corporation
Timex Corporation
Torin Corporation
Torsion Balance Company
Transairco, Inc.
Transport Pool Corporation
Trippeer, R. A., Inc.
Troster Singer & Co.

Unigard Mutual Insurance Company
Unionamerica, Inc.
United Buckingham Freight Lines, Inc.
United Nuclear Corporation
United Screw & Bolt Co.
United States Radium Corporation
Universal Drilling Company, Inc.
Universal Optical Company, Inc.
Utilities & Industries Corporation
Valley Company, Inc.
Van Dorn Company
Vikoa, Inc.
Visual Electronics Corporation
VLN Corporation
Volkswagen of America, Inc.
Vornado, Inc.
Warner National Corporation
Wayne Gossard Corporation
Webb, Dell E. Corporation
Webster Manufacturing, Inc.
Wells Fargo and Company
Werthan Industries, Inc.

EXHIBIT B
(continued)

West Indies Corporation

Western Gear Corporation

Western International Hotels

Wilkerson Corporation

Williamhouse-Regency, Inc.

Williams Gold Refining Company, Inc.

Wimpfheimer, A. & Bros., Inc.

Winn-Dixie Stores, Inc.

Winston, N. K. Corporation

Wolf Composition Company, Inc.

Wright Industries, Inc.

Xerox Corporation

Xomox Corporation

Zimmer Paper Products, Inc.

in international operations such as Exxon, Gulf and Occidental Petroleum, the aggregate size of the U.S. corporations in the data base as well as the aggregate amount of taxable income they reported for the year 1972 or periods ending therein provide a clear indication of the significant volume of activity these corporations represented.

The U.S. corporations represented by the study controlled 3,412 foreign subsidiaries. This figure is based on the information returns that are filed with the U.S. corporate tax returns of the U.S. corporations and represents only those foreign affiliates in which U.S. corporations had more than a 50 percent controlling interest. It did not represent all foreign affiliates in which these U.S. corporations had sufficient interest to require reporting of earnings on an equity basis for accounting purposes nor on which they could report deemed paid credits on dividends for tax purposes.²⁰⁵ The foreign subsidiaries represented in this data, however, do account for a substantial amount of foreign involvement by these U.S. corporations. This can be seen by the fact that the aggregate earnings of the foreign subsidiaries controlled by the U.S. corporations in the data

205. See Opinion No. 24, Accounting Principles Board, American Institute of Certified Public Accountants, and Section 902 of the Code.

base was \$321,200,000 for an average of \$942,000 per company. The dividends paid by the foreign subsidiaries of U.S. corporations aggregated \$70,824,000 for the year on which the data base was compiled. In essence, the foreign subsidiaries whose data is represented in the data base generated pre-tax income of slightly over a half billion dollars with the exact figure being \$503,890,000.

From this profile of the data base, we can see the extensive nature of the U.S. corporations comprising the data base as well as the foreign subsidiaries which they controlled. Based on this compilation of data, then, we were able to perform meaningful research into the extent to which foreign tax burdens are incurred by U.S. corporations. In the succeeding chapters, we will delve into the specific areas of that research.

CHAPTER III

EXAMINATION OF THE COMPOSITION OF THE FOREIGN TAX BURDENS ACTUALLY INCURRED BY U.S. CORPORATIONS

We are now in a position to examine the extent to which U.S. corporations are actually incurring foreign tax burdens and relate those foreign tax burdens to some standards of measurement in order to determine the relative importance of those burdens to U.S. based corporations as a group. Our purpose in doing this is to gain at the outset of our study, an appreciation of the overall impact that foreign taxes are making on U.S. corporations at the present time by comparing those taxes to the overall tax burdens of U.S. corporations in the data base. This will enable us to appreciate the elements of the overall foreign tax burden incurred by U.S. corporations by seeing the manner in which it is composed of direct tax burdens and indirect burdens incurred through foreign subsidiary structures. Furthermore, the research revealed in this chapter provides us with an insight into the nature in which the carryover provisions of the foreign tax credit mechanism provide a time dimension to the

foreign tax burden factor in the United States. It also provides an indication of the extent to which U.S. corporations actually incur excesses of foreign tax burdens over the allowable limits contained in the foreign tax credit mechanism, thus giving a more precise indication of the manner in which foreign tax burdens are impacting on U.S. based corporations.

A. The Relationship of Foreign Income Earned and Foreign Taxes Incurred by U.S. Corporations to Total Worldwide Income and Total U.S. Tax Burdens of Those Companies

At the outset of our research, we determined that foreign involvement by U.S. corporations is becoming an increasingly larger part of their activities. From data published by the Office of Foreign Direct Investments of the U.S. Department of Commerce for the year 1972, it was indicated that foreign direct investment by U.S. corporations increased from \$4.9 billion in 1971 to \$5.3 billion in 1972, the year covered by the data base for our study.²⁰⁶ Since the foreign direct investment program did not include Canada, these figures would be even higher for the years in question with Canada added. Looking at a six year trend line for this data indicates that the increases in foreign direct investment of U.S. companies rose from a low point in 1968 of \$1.2 billion to \$2.3 billion for 1969 and \$3.7

²⁰⁶. Foreign Direct Investment Program Selected Statistics, U.S. Department of Commerce, Office of Foreign Direct Investment (December 1973), pp. 2-4.

billion for 1970.²⁰⁷ At the outset, then, our study established that foreign investment by U.S. based corporations has been an increasingly important aspect of their operations. This is particularly true since by the end of 1972, the aggregate U.S. direct investment abroad totalled some \$94.4 billion.²⁰⁸ This recent figure of total foreign direct investment constitutes 51.6 percent of the total direct investment of the United States for the year 1972, a percentage which has grown from 48.7 percent in the five year period from 1968.²⁰⁹

A further indication of the growing importance of the international involvement of U.S. based corporations is contained in statistics published by the U.S. Treasury Department. Unfortunately, a complete set of data dealing with the foreign income taxes of U.S. based corporations has only been published by the Treasury Department through 1966. The published data does indicate a substantial increase in taxable income from foreign sources rising from \$1.5 billion for the year 1954 through \$7.1 billion for the year 1966. During that same period, the amount of foreign tax credit claimed quadrupled going from

207. Survey of Current Business, U.S. Department of Commerce, Bureau of the Census (March 1971), pp. 53-58.

208. Survey of Current Business, U.S. Department of Commerce, (March 1973), pp. 47-52.

209. Survey of Current Business, U.S. Department of Commerce, (March 1969).

a figure of \$725 million to \$2.8 billion.²¹⁰ This latter figure can be compared with an aggregate figure of foreign tax credit claimed by U.S. corporations on their 1971 tax return of \$5.5 billion.²¹¹ While the published data from the Treasury Department is not up-to-date, it does reflect an ascending trend of the amount of foreign tax credits claimed by U.S. corporations and points up the growing importance foreign tax burdens have for U.S. corporate entities.

To bring this information more up-to-date, we used the data base assembled for our research and compared the actual amount of foreign income earned to total income earned by U.S. corporations in the data base as well as the relationship of foreign taxes incurred by those corporations to their total U.S. tax burden before credits. This comparison revealed that, of the total taxable income of the U.S. corporations in the data base of \$4,012,206,000, some \$978,978,000 represented taxable income from foreign sources. This indicated that 24.4 percent of the total taxable income reported by U.S. corporations came from foreign sources representing a very significant portion of

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210. Statistics of Income 1964-1966 - Foreign Income and Taxes in Corporation Income Tax Return, Department of the Treasury, Internal Revenue Service, Publication 479 (4-73), pp. 6-8.
211. Statistics of Income 1971 - Corporation Income Tax Returns, Department of the Treasury, Internal Revenue Service, Publication 159 (11-73), p. 60.

the U.S. corporations' overall taxable base. When compared with the nationwide total of 15.9 percent for the year 1966, the latest year for which published Treasury Department statistics are available, this points out the growing importance of foreign operation to U.S. based corporations.²¹²

The numbers of corporations filing returns claiming foreign tax credits almost doubled from 3,215 to 6,197 for the years 1954 to 1966 pursuant to Treasury Department published data. This increase would have been even greater had it not been for the sharp rise in the number of parent corporations filing consolidated returns with their subsidiaries during the period 1963 - 1966.²¹³ This increasing number of U.S. corporations filing tax returns claiming foreign tax credits suggested the significant increase in the relationship that foreign taxes bear to the total tax liability of U.S. corporations. For the last year for which overall published statistics are available, the ratio of foreign tax credits to the total tax liability of U.S. corporations was 14.9 percent.²¹⁴ However, that data is

212. Statistics of Income 1964-1966 - Foreign Income and Taxes in Corporation Income Tax Returns, U.S. Treasury Department, Internal Revenue Service, Publication 479 (4-73), pp. 9-13.

213. Statistics of Income 1964-1966 - Foreign Income and Taxes in Corporation Income Tax Returns, U.S. Treasury Department, Internal Revenue Service, Publication 479 (4-73), p. 21.

214. Statistics of Income 1971 - Corporation Income Tax Returns, Department of the Treasury, Internal Revenue Service, Publication 159 (11-73), p. 4.

misleading in that it relates the foreign tax credit to the total U.S. tax burden before credits for all U.S. corporations filing returns for 1971 including those that did not claim foreign tax credits. Using the data base available for our research, we compared the amount of foreign tax credit to the total tax liability of U.S. corporations in the data base. That comparison indicated that of the U.S. tax before credit of \$1,925,858,000, the U.S. corporations in the data base had claimed foreign tax credits of \$401,986,000 or a ratio of 20.9 percent of the total tax of these companies. This confirmed more strikingly that the amount of foreign tax used as credits by U.S. corporations against their U.S. tax liabilities is a very significant element for U.S. based companies engaging in foreign operations.

At the outset of our research, we can confirm the growing importance to U.S. corporations of their investment in foreign operations as well as the growing importance of foreign income to their total income picture. Furthermore, we have documented the increasing amount of foreign taxes which are being used to a greater extent to offset U.S. tax liabilities. At this stage, then, we know we are dealing with a subject of growing magnitude to U.S. base corporations from an overall standpoint.

B. The Relationship of Foreign and U.S. Tax Burdens
of U.S. Corporations to Foreign Income

At this point, it becomes important for purposes of our study to examine how these foreign tax burdens relate to taxable income from foreign sources. From this, we can determine the effective foreign tax rate for all U.S. corporations in the data base so that we will be able to compare that effective tax burden with the U.S. tax burden on foreign taxable income. The significance of this analysis is that it provides a basis for evaluating the trends which are hinted at in the Treasury Department published statistics to the effect that there may be a significant excess foreign tax credit problem for U.S. based corporations.²¹⁵

Utilizing the published data through 1966 from the Treasury Department, we find that U.S. corporations incurred foreign taxes of \$4,813,209,000. This was composed of (a) direct foreign taxes paid or accrued of \$2,392,051,000, (b) deemed paid foreign taxes of \$1,188,113,000, and (c) foreign tax credit carryovers of \$1,233,065,000. As we have seen earlier, the actual foreign tax credits claimed for 1966 per the Treasury Department statistics was \$2,843,211,000. This suggests that

215. Statistics of Income 1964-1966 - Foreign Income and Taxes
in Corporation Income Tax Returns, U.S. Treasury Department, Internal Revenue Service Publication 479 (4-73), p. 22-25.

there was a substantial excess foreign tax credit in 1966 of \$1,969,998,000 (\$4,813,209,000 - \$2,843,211,000). Furthermore, an important aspect of these figures is that the excess credit exceeds the portion of the foreign taxes available for credit due to carryovers by some \$736,933,000 (\$1,969,998,000 - \$1,233,065,000). This data reveals that there is a significant potential foreign tax credit problem faced by the totality of U.S. corporations conducting international activities in 1966 and that it is a problem which is increasing in importance because of the fact that the excess credit exceeds the carryovers from prior years, thus creating new excess credits every year.²¹⁶

In order to obtain a more precise and up-to-date insight into the relationship of foreign tax burdens to foreign income generated by U.S. corporations, we utilized our data base and computed the relationship of U.S. and foreign tax to foreign taxable income reported by the U.S. corporations. This reflected that the total foreign taxable income which all companies in the data base generated from foreign sources was \$978,978,000. The U.S. tax attributable to that income would have been \$469,909,000 compared with total foreign tax burdens incurred by corporations in the data base of \$432,708,000. We will see in a later portion

216. Statistics of Income 1964 - 1966 - Foreign Income and Taxes in Corporation Income Tax Returns, U.S. Treasury Department, Internal Revenue Service Publication 479 (4-73), pp. 27-31.

of this study the extent to which these foreign taxes were actually utilized as foreign tax credits by the companies in the data base. However, from an overall standpoint at this juncture, the initial indication is that the amount of foreign taxes that were incurred by U.S. companies were generally absorbable against the U.S. tax on foreign income. It is recognized that these figures are a composite of all 407 companies in the data base and involves the averaging of all their statistics. However, it provides an interesting profile of the relationships that U.S. companies have maintained between foreign tax burdens and U.S. tax burdens on their foreign taxable income. At the outset, it dispels the concern expressed by some that U.S. corporations are being adversely impacted to a significant degree by the foreign taxes that they are incurring due to the fact that they have developed significant excess foreign tax credits. On the contrary, it appears that U.S. corporations at the present time are able to utilize a good deal of their foreign tax burdens as offsets against their U.S. tax liabilities.

C. Composition of the Foreign Tax Burden of U.S. Corporations

In order to analyze the foreign tax burdens incurred by U.S. corporations more closely, one has to examine the manner in which they are compiled by U.S. corporations for U.S. tax

Purposes. As we saw from our discussion of the U.S. foreign tax credit system in Chapter I, U.S. corporations are not only able to claim as credits those foreign taxes directly incurred in the current year by themselves; they are also able to claim as deemed paid credits, foreign taxes imposed on earnings of foreign subsidiaries that are paid to them as dividends, or whose income has been imputed to the U.S. corporations under the Subpart F provisions of the Revenue Act of 1962.²¹⁷ Furthermore, the foreign tax credit may include carryovers of foreign taxes from certain prior and past years which could not be utilized in those years due to the foreign tax credit limitation.²¹⁸ Consequently, the available foreign tax burdens are an amalgamation of foreign taxes from other corporate entities as well as different time periods. Therefore, it is essential for our study that we analyze the portion of the foreign tax burden that comes as a result of directly incurred liabilities of U.S. corporations - as well as the amount of foreign tax burdens that are reflected through the deemed paid credit and foreign tax credit carryovers - if we are to understand how the U.S. corporations' foreign tax responsibilities are actually structured.

217. A. R. Rado, United States Taxation of Foreign Investment - The New Approach, (International Bureau of Fiscal Documentation, Amsterdam 1963), pp. 27-36.

218. Section 904(e) of the Code.

Analyzing the composition of the foreign tax burdens of U.S. corporations in the data base revealed that the total foreign taxes of \$432,708,000 consisted of the following three segments:

Foreign Tax Burdens Directly Paid or Accrued	\$213,411,000
Deemed Paid Foreign Tax Credits	170,188,000
Foreign Tax Credit Carryovers	49,109,000

From these relationships, it can be seen that the directly incurred foreign tax burdens of U.S. corporations constituted some 49.3 percent of the total foreign taxes available. The deemed paid credits accounted for 39.3 percent, a very substantial proportion. Finally, carryovers from prior years constituted the balance of the foreign taxes available for credit or 11.4 percent. This is an important analysis, in that, from it we can see that the total foreign tax burden picture of U.S. corporations depends very heavily on the deemed paid credits stemming from distributions from foreign subsidiaries. The foreign subsidiary aspect of the foreign tax burden problem of U.S. corporations is therefore a more complex problem than one might conceive of at the outset. Having gained this insight, we have segregated a more detailed analysis in Chapter VI to examine this question of the foreign tax burden of foreign subsidiaries of U.S.

corporations more closely. However, at this point, it can be said that the sheer quantum of the foreign burdens of U.S. corporations that are accounted for through the deemed paid credit make this element of the foreign tax credit picture for U.S. corporations quite significant. It also highlights the importance of the extremely flexible and broad based rules of the Code which we have examined in Chapter I dealing with the multi-tiered levels through which foreign taxes can be incurred and still made available to U.S. corporations.

D. Role of Foreign Tax Credit Carryovers as They Affect
The Impact of Foreign Taxes on U.S. Corporations

One important feature of the foreign tax burdens imposed on U.S. corporations and the manner in which they are accumulated is the carryover aspect of excess foreign tax credits. As we saw in Chapter I, if a U.S. corporation elects to claim its foreign taxes as a credit in a given year and the amount of taxes exceeds the allowable limitation computed on a per country or overall basis, the excess credit may be carried back two years or carried forward five years. This provides an eight-year spread over which foreign tax burdens can be utilized as credits. In order to ascertain the manner in which the foreign tax credit carryovers were utilized for purposes of the study, we examined the source and use of the foreign tax credit

carryover as related to the corporations in the data base.

In this analysis, we examined the manner in which foreign tax credit carryovers were carried into the year 1972 and passed onto future years. As demonstrated in Exhibit C, the total foreign tax available as a credit to the companies was \$432,708,000. Of that figure, some \$49,109,000 represented credits from prior years which could not be used because they exceeded available limitations of the foreign tax credit in those years. Consequently, the carryovers accounted for approximately 11.4 percent of the total foreign taxes available for credit. In the year represented by the data base, some \$18,387,000 were utilized as credits by taxpayers so that the carryover from the current year into future years was only 7.1 percent of the tax of the current year. That is, since \$401,986,000 of foreign taxes were used as a credit and this was 92.9 percent of the available foreign taxes, this left \$30,722,000 of foreign taxes to be carried over to future years which accounts for \$18,387,000 being utilized as credits in the current year.

From this analysis, we can begin to appreciate the ability of U.S. corporations to absorb not only foreign taxes incurred in the current year, but also the ability to absorb a certain amount of carryovers to current years from prior years. This indicates that the concern expressed by some that

SOURCE AND USE OF FOREIGN TAX CARRYOVER

	SOURCE	USE	
\$49,109 (11.4%)	CARRY OVER	CARRY OVER	\$30,722 (7.1%)
	DEEMED	FOREIGN	
\$170,188 (39.3%)	PAID	TAX	
		USED	
		AS	\$401,986 (92.9%)
	DIRECT		
	PAID	CREDIT	
\$213,411 (49.3%)	OR		
	ACCRUED		

(ALL FIGURES IN THOUSANDS)

U.S. corporations are unable to utilize all foreign taxes as a credit because of the stringency of the U.S. tax laws is not completely borne out. This analysis indicates that the foreign tax burdens of U.S. corporations from a carryover standpoint are quite manageable.

E. Extent to Which U.S. Corporations Actually Suffer Excess Foreign Tax Credits

At the heart of our study is the question of the impact that foreign tax burdens make on U.S. based corporations. Given a U.S. tax system which permits U.S. corporations to utilize foreign tax burdens incurred as credits against U.S. taxation, a key question then becomes the extent to which U.S. corporations are not able to utilize their foreign tax burdens as offsets directly against their U.S. tax liability. To the extent this is significant, it would indicate that the foreign tax burden impact is adverse. If it is not significant, it would suggest that, although U.S. corporations may incur substantial amounts of foreign taxation, the ability to utilize it as tax credit mitigates the impact.

In order to put this issue clearly in focus, a determination was made as part of our research of the extent to which U.S. corporations in the data base actually suffered excesses of foreign tax burdens over foreign tax credit limitations.

The results of our analysis showed that 46 of the 407 companies in the data base had actually incurred an excess foreign tax credit for a percentage of 11.2 percent. Looking at the data from the standpoint of the amount of excess foreign tax credits shows that some \$30,722,000 or 7.1 percent of the foreign tax burden exceeded the amount that could be utilized as foreign tax credits. Consequently, it can be seen that, of the companies in the data base, almost 9 out of every 10 companies did not incur an excess foreign tax credit in actual fact. Furthermore, less than one-tenth of the foreign taxes incurred by the corporations in the data base resulted in excess foreign tax credits. This material is significant when compared to the earlier analysis performed which showed that, if all the companies were aggregated, there would not appear to be an absolute excess of foreign taxes over their U.S. tax on foreign income. This analysis discloses that, notwithstanding the fact that published data up to 1966 indicates the potential for significant excess foreign tax credits for U.S. corporations, there was not a significant number of situations in which U.S. corporations were unable to use the major portion of their foreign taxes as credits.

In essence, this confirms that a high percentage of U.S. corporations are actually able to manage their foreign tax

burdens in such a way as to offset them against the U.S. tax that would otherwise be due on its income. Thus, at this point, the burden aspect of foreign taxes appears to be somewhat minimized since the increase in foreign tax liability is offset to a great extent by a commensurate decrease in U.S. tax liabilities for these companies on their foreign source income.

In order to put this issue of excess foreign tax credits even more clearly in focus, a further analysis was done negating the effect of carryovers of excess foreign tax credits from prior years in the computation of excess foreign tax burdens. In that analysis, we examined the manner in which foreign tax credit carryovers affected the excess foreign tax credit situation for the U.S. corporations in the data base. The data was adjusted for foreign tax credit carryovers into the year affected by the data, so that foreign tax credit carryovers were not included in the amount of available foreign taxes for foreign tax credit purposes. After making this adjustment to exclude foreign tax credit carryovers, the excess foreign tax credit situation was reduced so that only 36 of the 407 companies would have shown an excess foreign tax credit in the current year for a percentage of 8.8 percent. If carryovers were eliminated from the foreign tax credit availability, the actual amount of excess foreign tax

credits for the year in question would have been reduced to 6.2 percent as opposed to 7.1 percent reflected earlier. Consequently, it can be seen that if only the foreign taxes which are being directly incurred or which are deemed to have been paid by U.S. corporations in the current year are taken into account, the propensity of U.S. corporations to actually generate excess foreign tax credit is even further reduced. This further buttresses the conclusion that foreign taxes incurred on a current basis are basically quite manageable within the overall planning of U.S. based corporations and that excess foreign tax credits are not a substantial problem based on the results reflected by U.S. companies in actually filing their tax returns.

In order to give our research a more intimate approach to the data base, we delved further into the nature of the actual foreign tax credits reported by the companies in the data base. We selected the ten companies out of the forty-six which accounted for the greatest amount of actual excess credit and followed the path of their excess credit to seek the manner and extent to which it was eventually utilized. The figures for the companies in the data base were for the year 1972. However, as we saw in our discussion in Chapter I, the U.S. tax credit system permits the carryback of excess foreign tax credits to the two preceding years and, to the extent not utilized, a carryforward of five

years. Given this two year carryback and five year carryforward of excess foreign tax credits, it becomes important in the viewing excess credits in a single year to follow the extent to which they have been eventually utilized. In order to do this most effectively for our study, we had to inspect the activity of specific U.S. corporations which have incurred excess credits in the year under examination and trace the span of carryback and carryforward years to determine the manner by which these corporations actually absorbed the excess credits. For purposes of our research, we selected the ten corporations that reflected the largest amount of excess credits per the tax return in the year under review and followed the path of their utilization of such excesses.

We noticed that, in the first company, the excess resulted from the fact that the company conducted operations only in Canada and that its effective foreign tax rate in Canada was 73.2 percent. This was composed of a 47.5 percent deemed paid credit on dividends received from Canada, an 8.8 percent direct credit and a 16.9 percent credit consisting of foreign tax credit carryovers from prior years. Obviously, this high effective tax rate was exaggerated by carryovers from prior years. When compared to a U.S. effective tax rate on the company's

Canadian taxable income of 47.2 percent, it presented a situation in which the company could not carryback the excess credits to prior years because there were already carryovers to the current year. Because of the continuation of this situation in later years, this company has not utilized the excess credit on a carryforward basis.

In the second company reporting excess credits, we found a somewhat similar situation in that the company conducted operations primarily in Canada and was incurring a 62.4 percent effective foreign tax rate compared with a 47.6 percent U.S. tax rate attributable to the Canadian taxable income. In this case, there also were foreign tax credit carryovers from prior periods so that there was no ability to carryback the excess credits of the current year and claim tax refunds. A substantial portion of the Canadian tax consisted of a deemed paid credit on dividends from Canadian subsidiaries. However, only 3 percent of the Canadian tax was accounted for by carryovers of excess foreign tax credits from prior years. As in the case with the preceding company, the excess situation continued into later years and the company has persisted in accumulating excess credits.

In the case of the third company that reflected excess credits, the excesses in this case were due to operations conducted

in both Canada and Australia. The company was not able to carryback its excess foreign tax credit from these countries since the operations in Canada and Australia had already been productive of excess credits in prior periods. This more than offset the excess limitation provided by the other countries in those years. In this particular case, 33.1 percent of the taxes incurred in Canada consisted of foreign tax credit carryovers from prior periods. Had it not been for these carryovers, over 82 percent of the foreign taxes incurred in the current year would have been absorbed in the limitation for Canada and almost 90 percent of Canadian taxes incurred would have been absorbed by the company through Canadian and other country limitations.

In the case of the fourth company reporting actual excess credits, the excesses were due to taxes incurred in Australia, Canada, and New Zealand. In the case of Canada, the effective rate was 82.8 percent; in the case of Australia, it was 79.5 percent; and in the case of New Zealand, it exceeded 90 percent. These extraordinarily high rates were due to the fact that the income generated by the United States company in these countries was being assessed by those countries on a different tax basis than that which existed for the U.S. calculation of the countries' effective foreign tax rate. In the case of Australia for example,

the company received significant royalty income which was subject to a 47.5 percent withholding tax on gross income. With the application of expenses attributable to that gross income being made in the United States for purposes of computing the foreign tax credit limitation, this had the effect of decreasing the Australian taxable income for purposes of the calculation and increasing the effective Australian tax rate. This particular company did not have a history of carryovers from prior periods. Consequently, it was able to carryback the excess credits for the current year and claim a refund by utilizing these tax credits in the two prior years when the aggregate effective foreign tax rate was less than the U.S. effective rate on foreign income.

The fifth company in the group generated substantial income from Pakistan and incurred a tax in Pakistan which actually exceeded the Pakistan taxable income computed using U.S. standards. This meant the tax rate in Pakistan exceeded 100 percent of the taxable income and was compared with a U.S. effective tax rate on the Pakistan income of 47.2 percent. Not only did this company have an excess for the current year but had substantial carryovers of excess credits for Pakistan from prior years. In this particular situation therefore, the company

was unable to carryback the excess credits to prior years and has not been able to utilize any of these excesses in the succeeding year because of the aggravated tax situation in Pakistan.

The sixth company which generated excess tax credits on its tax return conducted activities primarily in Bolivia, Brazil, Mexico, Peru and Venezuela. Its tax rate in Bolivia was 35.8 percent and its tax rate in Peru was only 33.2 percent. While these rates are not significant in relation to the U.S. tax rate in general, this particular company had a net operating loss for the current year. Consequently, it had no U.S. tax against which it could apply the foreign tax credits. Because of the carryback of the net operating loss, the company was not able to utilize the foreign tax credits on a carryback basis. It did carryforward the excess foreign tax credit and was able to utilize close to half of the credits in the later year.

The seventh company having excess foreign tax credits generated them in a number of countries; specifically, Argentina, Australia, Canada, Japan, United Kingdom and Zambia. This company showed effective foreign tax rates as follows: Argentina, 20.3 percent; Australia, 41.9 percent; Canada, 50 percent; Japan, 27.1 percent; United Kingdom, 36.7 percent; and Zambia, 10 percent. The reason this company reflected an excess tax credit was that

it had losses from other countries which reduced the U.S. tax base and consequently, the amount of U.S. tax against which these taxes could be used as credits. While in the prior company's situation, the carryback of a net operating loss had the effect of eliminating much of the tax base in the prior years, this company did have the ability to utilize the foreign tax credits as carrybacks. Approximately 83 percent of the excess tax credits have been utilized on a carryback or carryover basis, so that the company has - for all practical purposes - been able to absorb these excess tax credits.

In the case of the eighth company, the excess credits were generated in Australia, Costa Rica, France, Iran, Japan, the Netherlands and United Kingdom. The company was able to absorb part of the excess because of income it received from Australia, Germany, Italy, Panama, Peru and Switzerland. However, the fact that over 17 percent of the total foreign tax consisted of carryovers from prior periods aggravated the excess credit situation in the current year and prohibited the carryback of the unused excesses to prior years. This particular company has not been able to utilize the excess carryovers in the subsequent year. Consequently, it still finds itself in an excess credit position from the carryover standpoint.

The ninth company generated its excess foreign tax credits

primarily from Austria, Denmark, France, Holland and Portugal. It was able to offset these excess credits to some extent against income from the United Kingdom and Sweden. However, the aggregate effective tax rate abroad was 58.1 percent which exceeded the U.S. effective tax rate of 47.6 percent. Consequently, the company had an excess but it was able to carry it back to a prior period and secure a refund of U.S. tax. Consequently, this particular company did not suffer because of the excess credits in the current year.

The final company examined accumulated excess credits primarily because of foreign losses. This company incurred taxes in Switzerland, Hong Kong, Spain, Italy, New Zealand, Japan and Brazil. In computing its taxable income under U.S. standards, it had a tax loss in Italy, New Zealand and Brazil with the most substantial loss being in the last country. The losses incurred in these countries offset to a great extent the taxable income generated in the profitable countries. Consequently, the amount of foreign tax incurred in the current year exceeded the U.S. tax on the aggregate foreign taxable income which was significantly reduced by these foreign losses. This company, however, was able to carryback the excess credits incurred in the current year to prior years and recoup the excess through refund of U.S. tax.

From these ten companies, we can see at close hand that in certain cases the excess foreign tax credits in the current year under study have been utilized on the carryback basis. Furthermore, in those cases where this was not possible, it has been utilized at least to some extent on a carryover basis. Of the aggregate excess credit in 1972, approximately 39 percent was recouped via carryback and some 14 percent was already used up on a carryover basis. Since the carryover period for the year 1972 does not expire until the taxable year 1977, there is still time for these companies to plan for full absorption of these excesses. We will examine the techniques which U.S. companies use to achieve this result in Chapter X. For reasons of tax equity, it might appear appropriate to modify this latitude given the existence of U.S. tax deferral on earnings of foreign subsidiaries which already provides a lag factor in favor of U.S. based corporations concerning their foreign tax burdens. This and related conclusions are developed fully in the last chapter of our study.

CHAPTER IV

THE ROLE THAT PARTICULAR FOREIGN
COUNTRIES PLAY REGARDING THE FOREIGN
TAX BURDENS OF U.S. CORPORATIONS

In the previous chapter, we examined the extent to which foreign tax burdens were incurred by U.S. corporations from an overall standpoint. It revealed that the burdens that are incurred by U.S. corporations are basically managed in such a way as to minimize their disadvantageous impact on the U.S. corporations. However, in view of the fact that foreign taxes are incurred by U.S. corporations in a wide range of countries, our study had to delve into the specifics of those countries in which U.S. corporations are generating their income and in which countries they are incurring these foreign tax burdens. Doing so places our study in a position to observe the manner in which U.S. corporations combine and control these foreign tax liabilities so as to make them absorbable within the foreign tax credit network.

In this chapter, we explore how these foreign tax burdens were incurred by particular countries, the variations between

the countries in which U.S. corporations incur their taxes and those in which they generate their income, the differences between the statutory and effective rates of tax imposed by foreign countries, the relationship of foreign taxes to foreign taxable income by major countries in which U.S. companies operate, the extent to which certain countries contribute to the U.S. excess foreign tax credit problem, and finally, the extent to which excess foreign tax credits in a given country are utilized against the U.S. tax burdens on other foreign income.

A. Foreign Countries in Which U.S. Corporations Generate Their Foreign Income and Incur Their Foreign Tax Burdens

In order to gain an appreciation of the foreign countries in which U.S. corporations generate their income, our study profiled the number of countries in which U.S. corporations generally conduct their activities. The analyses that were performed indicated a strong correlation between the increasing number of countries from which U.S. corporations generate income and the increasing size of U.S. corporations. The feeling of some that, as a U.S. company grows larger, the number of countries in which it will generate foreign income and incur foreign taxes also increases, is borne out by our research. Our data base showed that, as the U.S. corporation gets larger, the number of countries

in which it generates foreign source income also tends to increase. It is a fairly consistent relationship in that, for the smaller companies, there is only an average involvement of two countries per company. However, once the U.S. corporation reaches the \$100 million asset mark, our research found that it tends to be operating in at least 10 countries. This fact accounts in part for the greater range of foreign taxes incurred by the larger U.S. corporations and the greater complexities in its foreign picture, suggesting a greater potential adverse impact of foreign taxes on such companies. Thus, it can be said that the numbers of countries from which U.S. corporations generate income increase as size increases.

As our research in Chapter X will indicate, one reason that large U.S. corporations generate income in a number of countries is not only due to the economic interest on their part in conducting activities in those countries, but also because income generated in certain countries can be utilized within the foreign tax credit system to offset U.S. taxes that otherwise would be due on that other foreign income. We saw the potential for this from a conceptual standpoint in our discussion in Chapter I of the overall limitation on the foreign tax credit and the manner in which it permits averaging of high and low tax rates.

As our study proceeds, we will see that this phenomenon is a keystone to the minimization of the adverse impact of foreign tax burdens by U.S. corporations.

Having seen that, as U.S. corporations increase in size, their involvement in a number of foreign countries takes place, our study proceeds to examine those particular countries in which U.S. corporations incurred a major portion of their foreign taxes and in which they generated a substantial portion of their foreign income. An interesting aspect revealed by this analysis is that there is a clear parallel from total country standpoint but not with regard to particular countries. That is, although there may be a general feeling that U.S. corporations incur their foreign taxes in foreign countries in roughly the same proportion as they generate their foreign income, this is borne out by the aggregate data but not by specific country data reflected on U.S. corporations' tax returns. In fact, there is a fairly significant disparity in given countries between the foreign taxes which are incurred and the foreign income generated. For purposes of our study, we selected ten countries in which U.S. corporations in the data base generated a significant portion of their foreign source taxable income and examined the manner in which the percentage of foreign tax burden and percentage of foreign source income were related in each of those

countries. An interesting result of this analysis reveals the fact that there is not a clear parallel between the two. That is, although one might think that U.S. corporations incur foreign taxes in foreign countries in roughly the same proportion as they generate their foreign income, this is not the case. Based on the details reflected in our data base, we reflect in Exhibit D the percentage of foreign income earned by U.S. corporations in the data base from various countries as well as the percentage of foreign tax burden incurred in those countries. As can be seen from this exhibit, there is a fairly significant disparity for U.S. corporations in our study between the percentages of income generated from a country and the percentage of foreign tax generated in that country.

In countries such as France, Germany, Italy, Japan and the Netherlands, the percentage of income from those countries to the total foreign source income is higher than the percentage of foreign tax burdens in those countries to total foreign taxes. Conversely, in the case of Canada, Mexico and the United Kingdom, the foreign taxes of those countries as a percent of total foreign taxes is measurably higher than the percent of income from those countries.

From this portion of our study then, we can see that there are wide disparities between foreign countries with regard

FOREIGN COUNTRIES ACCOUNTING FOR
FOREIGN INCOME AND FOREIGN TAX BURDENS

	<u>% of Foreign Income</u>	<u>% of Foreign Tax</u>
CANADA	23.9%	28.9%
UNITED KINGDOM	13.1	14.1
GERMANY	8.2	7.1
JAPAN	7.3	5.2
FRANCE	6.8	6.1
MEXICO	6.2	7.0
AUSTRALIA	5.0	4.8
BRAZIL	4.1	4.3
ITALY	3.8	2.1
NETHERLANDS	3.2	2.9
ALL OTHERS	18.4	17.4
	<u>100.0%</u>	<u>100.0%</u>

to the amount of foreign income generated in them by U.S. corporations and the foreign tax burden which they suffer. These countries account for 81 percent of the total foreign income generated by U.S. corporations from foreign sources and 82 percent of foreign taxes incurred. Thus, although there is a fairly close correlation of overall percentages of foreign income and foreign tax burdens, significant disparities between countries indicate that particular foreign countries account for different impacts in the area of foreign tax burdens for U.S. based corporations.

B. Statutory Versus Effective Rates of Foreign Tax of U.S. Corporations

Having established that the foreign tax burdens of U.S. based corporations vary significantly by country, our study then focused on the relationship of the actual foreign tax levied by foreign countries to the statutory rates of tax which countries impose on various types of income. In many cases in literature in the field, a discussion of foreign taxes often tends to focus on the statutory rates declared by foreign governments. However, a meaningful distinction to make regarding foreign taxes from the standpoint of U.S. based corporations is the statutory rate versus the effective rate.²¹⁹

²¹⁹. Section 964(a) of the Code.

1 By effective rate of foreign tax is meant the foreign tax burden related to foreign taxable income computed under U.S. standards of income computation. The effective rate is critical because it is the key ingredient in determining which foreign taxes can be utilized by U.S. corporations to reduce their U.S. tax burdens. This basic concept we saw in our discussion of the foreign tax credit limitation in Chapter I.

The purpose of the computation of the statutory amount of foreign tax on the taxable income from each country was to ascertain what the foreign tax burdens for the U.S. corporations in those countries would have been had they imposed the rate of tax stipulated in their taxing statutes. This statutory tax burden was then compared with the actual foreign tax burden which U.S. corporations incurred in those countries in order to provide a basis of comparison between the statutory and effective rates of foreign tax that U.S. corporations are incurring in the major countries in which they are generating their foreign source income.

From our analyses of this subject, it was seen that the foreign tax burdens of U.S. based corporations were considerably lower than one would normally expect when giving consideration to their statutory rates. As can be seen in Exhibit E, there

RELATIONSHIP OF FOREIGN STATUTORY TAX
RATES TO FOREIGN EFFECTIVE TAX RATES

	<u>STATUTORY</u> <u>RATE</u>	<u>EFFECTIVE</u> <u>RATE</u>
AUSTRALIA	47.9	46.9
BRAZIL	47.2	41.9
CANADA	58.7	55.1
FRANCE	45.3	37.9
GERMANY	51.9	39.8
ITALY	39.7	20.2
JAPAN	35.1	29.9
MEXICO	59.5	51.9
NETHERLANDS	47.9	39.0
UNITED KINGDOM	50.9	48.9

(For further information regarding statutory versus effective foreign tax rates cf; M. D. Harmon, "Calculating Earnings and Profits for Foreign Subsidiaries: Background and Some Actual Results Showing Differences Among Countries", TAXES (July 1973), p. 407-436.)

is a general reduction from the statutory rates to the effective foreign tax rates imposed by the major countries in which U.S. corporations in the data base incurred their foreign taxes. As a result, this aspect of our study revealed that, what initially appeared to be overly burdensome foreign tax rates in certain foreign countries, are actually tax rates which are manageable when compared to U.S. standards of income determination.²²⁰ Thus, the indication that a potential excessive foreign tax burden might exist for U.S. based corporations is partially explained away by the erosion of the impact of the foreign tax rates as declared by the foreign countries taxing the corporation in the data base.

Having now obtained an insight into the relationship - on a country-by-country basis - of the countries in which U.S. based corporations incur their major foreign tax burdens and compared those effective foreign tax burdens with statutory rates of tax promulgated in those countries, we are now in a position to examine the extent to which those foreign taxes incurred in particular countries are utilized as foreign tax credits by U.S. corporations.

220. Contrast this with Footnote 215 on Page 145 which indicated a significant potential excess foreign tax problem for U.S. based corporations.

C. Extent to Which Foreign Taxes Incurred in a Given Country Actually Exceed the U.S. Tax Attributable to the Foreign Source Income from that Country

This portion of our research provided a key ingredient in our study of foreign tax burdens as they impact on U.S. based corporations. It compared the foreign taxes incurred in a given country with the U.S. tax attributable to the income from that country. Being able to perform such an analysis provided a clear insight as to whether significant international double taxation does or does not exist with regard to income that U.S. corporations generate in certain countries and the foreign taxes which they incur in those countries. This segment of our research addressed itself to the question of whether U.S. corporations are actually in danger of incurring excess foreign tax credits on an individual country basis. It also determined the extent to which certain countries provide U.S. corporations with an excess margin for absorption of foreign taxes from other countries within the framework of the foreign tax credit mechanism as adopted in the U.S. tax system.

This analysis essentially placed all U.S. corporations on a per country limitation basis. It ascertained the extent to which U.S. corporations would have incurred foreign tax in a given country in excess of that needed to offset the U.S. tax on income from that country. This approach neutralized

the flexibility afforded by the overall limitation on the foreign tax credit discussed in Chapter I and enabled us to appreciate how much foreign tax is used to offset U.S. tax on income of a given foreign country.

The basic results of this research were that there would have been a significant degree of difficulty for U.S. corporations to absorb foreign taxes as credits had they not been able to utilize foreign taxes incurred in certain countries against the U.S. tax on income from other countries. Thus, foreign tax burdens would have made a more significant impact on them, if the overall limitation had not been available. As can be seen from Exhibit F, the actual foreign tax in a given country is compared with the limitation imposed by recomputing the data for the U.S. corporations on a per country basis. This reveals that the amount of foreign taxes from a single country that can be used as a credit produces a number of situations in which substantial excess foreign tax credits are created in relation to the total foreign tax incurred in that country. When compared with the results in our earlier discussion dealing with actual excess foreign tax credits,²²¹ this provides an interesting contrast to the excess foreign tax credit posture

221. See Section E., Chapter III, of this study.

RELATIONSHIP OF FOREIGN TAX AND FOREIGN
TAX CREDIT LIMITATION - BY COUNTRY

<u>COUNTRY</u>	<u>EXCESS CREDIT</u>	<u>EXCESS LIMITATION</u>
ARGENTINA	\$ 986	\$ 450
AUSTRALIA	11,392	11,473
AUSTRIA	440	147
BAHAMAS	-	428
BELGIUM	678	634
BERMUDA	-	225
BOLIVIA	287	255
BRAZIL	3,289	2,387
CANADA	50,122	25,562
CHILE	401	144
COLOMBIA	338	510
COSTA RICA	483	255
DOMINICAN REPUBLIC	389	618
DENMARK	472	514
ECUADOR	229	451
FINLAND	208	321
FRANCE	4,682	5,999
GERMANY	3,447	21,246
GHANA	314	524
GREECE	412	534
GUAM	487	393
GUATEMALA	434	485
HONDURAS	316	404
HONG KONG	233	599
INDIA	553	255
INDONESIA	373	434
IRAN	481	48
IRAQ	346	34

(ALL FIGURES IN THOUSANDS)

<u>COUNTRY</u>	<u>EXCESS CREDIT</u>	<u>EXCESS LIMITATION</u>
IRELAND	226	377
ISRAEL	213	514
ITALY	1,391	7,549
JAMAICA	118	249
JAPAN	2,466	1,363
KOREA	239	569
KUWAIT	527	78
LEBANON	201	208
LIBYA	273	51
LUXEMBOURG	576	757
MALAYSIA	247	597
MEXICO	5,226	8,152
MONACO	101	204
MOROCCO	111	112
NETHERLANDS	1,683	1,524
NETHERLANDS ANTILLES	209	772
NEW ZEALAND	607	132
NICARAGUA	167	312
NIGERIA	376	607
NORWAY	532	743
OKINAWA	214	341
PAKISTAN	2,473	246
PANAMA	678	2,014
PARAGUAY	289	761
PERU	587	401
PHILIPPINES	753	451
PORTUGAL	327	544
PUERTO RICO	773	5,146

(ALL FIGURES IN THOUSANDS)

EXHIBIT F
(continued)

<u>COUNTRY</u>	<u>EXCESS CREDIT</u>	<u>EXCESS LIMITATION</u>
RHODESIA	287	374
SAN SALVADOR	106	121
SAUDI ARABIA	372	39
SINGAPORE	213	489
SOUTH AFRICA	861	3,561
SPAIN	425	766
SWEDEN	615	1,215
SWITZERLAND	284	1,513
TAIWAN	236	361
TANZANIA	212	577
THAILAND	217	497
TRINIDAD & TOBAGO	304	538
TUNISIA	203	317
TURKEY	412	626
UGANDA	296	576
UNITED KINGDOM	8,106	12,637
URUGUAY	514	625
VENEZUELA	813	1,661
VIETNAM	207	325
VIRGIN ISLANDS	473	789
YUGOSLAVIA	106	229
ZAMBIA	325	116
TOTALS	<u>\$118,962</u>	<u>\$138,055</u>

(ALL FIGURES IN THOUSANDS)

of U.S. based corporation. From this exhibit we can see that, in a number of countries, the amount of excess credit would bear a fairly high percentage relationship to the total taxes incurred in that country. This means that there would be a significant potential for excess foreign tax burden, should U.S. corporations be permitted solely to use taxes incurred in a particular country for offsetting the U.S. tax on income from that country. Conversely, foreign tax burdens would have a much more significant adverse impact on U.S. corporations if the companies were not permitted to utilize those burdens to offset U.S. tax on income which is unrelated to the foreign taxes in question. When we consider the fact that, of the 407 companies in the data base, 338 or 83 percent of those companies utilize the overall method of limitation for foreign tax credit purposes, we can see what a significant impact the overall limitation has on the results of our study as it relates to the impact of foreign tax burdens on U.S. based corporations.

D. Extent to Which Excess Foreign Tax Credits on
A Per Country Basis are Utilized Against U.S.
Tax on Other Foreign Source Income

Based on the revealing insights which the foregoing analyses have given us, our research on a country-by-country basis was extended by examining the extent to which these potential excess foreign tax credits on a per country basis were

actually utilized against U.S. tax on other foreign source income. In order to achieve this, our study reviewed all U.S. corporations in the data base to determine those situations in which an excess of foreign tax credit on a country basis actually resulted in an excess foreign tax credit overall. Where a company showed an excess credit in a given country but no excess credit overall, this indicated that the tax incurred in that country was utilized to offset U.S. tax on income from other countries. Where the company actually reflected an overall excess foreign tax credit, the excess was deemed to come from each country in which an excess was indicated for that company, in relation to the amount of the per country excesses. Based on this analysis, our study established that, to a significant degree, foreign taxes incurred by U.S. corporations are utilized to offset U.S. taxes otherwise due on income from other foreign sources. In a high percentage of the cases where foreign taxes were deemed to be excess on a per country basis, they were in fact utilized to offset U.S. tax on other foreign source income. This is summarized in Exhibit G-1 which shows for the major countries the amount of potential excess credit as compared with the amount of actual excess credit with the utilization factor being computed. From the results of this analysis then, we can see

EXHIBIT G-1RELATIONSHIP OF POTENTIAL EXCESS FOREIGN
TAX CREDITS TO ACTUAL EXCESS CREDITS

<u>COUNTRY</u>	<u>POTENTIAL EXCESS</u>	<u>EXCESS</u>	<u>PERCENT OF EXCESS</u>	<u>UTILIZATION</u>
AUSTRALIA	\$11,392	3,713	32.6%	67.4%
BRAZIL	3,289	615	18.7	81.3
CANADA	50,122	11,127	22.2	77.8
FRANCE	4,682	1,343	28.7	71.3
GERMANY	3,447	710	20.6	79.4
ITALY	1,391	450	32.4	67.6
JAPAN	2,466	772	31.3	68.7
MEXICO	5,226	925	17.7	82.3
NETHERLANDS	1,683	481	28.6	71.4
UNITED KINGDOM	8,106	2,123	26.2	73.8

(ALL FIGURES IN THOUSANDS)

that the foreign tax burdens which U.S. corporations incur to various countries are a source of potential significant adverse impact on those corporations from the standpoint of their relationship to the U.S. tax upon that particular country's income. Substantial amounts of foreign taxes are incurred in major foreign countries which, were it not for the ability of U.S. corporations to absorb them against U.S. tax on another country's foreign income, would present a significant burden to U.S. corporations. We have in fact seen that significant excess burdens are not produced because of the flexibility of the foreign tax credit mechanism in the U.S. tax system. Consequently, it may be concluded that while on the surface foreign tax burdens do not appear to make a significant impact on U.S. corporations, on a country-by-country basis, there is a hidden potential adverse impact.

From the data in Exhibit F, we can determine that there was a potential excess foreign tax credit in all countries of \$118,962,000. This was the aggregate of the amount of foreign taxes incurred in a given country which exceeded the U.S. tax figure related to the foreign taxable income of that country, excluding carryovers, determined on a company by company basis for all companies in the data base. This indicates there are numerous instances in which U.S. corporations would not be able

to utilize all of their foreign taxes incurred against the U.S. tax attributable to the foreign taxable income determined on a per country basis. When we compare this potential excess foreign tax credit with the actual excess foreign tax credits generated by these companies in the data base, we find that only \$30,722,000 of excess foreign tax credits actually resulted. Therefore, of the potential excess credits that could have impacted on U.S. corporations, only 25.8 percent actually resulted in excess credits to the U.S. corporations when they filed their tax returns.

The answer to how this result came about is found to some extent in Exhibit F which also reflects the excess limitations that U.S. companies generate in various countries. This excess limitation column indicates the extent to which the U.S. tax attributable to foreign taxable income in a given foreign country exceeded the foreign tax incurred in that country for a given taxpayer in the data base. From this exhibit, we see that an aggregate of \$138,055,000 of excess limitation were created by U.S. corporations. From an overall standpoint, the aggregate excess limitations exceeded the aggregate potential excess credits. The reason why excess credits actually resulted is due to the fact that, in a given corporation's situation, some companies generated excess limitations whereas others generated excess

credits. From an overall limitation standpoint, however, we can see that there is a significant degree of latitude in the total population of U.S. companies for absorbing excess credits in one country against available excess limitations in other countries. In order to appreciate more precisely the nature of this off-setting, our study delved into specific company data.

As can be seen from Exhibit F, the countries in the data base accounting for the greatest amount of potential excess credit, were Australia, Canada and the United Kingdom. In the case of Australia, some 32 companies in the data base reflected an excess of Australian taxes over the U.S. tax attributable to Australian taxable income for those taxpayers. In the case of Canada, we found that 84 companies in the data base reflected an excess of Canadian taxes over U.S. tax attributable to Canadian taxable income as reflected on their tax returns. In the case of the third major country, the United Kingdom, 30 companies in the data base reflected an excess of United Kingdom tax over the U.S. tax attributable to the United Kingdom taxable income. These figures are particularly interesting given the fact that only 46 companies actually reflected excess foreign tax credits in their returns as filed.

Continuing our research, we then examined the three U.S. corporations reflecting the highest potential excess credit

1 in these three countries. In Australia, it was noted that one of the three companies reflected an overall excess foreign tax credit on its returns as actually filed. In the case of the company reflecting an actual excess credit, it also had excess credits with regard to the taxes it incurred in Canada and New Zealand. However, it is important to note that even in this company, the aggregate of the excess credits in these three countries was less than the total excess because the company had excess limitations from its income in Puerto Rico, Trinidad, the Virgin Islands and the United Kingdom. Consequently, the actual excess credit in the case of this company amounted to approximately 66 percent of the potential excess credit that the company could have incurred.

In the case of the other two companies showing potential excess credit in Australia, the one company also had potential excess credits in connection with its taxes in the United Kingdom and Canada. However, these potential excesses were absorbed against excess limitations which the company generated on its Italian, Japanese, Mexican and Venezuelan taxable income. In this case, the excess limitation was 19 percent higher than the potential excess credit due to the availability of the low-taxed foreign income from Italy, Japan, Mexico and Venezuela.

The third company generating income in Australia showed

no actual excess foreign tax credit because it also generated income in many other countries which reflected excess limitations. In the case of this third company, it also had potential excess credits with regard to the taxes it incurred in Chile, India, Mexico, the Netherlands, and the Philippines. However, it generated excess limitations in twenty-four other countries which provided more than enough leeway for absorbing these potential excess credits. The countries accounting for the most substantial amount of excess limitations - which enabled it to absorb the excess credits - were Canada, France, Germany, Italy and Panama. In this case, the cushion provided by the excess limitations was approximately 27 percent higher than the potential excess credits.

In the case of the companies generating the largest potential excess credit in Canada, two companies actually reflected an excess credit on their tax returns as filed whereas one did not. In the case of one company that reflected an actual excess credit, this result came about from the fact that the corporation had an overall taxable loss on its federal income tax return for the current year. Consequently, it had no U.S. tax against which it could apply the foreign tax credit. We ascertained that this company was able to carryback its net operating loss to the third and second preceding years and recoup most of the U.S. tax

paid for those two years. These refunds created excess foreign tax credits for those years, however, and resulted in a refund of U.S. tax for the first year preceding the year of the net operating loss. Because these excess credits had to be used on a carryforward basis before the excess credits from the year of the net operating loss, this latter excess had not yet been utilized at the time our research was concluded. In the other instance, the company only generated income from sources in Canada. Consequently, its excess of Canadian tax over U.S. tax attributable to Canadian income was not available to the offset against any excess limitation from any other country. However, in this instance, the U.S. corporation was able to utilize the excess credit in the next year against excess limitations created in Brazil, Hong Kong and South Africa. Thus, the excess credit in the current year was eventually absorbed against U.S. tax. In the case of the third company, however, there was no actual excess credit in the current year. The potential excess credit from Canada was offset against excess limitations which the company generated from Colombia, Switzerland and South Africa. In fact, the excess limitations were 28 percent higher than the potential excess credit from Canada.

In the case of the three companies accounting for the greatest potential excess credit involving United Kingdom

taxation, in only one case did the company have an actual excess credit. This was due to the fact that loss operations in the United States had reduced the amount of U.S. tax against which a credit could be taken. Consequently, there was not sufficient U.S. tax against which the United Kingdom as well as Argentina, Japan and Pakistan tax burdens could be utilized.

In the case of one of the companies that did not show an actual excess credit, in addition to the United Kingdom, it also had potential excess credits in Canada, India, and South Africa. However, these were absorbed through the use of excess limitations from such countries as the Bahamas, Ghana, Mexico, Korea, Luxembourg and Netherlands Antilles.

The third company showing potential excess credits in the United Kingdom had no other potential excess credits and was able to utilize it against excess limitations generated in Germany, Mexico, Puerto Rico and South Africa and Sweden. In this case, the excess limitation was almost double the excess credit from the United Kingdom.

From the foregoing research, we see in a number of instances that a potential excess credit in a given country has been absorbed against excess limitations generated in a range of other countries. In those situations where actual excess credits resulted on the tax return in the current year, it was

due in certain instances to the fact that the U.S. tax base had declined in some cases to the point of a loss so that there was little or no U.S. tax to be paid in the current year. However, even in some of these instances, the excess credit was finally absorbed against U.S. tax on a carryback or carryover basis.

It should be noted that of the 32 companies reporting potential excess credits in Australia, only 8 actually showed excess credits on their tax returns. In the case of Canada, of the 84 companies showing potential excess credits, only 28 actually had reflected excess credits on their returns. Of the 30 companies showing potential excess in the United Kingdom, only 9 companies actually showed an actual excess credit in the current year.

Based on this in-depth review of specific tax returns of U.S. corporations reflecting the largest amount of potential excess foreign tax credits in the major countries, we find significant offsetting of that potential excess against the U.S. tax that would be due on foreign income from other countries. It would appear that, where there is no causal connection between the excess foreign tax credit from one country and the country where excess limitations arise, the ability to create this broad offsetting might be questioned. The reason for doing so would

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be to conform to the basic concept of tax neutrality, making certain that the use of the overall limitation of the foreign tax credit mechanism does not go too far beyond its original intent of avoiding double taxation but within the bounds of tax neutrality. This recommendation and others gleaned from the research reflected in this chapter are developed in the final chapter of this study.

CHAPTER V

COMPARATIVE ANALYSIS OF FOREIGN TAX BURDENS OF U.S. CORPORATIONS VIEWED FROM THE STANDPOINT OF CORPORATE SIZE, INDUSTRY CLASSIFICATION, AND TYPE OF INCOME

Having established in the prior chapter that foreign tax burdens of U.S. corporations vary significantly by foreign country, and furthermore, that the flexibility of the U.S. taxing system provides the means whereby varying foreign tax burdens in different countries are used to offset U.S. taxation on foreign income from other geographic sources, we are now in a position to examine the manner in which those foreign taxes are impacting on U.S. corporations looked at from several different points of view. The first point of view is to look at the foreign tax burdens incurred by U.S. corporations as those corporations are differentiated on the basis of corporate size. In so doing, we are able to see more precisely the role that foreign tax burdens play as U.S. corporations increase in terms of total assets committed to their economic endeavors. Secondly, we examined U.S. corporations and the foreign tax burdens imposed on them from the standpoint of the economic activities in which they are engaged. By doing this, we were able to gain an

appreciation of the exposure that activities in different industrial areas have to varying kinds of foreign tax burdens and the impact this makes on U.S. corporations overall. And thirdly, we looked at the foreign tax burdens imposed on U.S. corporations from the standpoint of the particular types of income that are subjected to foreign tax. This approach provided us with a means of evaluating the variety of tax burdens incurred by U.S. corporations by particular sources of income, thereby determining those types of income which United States corporations attempt to avoid and the types which they attempt to utilize to mitigate the burdens of foreign taxation. Reviewing the foreign tax burdens of U.S. corporations from these three particular vantage points put our study in the position of obtaining insights into the manner in which foreign taxes incurred by U.S. corporations are absorbed by U.S. corporations in such a manner as to decrease the adverse impact which they could have on these companies.

A. Foreign Tax Burdens of U.S. Corporations Analyzed by Size of U.S. Entities

This portion of our research contains the results of a series of studies that were performed on the empirical data using as a base of reference U.S. corporations stratified by varying sizes. The rationale behind this type of analysis is to determine the extent to which the general literature indication

that large corporations account for a major portion of the foreign tax credit was actually valid.²²² In essence, the empirical data utilized for our research supports the position that, as corporations become larger, their absolute amount of foreign tax burdens increases. However, as we shall see, the data further revealed that the size of the U.S. corporation also adds a degree of flexibility to their tax planning opportunities. This, in turn, serves to mitigate the potentially disadvantageous impact that foreign tax burdens could make on U.S. corporations of larger size. Therefore, we will see that the size of the corporation may indicate substantial amounts of foreign taxes incurred, but not necessarily a commensurate adverse impact for those foreign taxes on U.S. based corporations.

1. Profile of the Data Base by Size

In order to provide the basis for a meaningful examination of U.S. corporations by size, our research stratified the U.S. corporations in the empirical data base by various measurements of size. Since measurement of size based on gross income was considered more volatile from year to year, our research settled on gross assets as an appropriate determinant of size of the U.S. corporations for purposes of this analysis.

222. Vanick, "Study of Taxes of the Nations - 160 Largest U.S. Corporations", December 1974.

The companies in the data base were wide ranging from the standpoint of size. As a result, they provided a means for making comparisons of foreign tax burdens on this basis. Approximately one-third of the companies in the data base had assets of \$50 million or more. Thus, the representation by companies of fairly substantial size was significant. However, 13 percent of the companies in the data base only had assets ranging up to \$500 thousand and slightly more than one-third of the companies in the data base had assets of less than \$5 million. Consequently, the smaller size corporation is also represented in the data base. As we shall see in the later sections of this chapter, the data related to smaller companies present an interesting insight into the subject of the impact of foreign tax burdens.

2. Total Foreign Taxes Incurred by U.S.
Corporations of Varying Sizes

Having achieved a stratification of the data base by size and seeing that it accounted for U.S. corporations of significant variation, it becomes important to examine the amount of foreign tax burdens that were imposed on these U.S. corporations of varying sizes. The details of this analysis support the contention made that the larger the U.S. company, the greater amount of absolute foreign taxes it will incur. Our study revealed that 87 percent of the foreign taxes incurred by

corporations in the data base were incurred by companies with \$100 million or over of assets. These companies represented only 18 percent of the total population of the U.S. corporations in the data base. On the other hand, 82 percent of the corporations in the data base accounted for only 13 percent of the total foreign taxes incurred. Thus, our research documented that the larger U.S. corporations account for a significant percentage of the absolute volume of foreign taxes incurred.

3. The Relationship of the Foreign Tax to Total Tax Liability of U.S. Corporations By Size

Once having determined that the larger U.S. corporations incur a major portion of foreign taxes, it becomes important to determine the extent to which these foreign taxes were as relatively important to companies of larger size. That is, notwithstanding the fact that larger corporations incur more foreign tax in total amount than smaller corporations, it was important for our study to ascertain the extent to which the foreign taxes were as important to the large companies as they were to the small.

Having examined the relationship of the foreign tax credit to tax liability by size of company using the same classification of U.S. corporate size, our research disclosed that the relationship for the data base as a whole was 20.8

percent. This is closely paralleled by the figure for companies with \$100 million in assets since this group reflects a slightly higher relationship of 21.3 percent. Looking at the classifications of corporations by various sizes, in the categories of \$1 million in assets to \$50 million in assets, there is a fairly consistent relationship of foreign tax credit to total tax liability ranging from 13.6 to 15.8 percent. Of even more interest is the fact that in the smaller categories of companies, the ratio becomes even higher, ranging as high as 45.9 percent of companies with assets up to a half million.

This research confirmed that, although small corporations incur a lesser amount of foreign tax burdens, these taxes can be relatively more important to them than in the case of the larger U.S. companies. Thus, the potential for adverse impact by foreign tax burdens exists for U.S. corporations of all sizes and a greater propensity for adverse impact exists in a number of smaller companies.

From the foregoing research, we see that the companies in the data base were able to utilize foreign taxes incurred to offset slightly more than one-fifth of their total U.S. tax liability. In absolute terms, this figure relates to the \$401,986,000 figure reflected in Exhibit C. In further

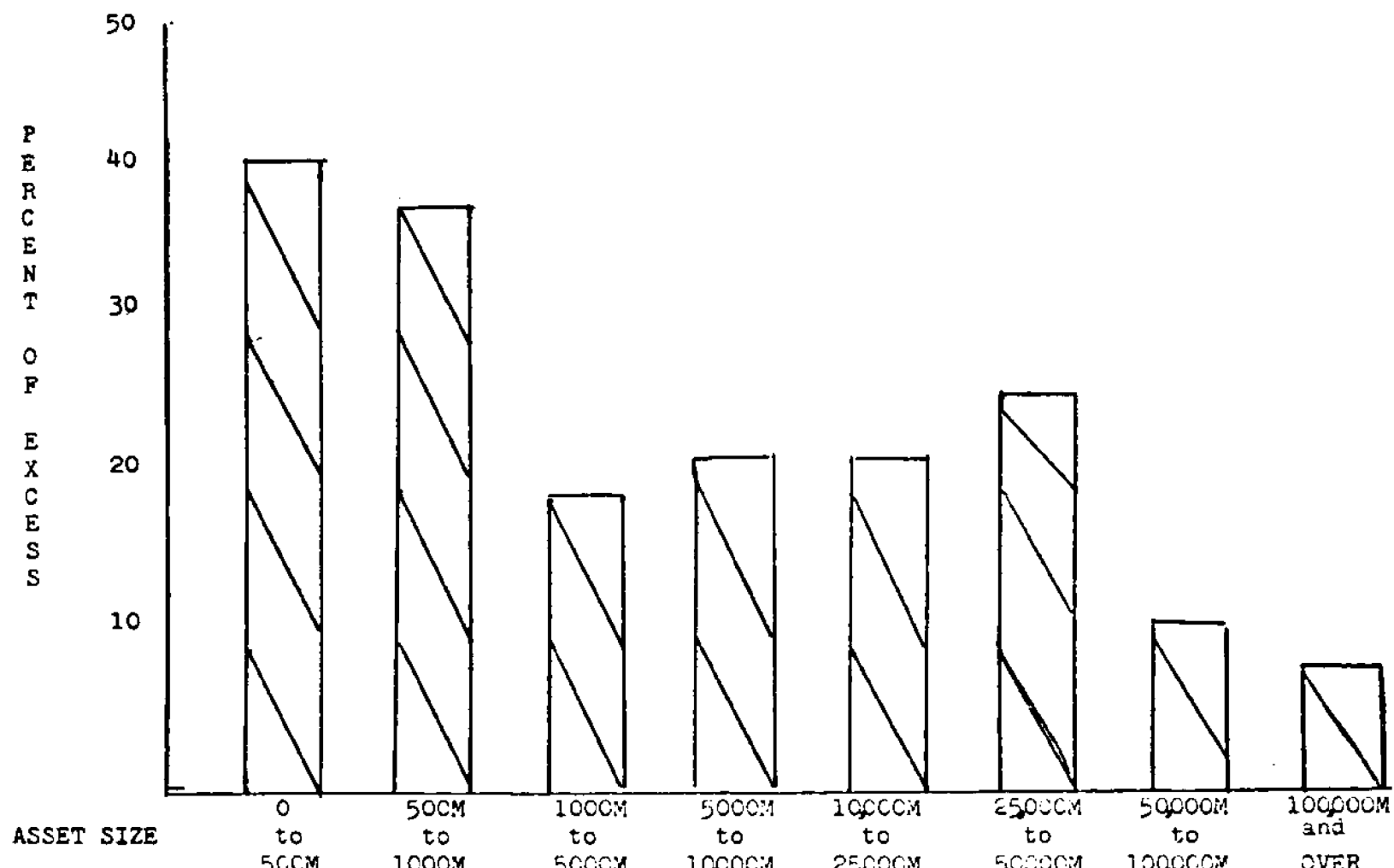
reference to Exhibit C, we can see that this was almost \$31 million less than the total amount of foreign taxes available for credit. Had the total amount of foreign taxes available for use been actually utilized as credits without limitation by the Code, then foreign taxes would have offset U.S. tax to the extent of 22.5 percent.

4. Extent to Which U.S. Corporations Actually Incur Excess Foreign Tax Credits by Varying Sizes

Having now established that corporations of all sizes have the potential for suffering adverse impact from the foreign tax burdens which they incur, we are at the key point of examining the extent to which actual excess foreign tax credits are generated by companies of various sizes. From Exhibit 4a, we can see the interesting relationships regarding the percentage of excess foreign tax credits to total foreign tax for companies in our data base of varying dimensions. We note that, in the initial stages when a company begins generating foreign tax credits, it apparently has a high risk of generating excess credits. In some cases, that risk exceeds 40 percent. When a company reaches a greater stage of maturity, its incidence of excess credits falls into a more moderate pattern. Then, as the company gets larger and begins developing more sophisticated

EXHIBIT G-2

U.S. CORPORATIONS INCURRING EXCESS FOREIGN TAX CREDITS



interests outside the United States, the incidence of excess foreign tax credits diminishes. This accounts for the fact that, in our data base as a whole, the amount of excess foreign tax credit was relatively small for the substantial amount of foreign taxes involved. We can therefore conclude from these analyses based on U.S. corporation by size that, although there is a concentration of foreign tax burdens in absolute amount on large corporations, their potential impact - and, in fact, their actual impact - from an excess foreign tax credit standpoint becomes minimized as the company becomes larger.

Thus, we can see that the ascending trend of foreign tax burdens in absolute amount is not paralleled in terms of exposure to excess credits. In many instances, it is the smaller companies that are exposed to excess credits whereas the larger companies (because of their greater resources and ability to generate foreign income from other sources), appear to be able to protect themselves against the disadvantageous impacts of excess foreign tax credits. This analysis enables us to reach a conclusion dispelling the notion that, since larger U.S. companies incur a great amount of foreign tax, they have commensurate exposure to excess foreign tax credits and greater adverse impact of foreign tax.

B. Foreign Tax Burdens by Industry

This section of the chapter contains the results of our examination of U.S. based corporations from the standpoint of the industrial activities in which they were engaged in order to determine the foreign tax burdens incurred in conducting those activities. This enabled us to determine the extent to which foreign taxes impact more heavily on one commercial activity than another and also provides us with another angle from which to examine the U.S. corporation to see how foreign tax burdens impact on it.

1. Profile of the Data Base by Industry Categories

In order to set the stage for a meaningful examination of the data base by industrial activities, our research divided the income of the companies in the data base along the lines of the various activities in which they were engaged using the Standard Industrial Classification Codes. In so doing, every attempt was made to assign to a given industrial activity the income and taxes attributable to it to the extent that that information was available on the tax returns of the companies forming the data base. It was felt that segregating the information according to industrial activities would provide a much more precise manner of ascribing foreign tax burdens to industrial

classifications than merely considering each U.S. corporation as being engaged in solely one activity.

Based on this approach, we found that approximately one-third of the income (32.7%) was generated in manufacturing activities of various sorts. This represented the largest group of industrial activity of the companies in the data base. The next largest classifications of income accounted for by the companies in the data base were the finance - banking area (20.2%) and the wholesale - retail area (19.6%), each accounting for approximately one-fifth of the data base. These three areas in the aggregate then accounted for almost three quarters of the companies in the data base and provided a significant insight into the foreign tax burdens incurred by companies in these general economic activities. The last activity accounting for more than 10 percent of the total was the service industry which, as an aggregate, accounted for some 13.1 percent. The balance of the major industrial classifications consisting of transportation industry, natural resource industry, construction industry, and agriculture, each accounted for less than 10 percent of the total companies in the data base. Thus, there was a sufficient amount of income of companies representing these major areas to provide a basis for a comparative analysis.

2. Total Foreign Taxes Incurred by U.S.
Corporations by Industry

Having established the general industrial activity makeup of the data base, we examined the amount of aggregate foreign taxes incurred by the various industrial groupings in order to put them in some perspective in terms of total foreign tax burden incurred. Essentially, this analysis showed that manufacturing activities accounted for over half (58.6%) of the total tax burdens of the companies in the data base, a high ratio since they accounted for only one-third of foreign income. The natural resource sector accounted for the next highest amount of total foreign tax burdens (15.7%) notwithstanding the fact it accounted for a much smaller portion of the foreign income of companies in the data base than the wholesale - retail sector and the financial sector. Furthermore, these latter two activities account for a substantially lesser portion of the total tax burdens than they do foreign income of companies in the data base. The service industry in particular reflected a much reduced foreign tax burden base (8.8%) given the high percentage of companies in the data base generating foreign income from activities in that area. Finally, the tax burdens in the transportation, construction, and agricultural activities reflected foreign tax burdens which are more closely related to their

1 representation in terms of foreign income of companies in the data base. From this information, we can see that some interesting relationships have developed between the total foreign taxes incurred by the U.S. corporations and the industrial activities in which they operate, in that certain types of activities generate a much higher foreign tax burden than the amount of foreign income would appear to warrant. We will now pursue this more closely.

3. Relationship of Foreign Tax Burdens to
Total Tax Liability by Industry

At this point of our research, we are in a position to examine the extent to which the foreign tax burdens incurred related percentage-wise to the total U.S. tax liability of U.S. corporations by their industrial activities. Our purpose here was to ascertain the relative importance of foreign tax burdens to U.S. companies in various industrial endeavors. As we saw in the case of the analyses involving corporations of different size, the absolute amount of foreign taxes is not necessarily a good measurement of the impact value of foreign taxes to a particular company. This is because the foreign tax in absolute terms may not be a major portion of the total tax liability of the company. In researching this area, we found that some very

interesting relationships developed with regard to the relative importance of foreign tax burdens to industrial activities.

Our findings established the fact that natural resource activities incur a significant amount of foreign tax in relation to their total tax liability with 50.4 percent of the tax liability being covered by foreign tax credits. This confirms the general feeling with regard to these companies as expressed in publications in this area in recent years. More precisely, it supports the data developed by Senator Henry M. Jackson on the foreign tax burdens of the major oil companies.²²³

That data was released on December 1, 1974 and revealed that for seven major oil companies over a five year period, the foreign tax burdens ranged from 78.5 percent to 88.6 percent of total tax liability. Perhaps somewhat more interesting is the fact that the financial industry also has a fairly high relationship of foreign tax to total tax (32.2%), a phenomenon which has not generally been reflected to date. In the manufacturing sector, which accounts for the highest absolute amount of foreign tax, the foreign tax relationship of 20.1 percent runs roughly parallel to that for the total figures of the data base. That is, there is a significant relationship of foreign tax to total tax

223. Jackson, "Report on Foreign Tax Burdens of Major Oil Companies", (Daily Report for Executives, Bureau of National Affairs, Washington, D.C., December 1974).

liability and it is one which is growing in importance over time. After the manufacturing sector, the transportation industry and wholesale - retail industry shows a moderately high relationship of foreign tax burdens to total tax liability each ranging in the 10 to 15 percent category. After that point, we found the relative significance of foreign taxes seemed to drop significantly when one analyzes the figures for those activities on an overall basis. At this juncture, we can see that foreign tax burdens are relatively quite significant for U.S. based corporations involved in oil and gas development, mining, manufacturing activities, banking, transportation and the wholesale - retail sector. In a later chapter, we will delve into the specifics of how corporations engaging in these activities cope with their foreign tax burdens.

4. Extent to Which Excess Foreign Taxes in One Industry Offset Tax in Another

As indicated earlier, in our assembling of data for analyses based on industrial activity, we sought to separate the types of income generated by U.S. corporations by major categories to the extent the corporate tax returns enable that to be done with regard to income and tax from foreign sources. This enabled us to make determinations as to the extent to which foreign income from certain industrial activities are used to

absorb potential excess foreign tax credits from other industrial activities conducted by the same company. Considering the fact that tax credits can only be utilized by the same U.S. corporation (or group of corporations in a consolidated return), we found circumstances where a U.S. corporation engaging in several activities finds itself in a situation where the income from one activity generates a significant amount of foreign taxes in relation to its foreign income while income from other activities bear a lesser amount of foreign tax and is available to absorb potential excess credits from other areas. Determinations were made as to the existence of those situations. They reflected that potential excess burdens in certain industrial categories were buffered by U.S. corporations to a significant extent by foreign income from other classifications which tended to bear a lesser rate of tax.

We noted that in the banking area that leasing activities conducted outside the United States generally tended to produce a high effective foreign tax rate because of the matching of foreign tax burdens assessed in foreign countries to a reduced amount of income (or in some cases, loss) because of the U.S. tax rules regarding leasing income. The negative impact of this on the foreign tax credit was offset by financing operations conducted by these U.S. financial institutions abroad which tended

to bear a lesser rate of foreign tax and thus provided the ability to absorb potential excess credits from the leasing area.

In the area of insurance operations, it was noted that the foreign tax burdens imposed on foreign subsidiaries engaged in insurance activities in certain countries were somewhat high. However, they tended to be offset by insurance agency activities conducted in other countries which had a low tax burden imposed on them and thus provided the means of absorbing the potential excess foreign tax credits.

In the natural resource area, it was noted that companies in these areas tended to have potential excess credits because large losses were incurred on exploration for new sources. To some extent, income from transportation activities such as shipping, seemed to provide a certain amount of foreign income which was subjected to a lower amount of foreign tax and thus enabled the natural resource companies to forestall a certain amount of excess credits.

Manufacturing companies conducting activities abroad tended to be susceptible to high tax rates in countries where their manufacturing facilities were located. However, income from activities such as licensing of their technology provided a lower taxed foreign source income which afforded some

means for offsetting potential excess credits from the high tax areas.

In the service industry, such as entertainment, it was found that the income derived from the distribution of theatrical type productions are often taxed in the foreign countries on a gross income basis. This tended to provide a high rate of foreign tax on the distribution type income. However, when one looks at the financial type income generated by these companies, it seems to provide lower taxed foreign source income which provides the basis for absorbing potential excess credits from distribution.

Again, in the manufacturing sector, it was noted that some companies tended to generate low taxed insurance type foreign income which provided a basis for absorption of potential excess credits even though insurance was not the main activity of the company.

Finally, in the real estate area, U.S. corporations were generating potential excess credits from disposition of real estate abroad but were offsetting that by the finance activities in which they were engaging in order to reduce foreign tax burdens on that income. Similarly, in some manufacturing companies, the income generated in the wholesale - retail area

seemed to be bearing a lesser rate of foreign tax than the foreign tax burdens levied on manufacturing income. This provided leeway for absorption of excess foreign credits.

From the insights gathered from these investigations of the variations in foreign tax burdens within corporate entities from different industrial activities, our study provides an important glimpse into the offsetting that is being done because of the foreign tax burden effect on the primary activities of these corporations. The primary activities of certain U.S. corporations are those in which it is heavily engaged. However, these activities may be productive of excessive tax burdens. This appears to necessitate their consideration of entering other industrial activities in order to make the foreign tax burdens more absorbable.

While the data behind these interrelationships of industrial activity were not as capable of strict statistical comparison as that found in other areas of our research, they did provide us with insights into some sophisticated techniques that U.S. corporations have developed for utilizing their foreign burdens. As a consequence, the results noted above regarding the offsetting of tax burdens by industrial activity led us to delve more deeply into the methodology used by U.S. corporations. This

is explored more closely in our detailed examination of these techniques in Chapter X.

C. Foreign Tax Burdens by Type of Income

The foregoing examination of the foreign tax burdens of U.S. corporations by industrial activity revealed interesting insights into the manner in which U.S. corporations generate income from various types of activities which, because of the averaging effects of the foreign tax credit mechanism, permit them to buffer the adverse impact of the foreign tax burdens on them. These insights led our research into an even more precise determination. That was the examination of the types of income which were more susceptible to generating higher foreign tax burdens than others. This became important for the latter stages of our study in which we determined the techniques which U.S. corporations have adopted to absorb excess foreign tax credits and thereby avoid the stringent impact of foreign tax burdens. The present analysis enables us to determine the various types of income which U.S. corporations generate from foreign sources and, in so doing, views from a different perspective the burdens which these corporations face because of their foreign taxes.

1. Profile of Data Base by Type of Income Generated by U.S. Corporations

At the outset of our analysis, we had to determine

the basic types of income which account for the foreign tax burdens of U.S. corporations. This was necessary for purposes of examining those categories of income which U.S. corporations in the data base generated from foreign sources in order to provide a basic understanding of the types of income from foreign sources which are subject to foreign tax burdens. This analysis provided us with a feel for the mix of foreign source income generated by an average U.S. based corporation.

Our research indicated dividend income accounts for approximately 42.6 percent of the total foreign source income of the U.S. corporations being studied. We found the reason for this is not only because U.S. corporations conduct a fairly significant degree of their activities abroad in the form of foreign subsidiaries - a point which we will examine in greater detail in Chapter VI - but also because of the gross-up provisions of the deemed paid credit. As we saw in Chapter I, when dividends are received by U.S. corporations from developed country corporations abroad, the amount of deemed paid credit is added to the dividend income and forms part of the gross income base. Consequently, the foreign tax credit mechanism itself tends to increase the amount of dividend income that would be reported by U.S. corporations because of this gross-up provision. This, in turn,

is reflected in the percentage of foreign income attributable to dividends.

The type of income accounting for the next largest amount of foreign income to U.S. corporations is royalty income, accounting for approximately 17.6 percent of the total foreign income base of U.S. corporations. This income coupled with the fact that approximately 10.7 percent of the foreign income comes from services abroad is a reflection of the fact that U.S. corporations provide a significant amount of technology to their foreign affiliates as well as independent parties. The compensation for this use of these intangible property rights and technological services is reflected to a fairly significant degree by the percentage it represents of the total foreign income base of U.S. corporations.

Interest income is also a large source of foreign income for U.S. corporations accounting for 14.1 percent of the total. This reflects the fact that U.S. corporations are still providing a significant amount of capital to related and unrelated foreign entities and the return on those investments form a substantial part of the total foreign income base received by U.S. corporations.

Direct business operations conducted outside the

United States by U.S. corporations account for only 8.8 percent of the total foreign income of U.S. corporations. This is reflective of the fact that most U.S. corporations do not operate abroad through branch type operations, but have generally resorted to the foreign subsidiary form of operation. As we saw in Chapter I, this can be explained by the fact that the U.S. tax system still permits deferral of U.S. taxation on foreign income of foreign subsidiaries whereas the income of foreign branches would be directly subjected to U.S. taxation. This smaller amount of income is also explained in part by the fact that (as we saw earlier in this chapter dealing with income based on industrial classifications) although financial institutions account for a fairly significant number of companies in the data base, only these companies tend to operate abroad in branch form. This is reflected in the quantum of income based on direct operations abroad.

The last major category of foreign income is that generated from tangible property. This category is an amalgamation of income from various sources involving either the sale or lease of tangible property. It includes the income generated by leasing property abroad as well as income from the sale of tangible property such as in the case of Western Hemisphere Trade

Corporations. While a significant absolute amount percentagewise (6.2%), it is not a high percentage of the total foreign income of the U.S. corporations.

2. Foreign Taxes Imposed on Different Types of Income

Having categorized the major types of income that U.S. corporations generate from foreign sources, it became important to examine the amount of foreign tax burden that was levied on those types of incomes. In so doing, we were able to capture a feeling of the relative importance that foreign tax burdens present for the various kinds of income and also enable us to determine those types of income which present a higher degree of exposure to foreign tax burdens.

From our research, we found that dividend income had a significant foreign tax burden associated with it, accounting for 57.7 percent of the total foreign taxes reflected by U.S. corporations on their tax returns. This is explained by the fact that the foreign tax impact on dividends reflects the deemed paid credit which is accounted for by the flowing through of the underlying taxes from foreign subsidiaries.

Income generated from direct operations abroad as well as service income also reflected a fairly significant amount of foreign tax burdens accounting for 11.2 percent and

10.1 percent respectively of the foreign taxes incurred by U.S. corporations. On the other hand, interest income accounted for only 8.8 percent of the total tax burdens although, as we saw earlier, it accounted for over 14 percent of the taxable income. This confirms that interest income incurred by U.S. corporations provides a lesser amount of foreign tax burden overall than the amount of income itself.

Similarly, royalty income from foreign sources accounted for only 8.1 percent of the foreign tax burdens incurred by U.S. corporations whereas it accounts for almost 18 percent of the income. Here, there is an even more extreme disparity between the ratio of foreign tax burdens and amount of foreign source taxable income in the case of U.S. corporations.

In the case of income from personal property, there is a lesser amount of foreign tax incurred than is represented by the amount of income to total. Only 4.1 percent of the foreign tax burden came from this source, reflecting to some extent the influence of the Western Hemisphere Trade Corporation type operation for these companies. That is, the export type income of Western Hemisphere Trade Corporations resulted in the generation of foreign source income without a commensurate amount of foreign tax.

3. Relationship of Foreign Tax to Total Liability on Types of Income

Having analyzed the foreign tax burden incurred by U.S. corporations by type of income in absolute terms, we examined the relative importance of foreign taxes to total U.S. tax by type of income. This analysis cut across company lines and delved into the relative importance of foreign tax burdens by types of income generated by U.S. corporations in general. Our research revealed the highest ratio of foreign tax to total tax liability relates to dividend income which is 31.1 percent. This means almost one-third of the total tax liability on dividend income is accounted for by foreign tax burdens. This is due in great part to the deemed paid credit and the significant flexibility available to U.S. corporations due to the timing and multi-tier aspect of the U.S. tax rules on foreign subsidiary dividends. In a number of instances, it was noted that the foreign dividends received by U.S. corporations came out of more than the current year earnings and profits of the foreign subsidiaries. Thus, the current year's data included dividend income out of earnings of foreign corporations from more than the year under study. This is a result of the tax deferral concept in the U.S. taxing system which does not exist for other types of foreign source income generated by U.S. companies.

Research also shows that the ratio of foreign tax burdens to U.S. tax on service type income and income from foreign direct operation is also significant. In the case of the former type of income, foreign tax burdens account for some 19.8 percent of the total tax whereas, in the case of direct operations abroad, the foreign tax burdens exceed one-fourth (26.7%) of the total U.S. tax on net income.

In the case of income from interest and royalties, the relationship of foreign tax to total U.S. tax burden on this income is not as relatively great being 13.8 percent and 9.1 percent respectively. This reflects the fact that this type of income receives a greater deal of protection from foreign tax through the U.S. tax treaty network. This type of income generally enjoys a reduced amount of foreign tax or exemption from foreign tax because of tax treaties. We shall see in more specific terms in Chapter VII the effect that U.S. tax treaties have on various types of income. However, at this point, the analysis indicates that tax treaties do produce benefits for U.S. corporations as it relates to the income they generate from these two particular sources. It can be seen that these types of income provide a lesser amount of foreign tax burden to U.S. corporations, and therefore, are available to absorb potential excess credits

resulting from the other types of income that are susceptible to higher foreign tax burdens.

4. The Extent of Actual Excess Foreign Tax Credits by Types of Income

By determining the relative importance of foreign tax burdens to total U.S. tax liability incurred by U.S. corporations by type of foreign income, we are now able to delve into the extent to which U.S. corporations incur their actual excess foreign tax credits by type of income. This research was done by comparing the foreign tax burdens incurred by type of income to the foreign tax credit limitation attributable to such income by each U.S. corporation. In so doing, we were able to ascertain on a company-by-company basis the amount of U.S. tax that would have been attributable to foreign income by a particular type and relate that to the foreign tax burden incurred by particular U.S. companies on that type of income. Our research revealed that dividend income produced an average excess foreign tax credit of 18.4 percent while direct operating income produced excess credits in 11.3 percent of the cases and service type income produced excess credit in 8.9 percent of the cases. In the case of interest and royalty type income, there was a very low percentage of instances where they produced excess foreign tax credits. In fact, these types of income tended to produce

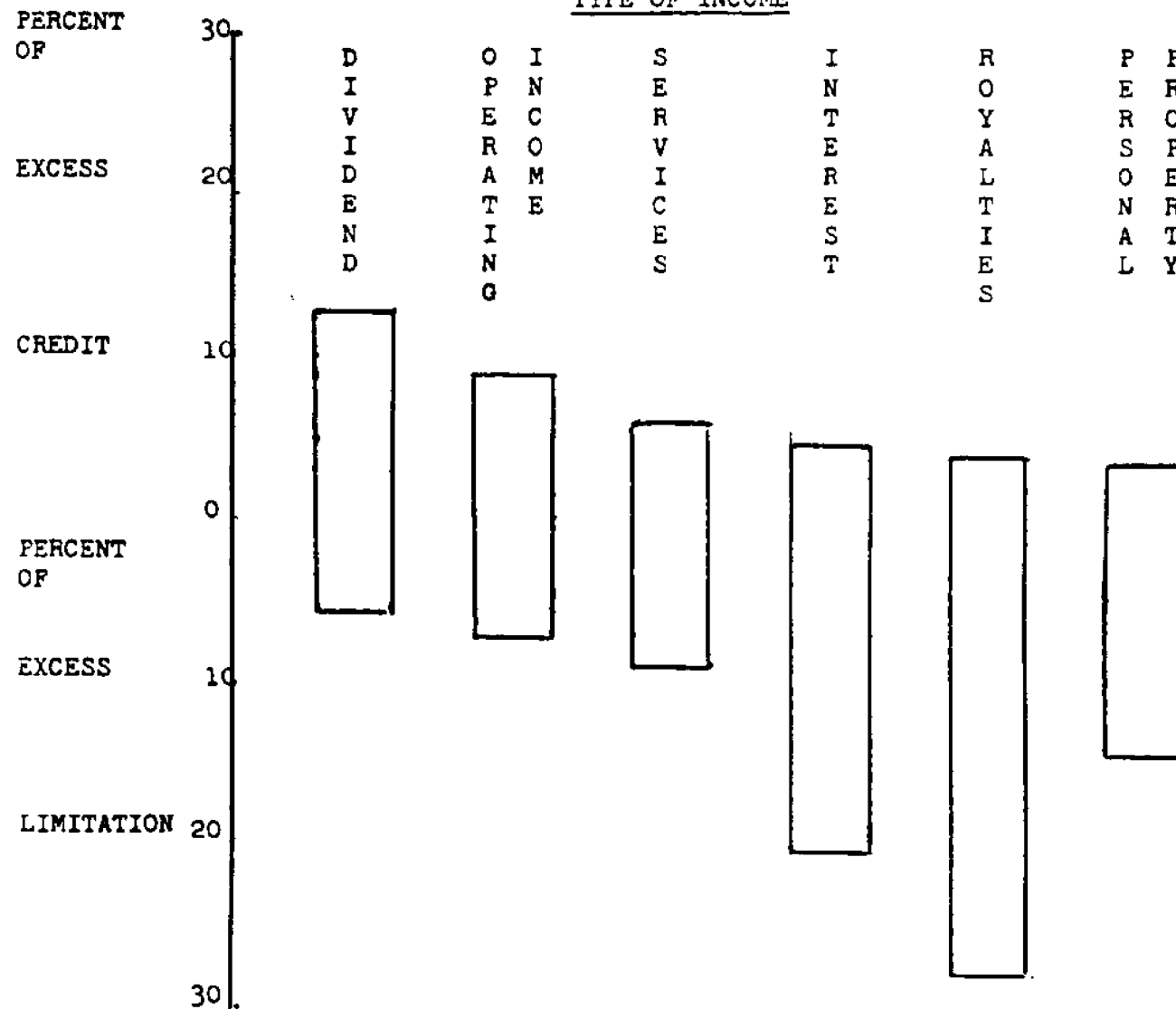
excess limitations in more instances and provided leverage for U.S. corporations to use to absorb excess foreign tax credits from the other types of income that tended to produce these excesses.

The analyses performed were compiled by relating by number of companies, the data for a given kind of income that produced an excess credit for that company. These analyses were continued by computing the percentages using the absolute amount of excess tax. That is, ratios were struck to show the amount of excess foreign tax credit by type of income to total foreign taxes. This analysis is reflected in Exhibit H which shows that the excesses by number of companies are not as significant when compared with the actual amount of foreign tax. But let us now examine the rationale for these results.

Based on the foregoing analyses, we can see that dividends tend to produce excess credits due to the fact that U.S. corporations are entitled to the deemed paid credit for taxes paid through several tiers of affiliated foreign corporations. The ability of companies to offset against U.S. tax on their dividends the underlying corporation tax, as well as withholding taxes levied through several tiers of foreign subsidiaries, produces a situation where these withholding taxes coupled with

EXHIBIT H

EXTENT OF EXCESS FOREIGN TAX CREDIT AND LIMITATION BY
TYPE OF INCOME



I the flexibility of the deemed paid credit tends to produce an excess of tax credits. In this case, it must be borne in mind that for foreign tax purposes, dividends include more than distributions from what would normally be considered foreign subsidiaries. It basically includes any dividend payments from a foreign corporation in which a 10 percent or greater interest is held by the U.S. corporation. This means that U.S. companies having minority interests in foreign affiliates can receive dividends from them which carry a prorated share of the foreign corporation tax attributable to the earnings out of which the dividends were paid.

The area of direct business income represents income generated by U.S. companies via foreign branch or partnership operations. On close inspection, it was noted that foreign branches are sometimes used when losses overseas are expected so that these losses can be deductible in the United States. One important side effect of this type of structure is that, at times, foreign countries do not respect the fact that overall losses are incurred in their country and therefore may still assess their tax on U.S. corporations using their concept of income determination. This produces situations where there may be foreign taxes incurred but very little foreign source income (or foreign losses) against which the tax can be credited. Furthermore, there are often inconsistencies as to the method of

computing the taxable base between the U.S. and foreign countries where foreign branch operations are used. These aspects of direct operations overseas produce phenomena where losses abroad are offset against profits but which tends to reflect a higher amount of potential excess credit.

In the case of royalty income, our research reflected that a high percentage of this income comes from Europe and other developed countries with whom the United States has tax treaties. Because of this fact, the rate of foreign tax imposed on royalties tends to be much lower on the average and thus makes that type of income less susceptible to creating excess foreign tax credits. The fact that excess credits might be incurred on this type of income is due to the fact that the taxes on royalties earned by U.S. companies abroad are often subjected to tax in the foreign country on a gross income basis. Where foreign taxes are imposed on gross income, it can raise a situation whereby the foreign tax on gross income is greater than the U.S. tax limitation based on net income. This is particularly true where the income concepts are computed under two different taxing jurisdictions. We saw this from a conceptual standpoint in our discussion in Chapter I of the foreign tax credit limitation calculation; the data in this chapter

supports that concept. However, from an overall standpoint, we do see in this data that royalty income is not productive of significant excess foreign tax credit burdens.

In the case of interest income, the general capital needs of foreign countries often results in their imposing low foreign tax burdens on interest. This, then, attracts U.S. corporations to invest in those countries. As a general rule, our research noted that interest income is not subjected to potential foreign tax credit burdens in a high number of cases. Again, it is to be noted that where the interest is flowing to the United States, tax treaties which the United States has signed often results in the interest not being subjected to any foreign tax or at least to a lower rate of foreign tax. Since this type of income is also subject to tax in foreign countries on a gross income basis, tax treaties remove the greatest danger of excess foreign tax credits on this type of income.

Finally, service income tends to be productive of potential excess credits, because of the fact that services must be rendered in a foreign country to be foreign source under the U.S. tax source of income rules as we saw in Chapter I. Once a U.S. corporation actually conducts physical activities in a

foreign country, that country will tend to tax it. Therefore, this type of income tends not to be shielded as much from foreign tax by tax treaties. In addition, this type of income tends to have a fair amount of expense attributable to it so that the net income from this type of income computed under U.S. standards is somewhat less than under foreign standards, thereby providing a tighter foreign tax credit limitation. We found the combination of these two factors account in great part for the potential excess credits noted for this type of income in our analysis.

5. Extent to Which Excess Foreign Tax on One Type of Income is Used to Offset U.S. Tax From Another Type of Income

Now having determined the potential for excess foreign tax credits by type of income, our analysis concluded by examining those instances in which the excess credit produced by type of income were actually utilized by U.S. corporations to offset U.S. tax on foreign source income from other sources. This was done by analyzing on a company-by-company basis those situations where excess foreign taxes imposed on certain types of foreign source income were actually productive of excess foreign tax credits to a U.S. company per its tax return. This analysis - similar to the one performed earlier in order to determine the offsetting of tax liabilities in the case of

I various foreign countries - is now based on the type of income incurred. From Exhibit H, we can see that the potential excess credits indicated by certain types of income are absorbed to a great extent because of excess limitations in the areas of interest income and royalty income. This thereby accounts for the fact that there is a relatively low actual excess foreign tax credit reported by U.S. corporations. This analysis, in effect, reconciles the potential excess foreign tax credit by type of income with the actual excess credit picture reflected in Chapter III. In essence, it can be concluded that the significant amount of foreign source income of certain types that bear reduced amounts of foreign tax burdens make it possible for U.S. corporations to significantly monitor their foreign tax credit position and thereby put themselves in the posture of not being exposed to substantial excess foreign tax credits.

To summarize Chapter V, it can be said that foreign tax burdens are basically incurred by the larger corporations in the manufacturing, financial and natural resource areas and that the type of income that incurs the highest amount of taxes is dividend income. Although these areas result in the incurrence of the highest amount of absolute foreign tax, the larger companies in the manufacturing sector also demonstrate a great deal of flexibility for generating foreign income in such amounts as

to absorb the potential excess foreign tax credits. This flexibility is lacking in the medium and smaller size U.S. corporations and so they are as susceptible to the adverse impact of foreign tax burdens as the large companies, if not more so. Furthermore, we see that U.S. corporations do tend to venture into other types of commercial activities, to some extent, to ward off the potential of generating excessive foreign tax burdens. They do so by taking actions to generate those types of foreign income, such as interest and royalties, which provide a cushion for foreign tax credit absorption.

CHAPTER VI

THE SIGNIFICANCE OF THE FOREIGN TAX BURDEN OF FOREIGN SUBSIDIARIES OF U.S. CORPORATIONS

One of the insights revealed in the preceding chapter is that dividends of foreign subsidiaries of U.S. based corporations are a type of income which is subjected to a high foreign tax burden. This is because of the ability of U.S. corporations to claim as a foreign tax credit, not only foreign withholding taxes levied on dividends remitted to U.S. parent corporations, but also for a portion of the underlying corporate tax paid by the subsidiaries. Because of the fact that this potential for excess foreign tax burdens of U.S. corporations tended to center around dividend income, and specifically around the remission of earnings of foreign subsidiaries, a detailed examination was made of the earnings structure of foreign subsidiaries of U.S. corporations in the data base, in order to evaluate the impact that their foreign tax burdens were making on their earnings and potentially on the U.S. parent corporations.

A. Foreign Tax Burdens on Foreign Subsidiaries

For this part of our study, we looked into the foreign

tax burdens imposed on the overseas subsidiaries of U.S. corporations. The data was compiled from the information returns required to be filed with the tax returns of the U.S. corporations. Essentially, the information showed that U.S. corporations generated \$503,890,000 of earnings before foreign tax in their foreign subsidiaries and on those earnings suffered taxes of \$182,690,000 for a ratio of approximately 36 percent. This produced after-tax earnings of \$321,200,000 for the foreign subsidiaries of the companies in the data base. Based on the data, our research was also able to determine that these subsidiaries distributed approximately 38.1 percent of their after-tax earnings and profits and retained some 61.9 percent of these profits. Thus, it can be said that the foreign tax burden of U.S. corporations related to their foreign subsidiaries consisted for the most part of the withholding taxes and deemed paid credit being attributable to a minority of the earnings of these subsidiaries because of the high percentage of retained earnings. At this point, therefore, it might not appear that the overall foreign tax burdens of foreign subsidiaries was so significant as to present the excess credit potential we have seen in earlier chapters. In order to get a better insight into this apparent inconsistency, we then examined the income of foreign subsidiaries in more precise terms.

B. Foreign Tax Burdens of Foreign Subsidiaries
of U.S. Corporations by Country

Based on the prior examination, our research then delved into the extent to which foreign subsidiaries of U.S. companies are structured in various countries around the world. At the same time, we looked at the foreign tax burdens as they were spread geographically by subsidiaries. The purpose of this analysis was to enable us to determine those countries in which U.S. corporations have established subsidiaries which are incurring high rates of foreign tax. The conclusion reached, as a result of this examination was that, although on the average the foreign tax burdens of foreign subsidiaries of U.S. companies was significantly less than the U.S. statutory tax rate, this was the result of the averaging of high and low tax rates in different foreign countries. This indicated the existence of potential pockets for excess foreign tax burdens depending on the country in which this subsidiary was located.

Based on this research, we determined the effective foreign tax rate of the foreign subsidiaries of U.S. corporations in a number of countries in which they are conducting subsidiary operations. Variations in foreign tax burdens above and below the U.S. statutory rate indicate the existence of potential pockets for excessive foreign tax burdens depending on the country

in which the subsidiary was located. The following illustrates instances reflected in our data base where the average foreign tax burden in a given country produces a tendency toward tax burdens which could exceed the U.S. effective rate of tax once withholding taxes on dividends are taken into account:

Argentina	47%
Colombia	46%
Canada	51%
France	50%
Germany	51%
Libya	59%
Netherlands	48%
Venezuela	50%

This analysis gives us a clearer view of the specifics of the foreign tax burdens of U.S. corporations that emanate from their foreign subsidiaries and helps to explain the reason why, notwithstanding the average effective foreign tax rate at the subsidiary level being somewhat below the U.S. rate, there is still a potential for excessive foreign tax credits.

C. Foreign Tax Burdens of Foreign Subsidiaries of U.S. Corporations by Industries

Having thus seen the disparity of foreign tax burdens reflected in the examination of foreign subsidiaries of U.S. corporations on a country-by-country basis, our study delved into the foreign tax burdens of those subsidiaries by the industrial activities in which they were engaged. The purpose of this examination was to determine those types of foreign business

activities which are susceptible of high tax rates as well as those which appear to be conducted at relatively low foreign tax burdens.

From our research, we saw that the manufacturing sector incurred a fairly high effective tax rate (50%) as did the wholesale - retail area (54%) and the service area (46%). Foreign tax burdens of subsidiaries in these areas are contrasted with those conducting activities in the transportation (36%), construction (32%) and natural resource area (24%). In these latter industries, the effective foreign tax rate at the subsidiary level is less than the U.S. tax rate, thus indicating a less grievous impact of foreign taxes at that level. Of particular interest is the fact that, although the natural resource companies in the United States tend to have a very high effective foreign tax burden, at the subsidiary level this is not borne out. From this analysis, it can be said for example that U.S. corporations conducting activities abroad in areas involving transportation (such as shipping) can use the dividend income from such affiliates to absorb excess credits that might be generated from operations conducted by subsidiaries in the manufacturing, wholesale - retail and service type areas. This also discloses that, by structuring foreign subsidiary operations in activities that are subjected to low foreign tax rates, U.S. corporations

are able - because of the deferral aspects of the U.S. tax system - to produce a reservoir of low tax foreign earnings which they can keep on a standby basis for purposes of absorbing excess foreign tax credits from other subsidiaries.

D. Determination of Foreign Tax Burdens of Foreign Subsidiaries of U.S. Corporations on the Basis of Full Repatriation to the United States

Continuing our analysis of the foreign tax burdens of foreign subsidiaries of U.S. companies, we examined the extent to which the foreign tax burdens would be heightened if the earnings of foreign subsidiaries which had been retained were actually distributed to the U.S. shareholders. As indicated earlier, there is a fairly high percentage of retention of earnings abroad.²²⁴ However, realizing that distribution of foreign earnings carry with it foreign withholding taxes, it was deemed important to determine exactly what the total foreign tax burden would be if these earnings were brought back to the United States. From our data base, it was determined that the burden would be significant requiring an additional \$38,193,000 of foreign tax. This additional tax would be 11.9 percent of the foreign subsidiaries' earnings after tax at the subsidiary level and would increase the overall foreign tax burden on subsidiary earnings by 20.9 percent.

²²⁴. See Section B(2), Chapter II, of this study.

This analysis answered the question as to why U.S. corporations control the dividend flows from their foreign subsidiaries for foreign tax credit purposes. It is clear that, to the extent foreign earnings of subsidiaries of U.S. companies were distributed on a current basis, there would have been a fairly significant additional foreign tax burden which could not have been as easily managed by U.S. corporations as their present burdens. To an extent then, the plow back of earnings of foreign subsidiaries is conditioned by this foreign tax impact factor and not merely by economic considerations.

E. Comparison of Statutory and Effective Foreign Tax Burdens of Foreign Subsidiaries

Examining the foreign tax burden structure of the foreign subsidiaries of U.S. corporations, it was not sufficient to look solely at the statutory tax rates imposed by foreign countries on such earnings. We noted in our analysis the erosion of the statutory tax rate down to the effective foreign tax rate in many countries. In order to approach this more analytically, we recomputed the foreign tax burden of the foreign subsidiaries of U.S. companies on the basis of what their tax burdens would have been had they paid the full statutory rates in those countries.

The details of this analysis for a number of major

countries contained in Exhibit I indicates that, if foreign subsidiaries of U.S. corporations paid the full rate of foreign tax on the various types of income they generate, the total foreign tax burdens of those subsidiaries would put U.S. corporations in a position where they would be beyond their capacity to absorb foreign taxes through the tax credit mechanism. An alternative conclusion is that U.S. corporations would be even more hard-pressed to utilize the sophisticated techniques they have developed for absorbing excess foreign tax credits. In reviewing this analysis, we must bear in mind that the effective foreign tax rate - which is the important statistic for U.S. foreign tax credit limitation purposes - is determined under U.S. standards whereas the statutory tax rate is imposed on foreign income based on foreign concepts of income. By reason of the fact that U.S. corporations compute the relationship of foreign tax to foreign income using U.S. standards of income, they are in a position whereby the effective rate appears to be sufficiently high to provide substantial foreign tax credit whereas not so high as to create substantial excess foreign tax credit problems.

F. Relationship of Effective and Statutory Rates of Tax of Foreign Subsidiaries to Their Repatriation Ratios

As a culmination of our examination of foreign subsidiaries of U.S. corporations from the standpoint of their foreign tax

RELATIONSHIP OF EFFECTIVE & STATUTORY
TAX RATES OF FOREIGN SUBSIDIARIES BY COUNTRY

<u>COUNTRY</u>	<u>STATUTORY RATE</u>	<u>EFFECTIVE RATE</u>
INDIA	55	59
IRAN	55	59
SAUDI ARABIA	45	57
KUWAIT	50	55
LIBYA	60	53
AUSTRALIA	47.5	49
GERMANY	51	49
CANADA	51	48
UNITED KINGDOM	40	47
ARGENTINA	48	47
FRANCE	50	47
NETHERLANDS	48	46
MEXICO	42	44
ITALY	40	43
PHILIPPINES	35	42
VENEZUELA	50	41
JAPAN	26	38
BRAZIL	30	37
COLOMBIA	36	33
SWITZERLAND	12	28

burdens, our research carried us to the relationship between the tax burdens incurred by these subsidiaries and their dividend payout. This was done in order to determine if the relationship between the two correlated. The results of this examination, indicated in Exhibit J, points out that in situations where the foreign tax rate is high, there is a definite tendency for U.S. corporations to withdraw dividends from their foreign subsidiaries. Conversely, where the foreign tax rate is low, there is a lesser degree of repatriation. Thus, it appears that the tax burden incurred by foreign subsidiaries very likely has an impact on the extent to which earnings are distributed to U.S. shareholders. This is explained by the fact that foreign dividends, bearing a high effective tax rate, can be essentially received tax free from a U.S. tax standpoint because of the deemed paid credit. In those situations where the earnings are subjected to a lesser rate of foreign tax, an additional U.S. tax would have to be paid on the dividends after foreign tax credit. This is a deterrent to the repatriation of those profits to U.S. shareholders. As we indicated earlier in our discussion in Chapter I, the U.S. tax deferral concept gives the U.S. corporations the ability to control the timing of these distributions and thereby better control their foreign tax burden impact.

RELATIONSHIP OF FOREIGN SUBSIDIARYEFFECTIVE TAX RATES TO REPATRIATION RATIOS

<u>COUNTRY</u>	<u>EFFECTIVE RATE</u>	<u>REPATRIATION RATIO</u>
GERMANY	49%	78
FRANCE	47	62
CANADA	48	58
UNITED KINGDOM	47	56
AUSTRALIA	49	54
SAUDI ARABIA	57	53
LIBYA	53	46
IRAN	59	44
NETHERLANDS	46	43
KUWAIT	55	42
MEXICO	44	41
ITALY	43	39
ARGENTINA	47	39
INDIA	59	38
JAPAN	38	34
VENEZUELA	41	33
COLOMBIA	33	32
BRAZIL	37	28
PHILIPPINES	42	28
SWITZERLAND	28	19

AN INQUIRY INTO THE FOREIGN TAX BURDENS
OF U.S. BASED MULTINATIONAL CORPORATIONS

by

WALTER F. O'CONNOR

Part 2

CHAPTER VII

EFFECTS OF U.S. TAX TREATIES ON THE FOREIGN TAX BURDENS OF U.S. CORPORATIONS

From our conceptual discussion in Chapter I of the role which tax treaties are designed to play in preventing double taxation, we saw that their basic impact on U.S. corporations conducting foreign activities is to reduce the quantum of foreign tax burdens they incur for purposes of their absorption within the U.S. unilateral double taxation mechanism, namely, the foreign tax credit. In order to properly determine the impact that foreign tax burdens have on U.S. corporations then, it was deemed necessary to examine the manner in which foreign tax treaties actually affect the foreign tax burdens that U.S. corporations have incurred or would incur if the tax treaty relief were not available. In order to do this, a number of analyses were made of the foreign tax burden data available for our research separating the impact that tax treaties specifically have on the foreign tax burdens of U.S. corporations.

A. Foreign Tax Burdens of U.S. Corporations - Tax Treaty Countries Versus Non-Tax Treaty Countries

At the outset of our research in this area, we segmented the data in order to compare tax burdens incurred by U.S. corporations in those countries with which the United States has a tax treaty versus those countries with which it does not have such treaties. The purpose of this examination was to obtain an initial insight into the relative weight of tax burdens imposed by these two major groups of countries. As a result of this examination, it was determined that approximately 59.1 percent of the foreign tax burdens of U.S. corporations were incurred in those countries with which the United States has a tax treaty and that 40.9 percent was generated in those countries with which we did not have tax treaties. Viewing this data in relation to income generated in non-tax treaty countries, it is interesting to note that a fairly significant difference existed in the tax treaty burdens versus non-tax treaty burdens. This provided an initial indication that tax treaty countries are a source of a fairly significant amount of the tax burdens incurred by U.S. companies even after treaty relief was given.

B. Determination of Effect of Tax Treaties on Foreign Tax Burdens of U.S. Corporations

The previous examination of the amount of foreign tax

imposed by tax treaty countries logically led to an examination of the amount by which the foreign tax burdens had been reduced because of tax treaty relief. In our descriptive analysis of the U.S. tax treaty network in Chapter I, we saw that with regard to U.S. corporations, this network essentially had the effect of either exempting or reducing the foreign tax burden that U.S. corporations would normally have incurred. An examination of that aspect of the U.S. tax treaties using the empirical data base indicated that there is a very significant reduction in foreign tax burdens incurred by U.S. corporations because of the workings of the tax treaties. This examination showed that from an overall standpoint, if tax treaties were not in existence, the foreign tax burdens of U.S. corporations in the tax treaty countries would have increased by 14.6 percent. Consequently, a fairly significant reduction is created in foreign tax burdens of U.S. based corporations by these treaties.

C. Recomputation of Foreign Tax Burdens of Individual Tax Treaty Countries

Our preceding examination indicated a substantial reduction in the overall tax burdens incurred by U.S. corporations in tax treaty countries. Because of the existence of those treaties, a redetermination was made of the change in foreign tax burdens produced by the treaty for each tax treaty

country. The purpose of this examination was to determine what countries help U.S. corporations the most from the standpoint of reducing its foreign tax burdens. The result of our study is set forth below:

United Kingdom	49%
Sweden	42%
Switzerland	40%
Jamaica	37%
South Africa	32%
Austria	31%
Belgium	28%
Pakistan	27%
New Zealand	24%
Germany	21%
Japan	20%
Australia	18%
Italy	18%
Netherlands	18%
Norway	18%
Denmark	17%
France	15%
Finland	12%
Greece	11%
Canada	8%
Ireland	6%

These figures show the percentage increase of the foreign burdens that would have incurred in each tax treaty country had the tax treaty not been in existence. As can be seen, countries such as Canada, the United Kingdom, France and Germany - which are countries in which the U.S. corporations in our data base incurred a substantial amount of foreign tax burdens - would have had a significant percentage increase in the foreign tax burdens. The

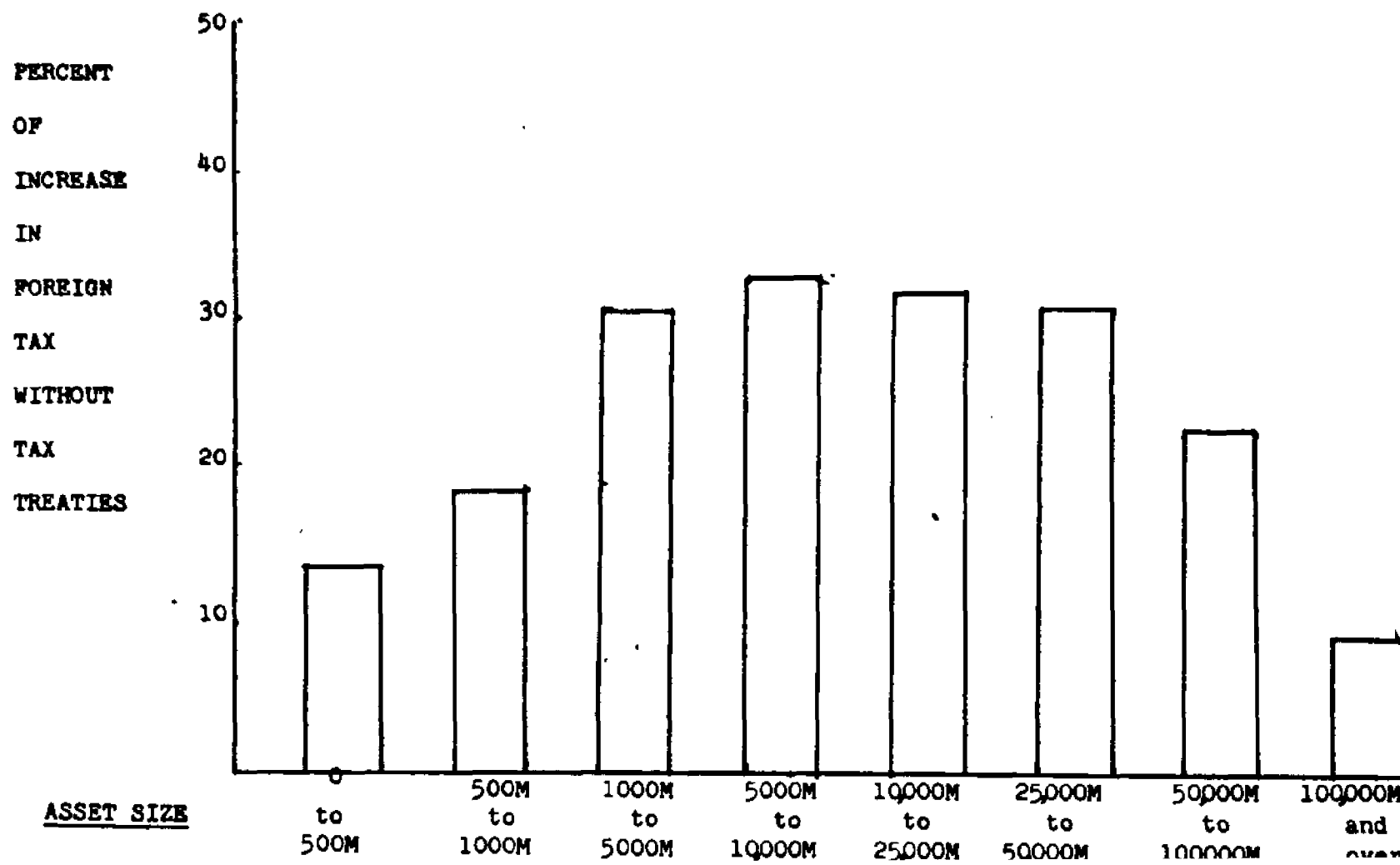
percentages range from 6 percent in the case of Ireland to 49 percent in the case of the United Kingdom. While not representing as high a percentage of foreign tax burdens to total, countries such as Austria, Belgium, Jamaica, New Zealand, Pakistan and South Africa also indicate a high percentage increase in their tax burdens would have occurred if the tax treaties were not in existence. Given the fact that U.S. corporations in general are expanding their international operations and would have the tendency of generating income in more of these tax treaty countries, this documents the substantial impact that tax treaties make toward reduction of these foreign tax burdens of U.S. companies in general.

D. Determination of U.S. Corporations Benefitted
by U.S. Tax Treaties by Size

In order to get a more clear focus on the specifics of the benefits that tax treaties provide U.S. corporations, we examined the data base to ascertain which U.S. companies benefit most from the tax treaty reduction of foreign tax burdens viewing them by their relative size. The result of this examination is reflected in Exhibit K which demonstrates that, as a company becomes larger and conducts its activities in a wide range of countries, it tends to receive substantial benefits from foreign tax treaties. This is due to the diversity of its interests and also because of the numerous tax treaty countries in which it is

EXHIBIT K

DETERMINATION OF U.S. CORPORATIONS BENEFITTING FROM
U.S. TAX TREATIES



generating income. However, the exhibit also is meaningful since it reveals that, although the overall tax burdens of the very large U.S. companies are substantial, the reductions provided by tax treaties in their case are not as large in relation to their total tax burdens as that which exists for companies of medium size. While apparently contradictory at the outset, the data can be explained when one considers that the base of foreign tax burdens is so large in the case of the major U.S. corporations that even the substantial reductions made by the U.S. tax treaties on income from those countries does not have the significant impact that it has with medium sized U.S. companies. However, as we saw in Chapter IV, as companies generally become larger, they also tend to conduct activities in a greater variety of countries. As a result, they have access to the benefits of more tax treaties. Since many of the countries with which we have concluded treaties are those in which U.S. based companies conduct a substantial amount of their operations, the data does indicate that the larger U.S. companies benefit more from the foreign tax burden reduction afforded by these treaties in absolute terms than do the smaller ones.

E. Determination of Extent to Which Foreign Tax Burdens are Reduced by Tax Treaties for U.S. Corporations in Various Industries

In order to more precisely pinpoint the extent to which tax treaties impact on the foreign tax burdens of U.S. corporations, the data base was also examined from the standpoint of industrial activities which seemed to benefit from tax treaties. This examination enabled us to determine in what industries U.S. corporations will engage to generate foreign source income which is subjected to reduced tax rates because of tax treaties. A sampling of this analysis is contained below:

Rubber Products	47.4%
Chemicals	41.6
Cosmetics	40.6
Scientific Equipment	39.8
Pharmaceuticals	38.9
Wholesale/Retail	38.3
Banking/Finance	32.2
Food Products	27.4
Primary Metals	23.6
Real Estate	21.7
Hotels	20.4
Amusement/Recreation	19.4
Construction	17.8
Transportation	17.4
Agriculture	14.7
Natural Resources	12.7

This indicates that activities such as banking - financial activities, wholesale - retail operations, and manufacturing activities are areas which would reflect the greatest increase in foreign taxes if tax treaties were not available. On

the contrary, companies engaged in natural resource operations, construction, agriculture and transportation activities would not have the same substantial increase if foreign tax treaties were not in existence. This analysis draws us to the conclusion that companies engaged in those activities which generate the highest amount of tax treaty benefit will structure their operations to fit into those industrial classifications and conduct activities in that area should they be desirous of minimizing their foreign tax burdens. Indeed, the ability to generate foreign income which is subjected to a lesser tax rate because of these tax treaty benefits is also attractive to those companies which have potential excess foreign tax credits. From this research, we can conclude that tax treaties not only can but actually do affect the manner in which U.S. companies conduct their operations because of this availability of tax treaty benefits.

F. Recomputation of Foreign Tax Burdens in Tax Treaty Countries by Type of Income

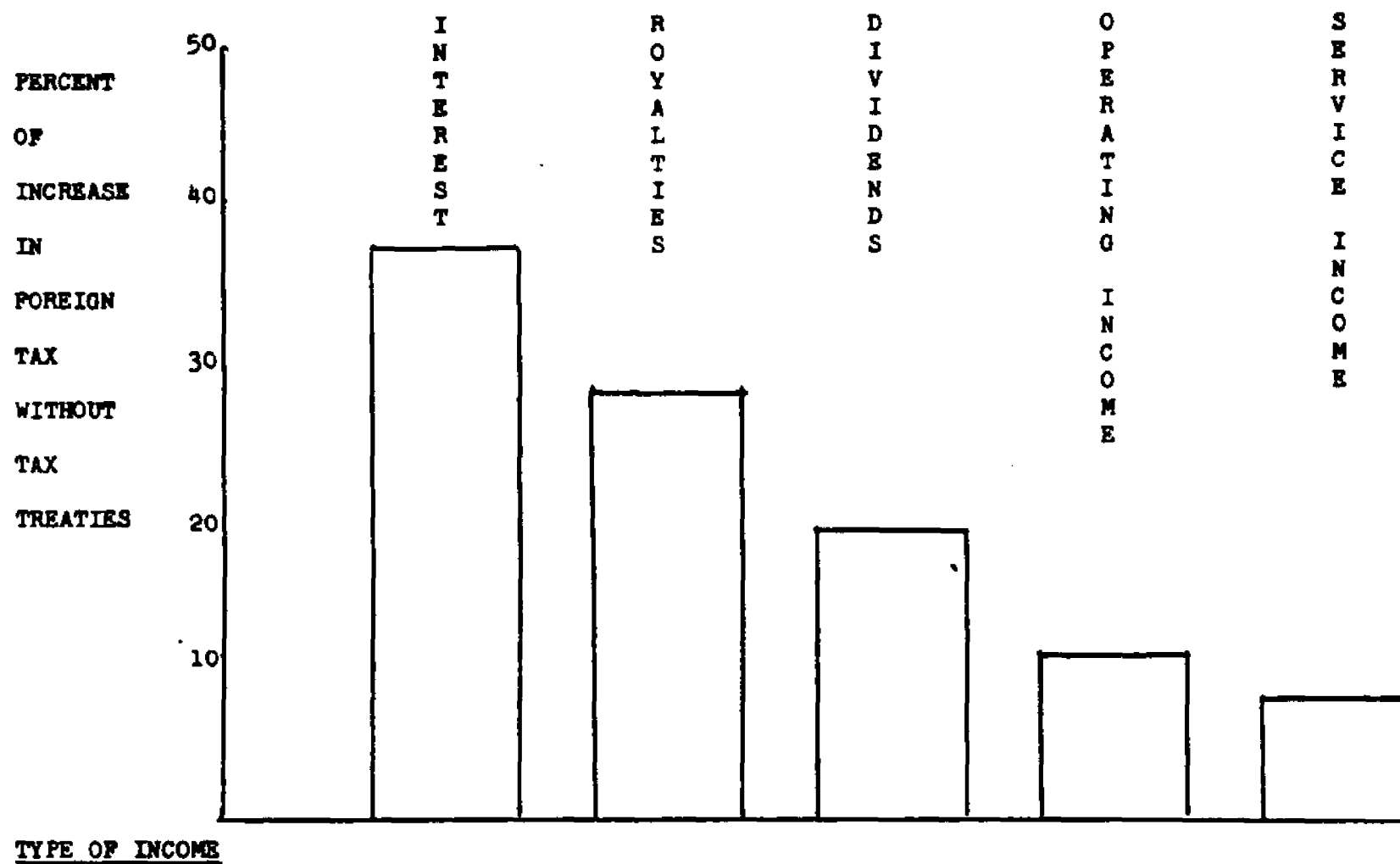
In Chapter IV, we examined the manner in which U.S. companies generate tax burdens by type of income in order to obtain a greater appreciation of the foreign tax burdens which they incur by type of foreign source income. In order to focus more clearly on the impact that foreign tax treaties make on U.S. corporations, an examination was made to identify the types

of foreign source income which U.S. corporations are prone to generate in tax treaty countries. This was done in order to see where the tax treaty benefits are most beneficial by type of income. The results of this study are highlighted in Exhibit L.

This examination of the tax treaty benefits by type of income highlights the fact that tax treaties generally reduce the tax burdens on such income as technology payments and payments for financial services. As a result, it reveals a reason for the tendency of some U.S. corporations to try and characterize their income in this fashion in tax treaty countries because they are the types of income that will provide the greatest amount of foreign tax reduction. Conversely, operating income in foreign countries and income from service charges do not enjoy the same amount of tax treaty reduction in foreign countries and, as a result, do not represent the kind of income that U.S. companies will try to generate in order to obtain tax treaty benefits. When we viewed the data earlier, it indicated that the foreign tax burdens on interest and royalty income were generally burdened with less foreign tax. We can now see that it related in part to the benefits available to those kinds of income from tax treaties.

EXHIBIT L

DETERMINATION OF TYPES OF INCOME BENEFITTING FROM
U.S. TAX TREATIES

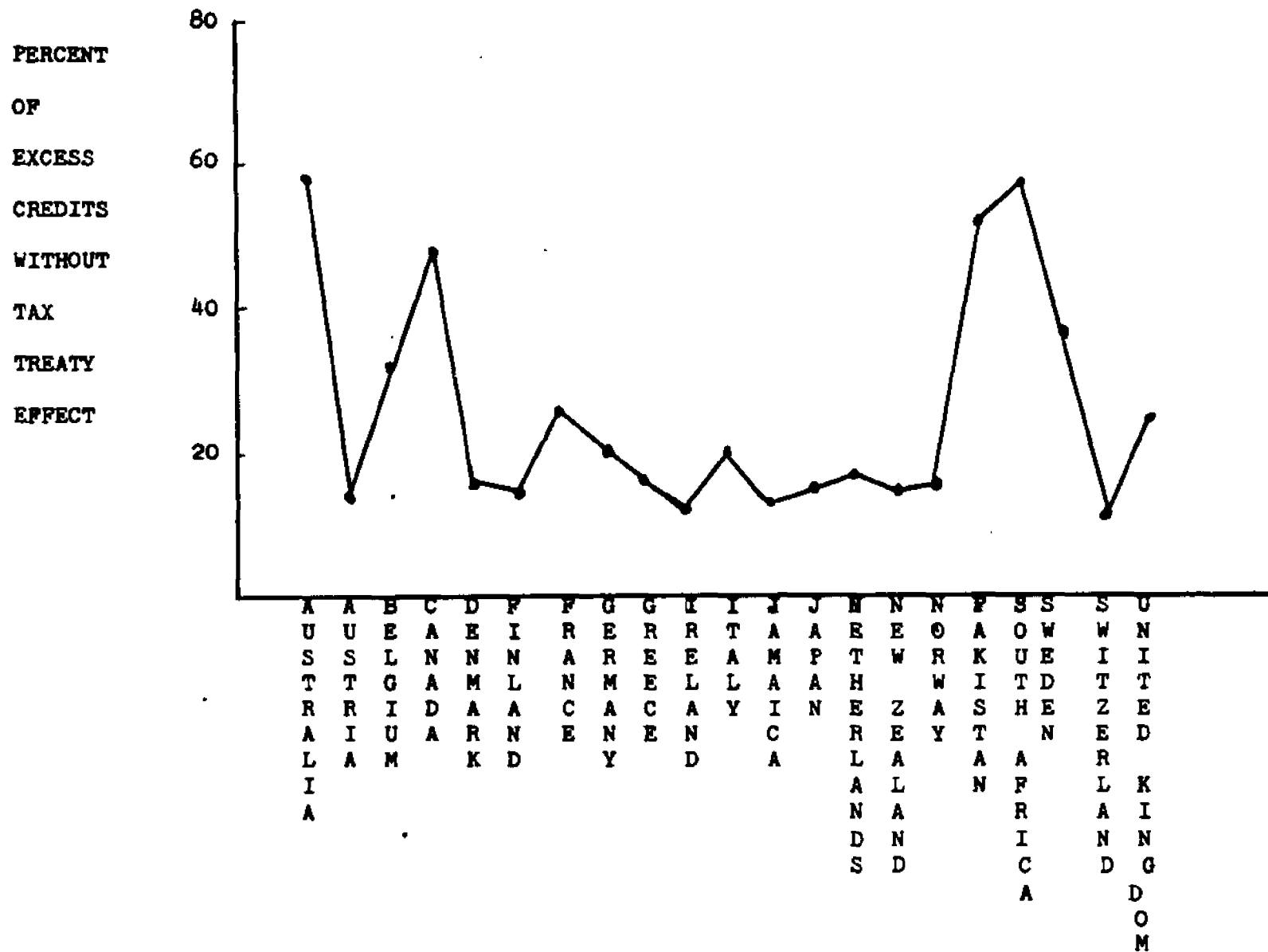


G. The Extent to Which Excess Foreign Tax Credit
Would Exist if No Tax Treaty Existed

Because one of the impacts that foreign tax burdens can have on U.S. corporations in the generation of excess foreign tax credits, we analyzed the data to determine the impact that the removal of tax treaties would have had on the excess foreign tax credit situation of U.S. corporations. The objective was to ascertain to what extent tax treaties are actually performing the role of preventing double taxation in the case of U.S. corporations with foreign income. On balance, we found that there would be a significant increase in actual excess foreign tax burdens of U.S. corporations if tax treaties did not exist. As a result, the removal of the tax treaty system would have a detrimental impact on U.S. corporations. This analysis was made by comparing the recomputed foreign tax burdens as if tax treaties do not exist with the U.S. tax on the tax treaty income. The results are illustrated in Exhibit M and indicates that from an overall standpoint, if tax treaties did not exist, in many countries the excess foreign tax credit as revised would be quite substantial. This is particularly true when related to the amount of potential excess foreign tax credit from those countries on the basis of tax liabilities as actually incurred. A key question now to be answered is to what extent U.S.

EXHIBIT V

EXTENT TO WHICH TAX TREATIES AFFECT EXCESS TAX CREDITS



corporations would have had an overall excess foreign tax credit if tax treaty relief were not available.

H. The Extent to Which Tax Treaties Affect
Income from Non-Tax Treaty Countries

The culmination of our research on tax treaties resulted in an examination of the extent to which the benefits of tax treaties are really being enjoyed by other countries with which we do not have tax treaties. The analysis in this case examined the extent to which the reduction of foreign tax burdens afforded by tax treaties actually resulted in enhancing the U.S. corporation's ability to absorb credits in the form of tax burdens assessed by other countries. A determination was made as the extent to which the reduction in tax treaty burdens tend to offset the U.S. tax on income from tax treaty countries versus income from other countries. Operating on the assumption that one basic objective of a tax treaty, as described in Chapter I, was to provide benefits to U.S. corporations with respect to the income generated in that particular foreign country with which the United States has a treaty, we examined the extent to which the recomputed foreign tax burden from a particular treaty country would have been used to offset U.S. tax on income from that country and also the extent to which any excess would be used to offset U.S. tax on income from other countries. The

results of our examination revealed that there is a fairly significant degree of offsetting of non-tax treaty tax burdens against income from tax treaty countries that have been spared the tax burden because of the tax treaty benefit. That is to say, by reducing the tax burden that U.S. companies generate in certain tax treaty countries below the U.S. corporate tax rate, there is created a margin of relief which permits U.S. corporations to absorb foreign tax burdens from non-tax treaty countries against tax treaty income. Thus, in a wide variety of instances, tax treaties are serving a function which was not intended when the United States negotiated the treaty with the particular foreign country. Thus, the reduction of tax burdens in the foreign country that are granted to U.S. corporations provide a margin for U.S. companies to generate income in other countries than the tax treaty country, and in so doing, use the tax treaty income to absorb potential excess foreign tax burdens. Since tax treaties are negotiated on a bilateral basis, this does not appear to be a purpose of the tax treaty. These results are depicted in Exhibit N which shows the difference in the ratios of foreign tax burdens before and after this recomputation by tax treaty country. This reflects the manner in which tax treaties create a differential between the U.S. tax rate and the reduced foreign tax rate

EXHIBIT N

COMPARISON OF FOREIGN TAX BURDENS OF
TAX TREATY COUNTRIES BEFORE/AFTER
TAX TREATY EFFECT DETERMINED

<u>COUNTRY</u>	<u>RATIO OF FOREIGN TAX TO INCOME</u>		<u>PERCENTAGE</u>
	<u>w/TREATY RELIEF</u>	<u>w/o TREATY RELIEF</u>	<u>CHANGE</u>
UNITED KINGDOM	46.9%	72.8%	23.9%
SWEDEN	49.7	70.6	20.9
SOUTH AFRICA	48.2	63.6	15.4
PAKISTAN	55.2	70.1	14.9
JAMAICA	34.2	46.9	12.7
AUSTRIA	37.8	49.5	11.7
NEW ZEALAND	48.3	59.8	11.5
BELGIUM	32.7	41.9	9.2
NORWAY	49.6	58.5	8.9
AUSTRALIA	46.9	55.3	8.4
GERMANY	39.8	48.2	8.4
NETHERLANDS	39.0	46.0	7.0
DENMARK	36.6	42.8	6.2
JAPAN	29.9	35.9	6.0
FRANCE	37.9	43.6	5.7
FINLAND	45.4	50.8	5.4
CANADA	55.1	60.1	5.0
SWITZERLAND	11.6	16.2	4.6
GREECE	38.7	43.0	4.3
ITALY	20.2	23.4	3.2
IRELAND	24.1	25.5	1.4

and; thereby, provides a margin whereby tax treaty income is
available to absorb as credits, tax burdens of non-treaty
countries.

CHAPTER VIII

THE LIMITATION ON FOREIGN TAX CREDITS AND ITS EFFECTS ON FOREIGN TAX BURDENS OF U.S. CORPORATIONS

From the segment of Chapter I dealing with the limitations imposed by the U.S. tax system on the use of foreign taxes as credits, we saw that the foreign tax burden alone is not the only factor that must be considered in determining the amount of foreign tax credit available to U.S. corporations. The limitations imposed in order to assure that the tax credit system does no more than offset U.S. tax on foreign source taxable income are the other portions of the tax credit system. However, the limitations on the foreign tax credit are the elements of the foreign tax credit even more within the taxpayer's control than the foreign tax burdens. As a result, it was essential that we study the role the limitation plays in the impact that foreign tax burdens make on U.S. corporations as well as the extent to which U.S. corporations are able to affect that limitation through their tax planning.

A. Limitations Imposed on the Utilization by U.S. Corporations of Foreign Taxes as an Offset to U.S. Tax Liabilities

At the outset of our examination of the limitation factor, we examined it from the standpoint of all the companies in the data base and compared the extent to which foreign tax credit burdens are limited by the actual data that corporations put in their tax returns. The purpose of this examination was to provide the initial ground work for the later analyses by showing the starting point of the limitation as actually reflected on the tax returns. We noted that by and large, U.S. corporations are not severely affected by their foreign tax burdens because the limitations on their foreign tax credit, as computed by these U.S. companies, are not overly strenuous.

The U.S. corporations in the data base were able to utilize their foreign tax credits in almost nine out of ten cases, since only 11.2 percent of the companies in the data base actually reflected an excess foreign tax credit. When looked at from the standpoint of the amount of foreign taxes, we saw that there was an actual excess foreign tax credit of only 8.8 percent which meant that over 90 percent of the foreign tax incurred were actually utilized as a credit. Consequently, we can see that the limitations imposed on the utilization by U.S.

corporations of foreign taxes were able to be managed by those companies to a significant degree.

B. Comparison of the Per Country and Overall Limitations Utilized by Corporations

Given the fact that the limitations did not appear to present a significant overall problem to U.S. corporations, we looked at the limitations which those corporations had themselves elected to use to compute their foreign tax credit limitation. For this examination, we looked at the number of companies in the data base that used either of the methods as well as the amount of the limitations. We also noted the extent to which the special limitations on individual types of income were applicable. Based on the data base, we ascertained that of those corporations generating income in more than one country, the overall limitation was used in 89 percent of the cases, whereas those using the per country limitation were only 11 percent of the cases. This revealed that a greater number of instances were involved in which U.S. corporations were able to offset excess credits from certain countries from excess limitations in others. This percentage was substantially higher than the 63 percent which was reflected in the published government statistics available for the year 1964. The significance of this growth in the use of the overall limitation is a reflection of the flexibility that the overall limitation

provides U.S. corporations for offsetting foreign taxes incurred in one country against U.S. tax on income generated in another. Alternatively, the overall limitation permits U.S. corporations that have already incurred foreign taxes in certain countries to search out foreign source income in other countries which may afford a lesser tax rate in order to absorb these excess credits. Thus, the conclusion from this portion of our research was that the high preponderance of companies are using the overall method of limitation.

One additional important aspect to the limitation involves the special limitations described in the foreign tax credit system in Chapter I. Notwithstanding the existence of these limitations, our data base indicated that such limitations did not provide a significant impact on the U.S. corporations in the data base. In fact, it was found that in less than 5 percent of the companies in the data base was there any limitation on the foreign tax credit because of these special limitations.

C. Recomputation of the Limitation on an Overall Basis

In order to enhance the results of our study, the limitation on the foreign tax credit for all companies in the data base was recomputed in order to ascertain what the limitation would have been if there was no per country limitation available.

In essence, the objective here was to see what the effect would have been on the 11 percent of the companies that use the per country limitation if that had not been available to them. The results of the recomputation was that, other than those companies in the natural resource industry, few companies would have been adversely affected if the per country limitation was not available. We can thus conclude that this particular limitation has been utilized mainly by companies in the natural resource industry and they are the major benefactors of the per country limitation.

D. Recomputation of the Limitation on a Per Country Basis

The purpose of this analysis was to provide a corollary to the preceding one. Namely, it was intended to determine the converse of the absence of the per country limitation and to see what benefits companies derived from the overall limitation. This calculation was used to evaluate the results which we were able to ascertain based on the analysis in Chapter IV. Based on this research, it was determined that if the overall limitation were not available to U.S. companies and they had to compute their limitation on a per country basis, there would have been a significant amount of excess foreign tax credits generated. In fact, our recomputation showed that if U.S. companies were placed on a per country limitation only, the amount of foreign

tax burdens when applied to income on a per country basis would produce an excess foreign tax credit in 53.1 percent rather than the actual 11.2 percent of the cases. When looked at from the standpoint of the actual amount of excess foreign tax credit, it would have increased from the actual figure of 7.1 percent to 27.5 percent. Consequently, it appears that U.S. corporations depend fairly heavily on the ability to intermix foreign taxes and foreign income in order to be able to absorb their total foreign tax burden and that without the overall limitation, the foreign tax burdens would be much more significant to them.

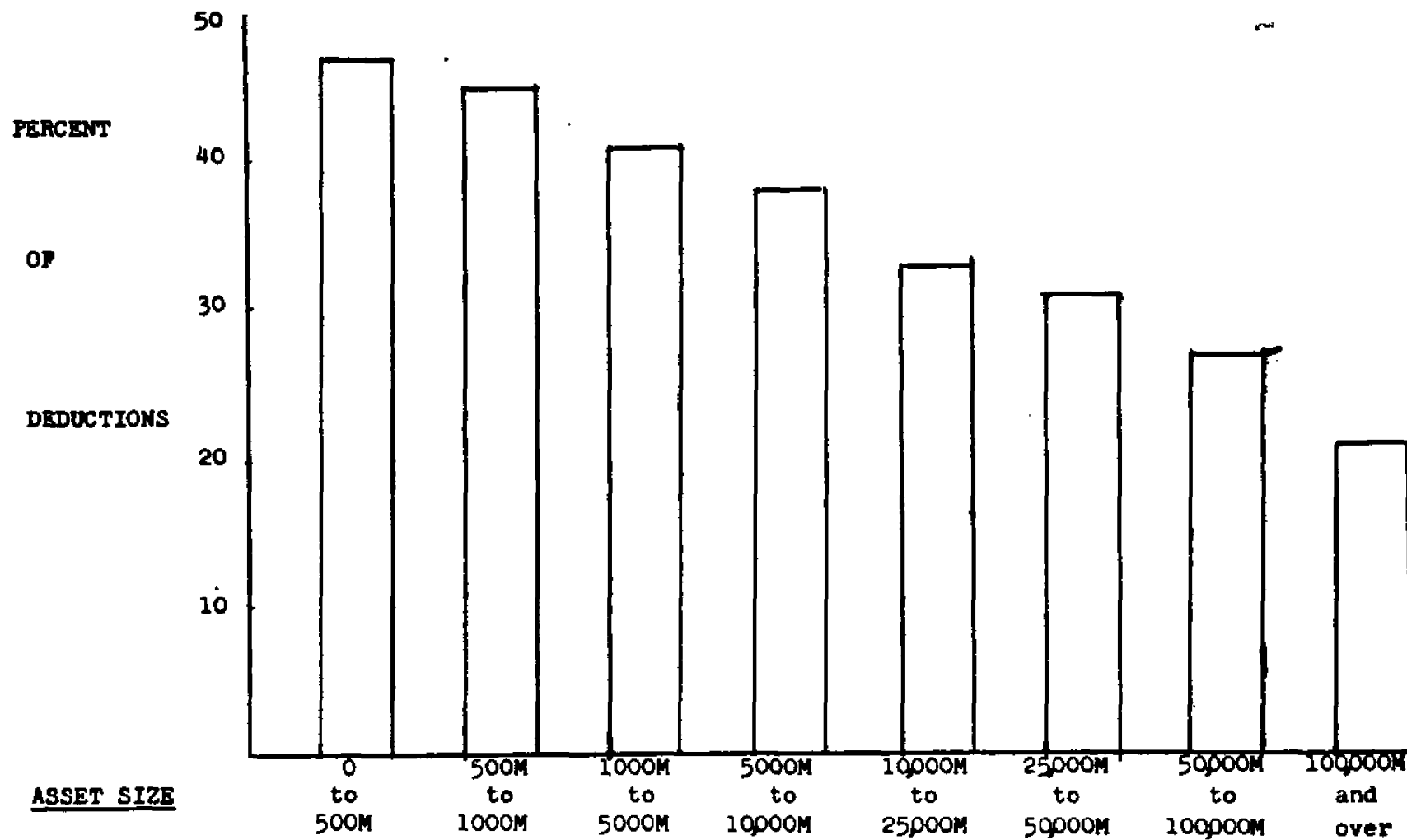
E. The Role of the Deductions Attributable to Foreign Gross Income in the Foreign Tax Credit Limitation

In the final segment of our examination of the limitation on the foreign tax credit, we delved into the relationship of the foreign gross income to foreign taxable income of U.S. taxpayers. In making our examination, it was noted that the relationship of expenses to foreign gross income was significantly less than that for the corporation's income as a whole as reflected on their tax returns. This led us to examine this matter more closely. On closer reflection, it became clear that to the extent deductions attributable to foreign gross income are minimized, it increases the limitation for U.S. corporations and thereby improves their ability to absorb foreign taxes as a credit.

The result of our study is reflected in Exhibit O. It points up quite succinctly that U.S. corporations have adopted a series of very sophisticated approaches for the determination of how much of their deductions are attributable to foreign source income. That is, although there may be an overall high percentage of deductions to gross income on the tax return as a whole, the amount of deductions relating to foreign gross income is not in the same proportion. This exhibit demonstrates that relationship and indicates that as companies become larger, the amount of expenses attributable to foreign gross income tends to decline reaching a point of approximately 21 percent when the U.S. corporation reaches the \$1 million asset range. Thus, we see the effect on the determination of the impact to foreign taxes is quite significant because this determines the important foreign tax credit limitation aspects of the utilization of foreign tax credits. This factor is crucial to many U.S. corporations for their foreign tax credits and we will examine more precisely in Chapter X the techniques that U.S. corporations have developed in this area.

EXHIBIT O

RATIO OF DEDUCTIONS TO FOREIGN GROSS INCOME



CHAPTER IX

COMPARISONS OF THE IMPACT OF FOREIGN TAXES ON U.S. CORPORATIONS FOR TAX PURPOSES VERSUS ACCOUNTING PURPOSES

Up to this point in our research, our attention has been focused primarily on the foreign tax burdens of U.S. based corporations as its impact can be measured from a tax standpoint. In order to broaden the base of our comparison, we went further and looked at the foreign tax impact as it can be measured from a non-tax standpoint. In so doing, we looked at the foreign tax impact as it is measured by the standard tax return filed by these U.S. corporations as well as by the standard of its impact on the accounting income of the U.S. companies in the data base. The objective of this chapter is to reveal the results of that research whereby we investigated the extent to which foreign tax burdens impact on the accounting data of U.S. corporations in a different manner than is found in their tax returns. In reviewing these results, it is important to recognize the fact that foreign taxes can impact on U.S. corporations in a number of ways. Therefore, more meaningful conclusions can be drawn

when more than one aspect of that review is performed.

A. Relationship of the Taxable Income of U.S. Corporations to Income Per Schedule M and Financial Statements

In order to provide a beginning for our comparison based on financial data, we examined the results of U.S. corporations in the data base viewed from the standpoint of comparing the total taxable income figure of the companies in the data base to the book income they reflected on Schedule M of their tax returns. This figure is basically the accounting income of the U.S. corporations to which the taxable income figure must be reconciled on the tax return. This provided a beginning for the determination of the disparity between taxable income and accounting income for the companies in the data base. In addition to this comparison, a supplementary comparison was made between aggregate taxable income and aggregate pre-tax net income as reflected on financial statements. The latter figure was taken from the published financial data that certain of the companies in the data base were required to report to U.S. government agencies. It represents the income that would have been reported to shareholders and the public in general. These comparisons enabled us to obtain an insight as to the relative status of the income reported by these companies for tax purposes with that reported by them for book purposes as well as for financial statements issued to the public.

The results of these comparisons are reflected below:

Schedule M Book Income	\$4,559,091,000
Add:	
A. Gross Income Not Booked	246,191,000
B. Non-Deducted Expenses	820,636,000
Deduct:	
C. Non-Includable Gross Income	(1,458,909,000)
D. Deductions Not Booked	(154,803,000)
Taxable Income	<u>\$4,012,206,000</u>

This illustrates the relationship of the accounting income reflected on the returns by all the U.S. corporations in the data base - that being their book income on Schedule M - compared with the taxable income of those U.S. companies. As the figures indicate, the taxable income reported by these companies was approximately 88.2 percent of the book income figure. As we will see in a later portion of this chapter, this book income figure is not the same as the financial statement income figure for these companies. Rather, it is the accounting income reflected by the U.S. companies on tax returns to which the taxable income figure must be reconciled.

The basic reason for the differences between the Schedule M income and taxable income are illustrated in the major categories set forth above. Category A "Gross Income Not Booked" represents income reported on the tax return but which was not reported on

the books of the company for the year 1972. In some cases, this represented income which had been reported for accounting purposes in prior years, but was only reported as taxable income for the current year. This involved such items as income being reported for tax purposes on the installment method of accounting. In other cases, the income represented items that are reported in the current period for tax purposes while being reported in the future for accounting purposes such as advance payments on service contracts. These items represented approximately 6 percent of the taxable income figure for the companies in the data base.

Category B type items, "Non-Deducted Expenses", represented deductions for accounting purposes which were not permitted as deductions for tax purposes. They include such items as foreign income taxes claimed as a credit on tax returns while being reflected as deductions from income for Schedule M purposes. These items represented 20 percent of the taxable income reported by the companies in the data base.

The biggest single category of reconciling items is Category C, "Non-Includable Gross Income". This constitutes income which has been reported for accounting purposes but which is not treated as gross income for tax purposes. It includes

such items of income as tax exempt interest on obligations of state and municipal governments which is excluded from gross income for tax purposes but reported in full for book purposes. This category constituted 36 percent of the taxable income and represents the largest single class of reconciling items.

Finally, Category D represents "Deductions Not Booked". This category constitutes items which reduced taxable income, but which do not reduce accounting income. It included such items as the dividends received deduction or deductions for research and development expenditures which are permitted for tax purposes but were deferred for accounting purposes. It also included the Western Hemisphere Trade Corporation deduction.

From this analysis, we obtain a comprehensive overview of the taxable income situation for the data base as a whole. The clear indication here is that there is a fairly significant difference in income bases when comparing book income and taxable income and an indication of the type of items accounting for that disparity.

Continuing our research, we looked at the inter-relationship of taxable income to accounting income from a different perspective; namely, from the standpoint of the comparison to financial statement income. This analysis utilized the data

for the 117 companies in the data base filing Form 10K in order to determine and refine the relationship of taxable income to accounting income as represented on published financial statements. Our research found that there is an even more significant disparity between financial statement income and taxable income than that reflected between Schedule M book income and taxable income. Since financial statement income was \$3,326,661,000 and taxable income was only \$2,491,366 in this particular case, only 74.9 percent of the figure shown as financial statement income constituted taxable income. This difference was accounted for in the data base by such items as the exclusion of minority interests in affiliates, the inclusion of income from non-controlled companies on an equity basis, the inclusion of income from foreign affiliates on consolidated financial statements, the difference between claiming foreign taxes as a credit versus as a deduction, the effect of net operating losses used as carryovers for tax purposes, the write-offs of various types of deductions for tax purposes, while being amortized for financial statement purposes. The combination of all of these reconciling items produced a fairly significant differentiation between the taxable income base for U.S. companies with overseas operations and the income base from an accounting standpoint.

The foregoing comparisons enabled us to observe the relative status of the income reported by these companies for tax purposes and that reported by them for book purposes on a tax return as well as financial statements issued to the public. The conclusion provided by the data is that there is a fairly substantial erosion of the tax base when one compares the taxable income to the book income from Schedule M. When the taxable income was further compared to financial statement income, there was an even greater disparity accounted for, to a significant degree, by the income of foreign subsidiaries of these U.S. companies.

Continuing our analysis, our study compared corporations from a size standpoint. Its results reflect the fact that large corporations account for a fairly significant portion of the disparity between taxable income and financial statement income. This was due in significant part to the fact that these companies traditionally have the highest number of foreign subsidiaries whose results are included in financial statements for accounting purposes but are not included in their tax return income for tax purposes.

Looking at companies required to file a Form 10K, the income for financial statement purposes was \$3,326,661,000 whereas the figure reported on Schedule M in the aggregate was

\$2,794,395,000 for a ratio of 83.9 percent. This ratio was less than the average for all companies and indicates that for companies filing Form 10K - which tended to be the larger companies in the group - there was an even greater disparity between financial statement income and Schedule M income. This was accounted for in great part to the fact that the larger companies tended to have overseas affiliates, the results of which were consolidated for financial statement purposes but which were not reflected in the book income figures for Schedule M. From this analysis, we can see that the income bases vary widely between those representing income for financial statement purposes and those representing income used for computing the tax base.

B. Relationship of Tax to Taxable Income and Financial Statement Income

Having examined the relationships of various bases of income, we delved into the relationship of the tax to the income bases. The purpose was to determine the comparative impact that taxes in general make on income per tax return and per financial statement. In making this comparison, it was noted that the relationship of tax to taxable income per tax returns was somewhat less than the statutory tax base. This revealed an effective U.S. tax rate that was eroded by U.S. tax reduction factors. When one looks at the financial statements, however, the ratio

of tax to pre-tax income was significantly less than that shown on the tax return. Consequently, at this stage of the comparison of the tax to the tax base, we noted that the impact of taxes on the financial statements is much less than the impact as seen by comparing it to the tax return. This result supports the general observations made in the Third Annual Report of Representative Charles Vanick (D-Ohio) on the approximate Federal income tax burdens of 160 of America's major corporations. In his case, he found the average effective tax rate to be some 23.6 percent.²²⁵ This was affected to a significant degree by natural resource companies, airlines, and financial institutions. For the industrial manufacturing corporations, the Vanick Report reflected an average effective corporate tax rate of 27.1 percent. Comparing those results to our data, some interesting comparisons were noted. We found the relationship of the tax provision on financial statements of \$1,382,940,000 to financial statement pre-tax income of \$3,326,661,000 for a ratio of 41.5 percent. This is contrasted with the same relationship for the tax returns of the tax of \$1,185,505,000 compared to a taxable income figure of \$2,491,366,000 for a ratio of 47.5 percent.

From this, we can conclude that the impact of taxes on U.S. companies is greater on the tax return than on the financial

225. Vanick, "Study of the Taxes of the Nations - 160 Largest U.S. Corporations", December 1974.

statement viewed from the standpoint of percentages. Put another way, our research revealed an erosion of the income base that takes place when going from financial income to taxable income. A key relationship is that of the income figures themselves which is illustrated by the fact that the taxable income figure was only 74.8 percent of the income figure for financial statement purposes. If one views the relationship of the actual tax burden to the net income per financial statements - keeping in mind the disparities in certain of the income and expense items - we determine the ratio of 35.6 percent of actual tax to financial statement income or a very definite lowering of the overall tax impact. Though not as low as the companies represented in the Vanick Report, there is still a clear indication of erosion of the tax base.

One reason the ratio of U.S. tax per tax return to financial statement income is fairly high is due to the fact that the U.S. tax figure is after investment tax credit but before foreign tax credit. Where the U.S. tax figure is reduced by the foreign tax credit, the ratio of actual U.S. tax paid to financial statement income reduces even more significantly to 25.3 percent. The composition of the tax can be seen in the following calculation of the U.S. tax before credit, investment

tax credit, foreign tax credit and finally, U.S. tax after all credits.

U.S. Tax Before Credits	\$1,274,957
Less Investment Tax Credit	<u>89,402</u>
Net Tax After Investment Credit	1,185,555
Less Foreign Tax Credit	<u>343,856</u>
Net Tax After All Credits	<u><u>\$ 841,699</u></u>

(000's omitted)

The above calculation reconciles the tax figure previously mentioned which is after investment credit but before foreign tax credit, with the actual tax paid by the corporations in the data base filing Forms 10K. Relating this actual tax paid figure to the financial statement income of the group of \$3,326,661 gives us the percentage of 25.3 percent. This percentage indicates the true relationship of tax cash flow to the U.S. Treasury when related to the net income before tax reported to shareholders. It reflects the considerable erosion of the tax base from that reflected in the accounting financial statements. Comparing the actual U.S. tax paid of \$841,699 with the tax provision per financial statements of \$1,382,940, we find that it constitutes approximately 61 percent of the tax provision based on financial statement income. This is basically caused by the difference between the timing of income on the financial statements and the timing of income in the tax return. One important element

accounting for this difference is the earnings of foreign subsidiaries which are reported for financial statement purposes, but:

- (a) on which there is no U.S. tax provided in the accounts because those earnings are to be left abroad relatively indefinitely and
- (b) on which no U.S. tax need be paid currently due to the tax deferral aspect of the U.S. tax law discussed in Chapter I.

During the year 1973, the Securities and Exchange Commission required that U.S. corporations reflect in their financial statements a reconciliation of the tax provision per those statements and the provision that would have been required if computed on the basis of the U.S. statutory rate (48 percent) applied to financial net income before tax. Essentially, this required a reconciliation of the effective U.S. tax rate and the statutory rate for a given reporting company.

In order to make this aspect of our study more meaningful, we selected at random approximately half of the 117 companies whose data is represented in the above analysis and examined their data for the succeeding year (i.e. 1973) in which they had to provide the reconciliation of their U.S. effective tax rate to the statutory tax rate of 48 percent.

As an overall effective tax rate, these companies reported 38.7 percent for 1973. The major items accounting for

the reconciliation to the U.S. statutory tax rate were as follows:

Statutory Rate	48.0%
Reconciling Items: (as percent of income)	
State and local taxes	2.2
Tax on earnings of foreign subsidiaries	(4.7)
Investment tax credit	(2.7)
Capital gains transactions	(.4)
Tax exempt income	(1.3)
Tax on earnings of DISC's	(.4)
Merchant Marine Act reserve fund	(.2)
Other	(1.8)
Effective Rate	<u>38.7%</u>

From this above breakdown of the factors affecting the effective tax rate, we can better appreciate how the U.S. corporation has been able to reduce the ratio of U.S. tax to pre-tax net income on an overall basis. By relating this to the prior analysis which compared the actual U.S. tax paid to the pre-tax net income for financial statement purposes, we can appreciate even more the role that foreign tax burdens play in reducing the actual tax paid to the U.S. Treasury. The difference between the 38.7 percent of tax to financial statement income before tax and the 25.3 percent of tax paid to financial statement income is accounted for primarily by the foreign tax burdens, tax on timing differences due to APB Opinion No. 11²²⁶ and certain

²²⁶. APB Opinion No. 11: Accounting for Income Taxes, Accounting Principles Board of the American Institute of Certified Public Accountants, December 1967.

state and local taxes which are reflected in provisions for taxes on financial statements.

C. The Relationship of Tax Liabilities to Tax Base of the Same Corporations

In order to obtain a more incisive look at the tax liabilities of the companies in the data base, a comparison was made of the tax provisions on their financial statements to two different items:

- (a) a computed tax liability on their book income as reported on Schedule M; and
- (b) their actual tax liability reported on the tax return.

This comparison took the extremes of the relationship of tax to tax base per financial statements and book income and provided a middle comparative point in terms of what the U.S. tax burden would be if it were imposed on book income on a Schedule M basis. This research reflected the fact that tax burdens per financial statements (\$1,382,940,000) and as computed on Schedule M income (\$1,341,309,000) were fairly close because the reduced income for Schedule M purposes was offset by the higher effective tax rate that was used. However, these two tax burdens were significantly higher than the actual tax burden imposed on the same corporations (\$841,699,000). This thereby indicated a lesser impact in terms of real tax liability than that

which would be reflected for financial statement purposes or for Schedule M purposes.

There was a fairly close relationship between the tax per financial statements and the hypothetical tax on Schedule M book income. As noted above, this close relationship is the result of two offsetting differences. In one direction, there is a difference between the income for financial statements and Schedule M with the latter figure representing only 83.9 percent of the income for financial statement purposes. However, this is offset by the fact that tax on financial statement income is computed under a lower effective tax rate of 41.4 percent versus the 48 percent tax rate used in making the hypothetical calculation on Schedule M income. These two offsetting factors almost resulted in an equalization of tax burdens. But there is no causal relationship for this. The actual tax liability per the tax returns, however, is substantially less than both of these figures as can be seen from the fact that the actual tax burden is approximately 62.7 percent of the hypothetical tax based on Schedule M income, and only 60.9 percent of the tax per provision on the financial statements.

D. The Effect of Tax Burdens on Foreign Income

At this point of our study, we are in a position to

examine the tax impact for tax returns and financial statement purposes of the same corporations viewed specifically from the standpoint of foreign tax burdens. For this purpose, an examination was made of the relationship of tax burdens to foreign income per tax returns and tax burdens on foreign income per financial statements. We delved into the specifics of the foreign tax burdens of the companies in the data base. The results reflect a significant disparity between the income reported for financial statement purposes and that reported on the tax returns. A major portion of the difference is the earnings of overseas subsidiaries which are included in the earnings for financial statement purposes, but which are not included in taxable income for tax return purposes. For financial statement purposes, foreign income constitutes approximately 43.3 percent of the total income of these U.S. based corporations. For taxable income purposes, however, foreign source income represents only 32.1 percent of the total income of the companies. While this latter figure is still substantial, it is significantly less than that for financial statement purposes.

Looking at the relationship of tax to the income, we found that for financial statement purposes, the relationship of tax to foreign income is approximately 37.1 percent, whereas the relationship of foreign tax to foreign income for the tax return

is in the range of 42.8 percent. Consequently, it can be seen that the impact of foreign taxes for financial statement purposes is less than it would be for tax purposes. Put in another way, the ability to claim tax credits on the tax return is much greater because of the higher effective foreign tax rate claimed on the returns. In essence, then, these figures produce a result favorable to the corporations in each connection. Namely, if a corporation is desirous of reflecting the lowest amount of foreign tax in his financial statements and thereby reflecting higher earnings, these results indicate the corporation is able to do so. Similarly, if the corporation wishes to have a high amount of foreign tax burdens so that it is able to claim the highest possible amount of foreign tax credit and reduce the U.S. tax burden, that is also being accomplished.

The results of this comparison, therefore, is that there is a fairly high ratio of foreign tax to foreign income on the tax returns and a significantly lesser relationship on the financial statement. This highlights the fact that U.S. corporations seem to be able to maintain a high foreign tax ratio on their tax returns in order to be able to claim the maximum foreign tax credit, but yet are not burdened with the same high ratio for financial statement purposes. Thus, the foreign

income is not eroded by severe foreign tax burdens for purposes of reflecting them on the financial statements.

E. Additional Tax on Retained Earnings of Foreign Subsidiaries

The continuation of our research into the tax versus financial statement impact in the foreign income area lead us to make a determination of the additional tax burdens that would be reflected for financial statement purposes if the earnings of foreign affiliates were repatriated to the United States.

The purpose in performing this research was to determine the latent tax burden that would be reflected in financial statements if these earnings were repatriated. This part of our research provides a companion with that done earlier in Chapter VI in connection with the additional tax that would be due on U.S. corporations if the earnings of their subsidiaries were repatriated from the standpoint of additional foreign tax burdens.

This analysis essentially involved comparing the effective foreign tax rate with the foreign earnings of the companies in the data base for financial statement purposes and the U.S. statutory rate on those earnings. From this analysis, an additional tax of \$158,710,000 or 11.2 percent of the pre-tax income would be required in order to bring the full tax burden up to the full statutory rate.

As in the case of the earlier research in Chapter VI involving foreign tax burdens, the assumption of distributions of this type would have resulted in a significant adverse impact on U.S. corporations' earnings results. The analysis here indicates that, as in the case of foreign tax burdens, there is a latent tax burden with regard to the foreign income of U.S. corporations from a financial standpoint in the same way as there is for foreign tax credit purposes. An additional significant point is that U.S. parent corporations are in control of this for financial statement purposes in much the same way as they are for tax purposes. As a result, the impact of these latent taxes are somewhat concealed and are not seen unless an analysis of this type is performed. Thus, it can be concluded there is a greater potential for a significant tax burden on foreign earnings than is revealed on tax returns and in financial statements.

F. Particular Experiences in the Erosion of U.S. Tax Base of U.S. Corporations

In order to provide a culmination to our research regarding the comparison of the impact of taxation on U.S. corporations for tax purposes versus accounting purposes and give it a greater intimacy, we probed into the actual experiences of several U.S. corporations and examined the manner in which their income and related taxation in their financial statements

telescoped down to the taxable income and federal income tax that they actually incurred. This was done for the year 1973 or fiscal periods beginning in 1973 since the published data on taxation for financial statement purposes was more detailed in that year due to expanded disclosure requirements of the Securities and Exchange Commission. As a result of such disclosure, it enabled our research to start with the pre-tax net income and tax figures and relate them to the final taxable income reported on the companies' tax return coupled with the actual tax payment made to the U.S. Treasury.

To better appreciate our research and to provide a guide to those interested in conducting such research, the procedure utilized involved the following steps:

1. Utilizing the published financial data, we ascertained the pre-tax net income reported on the consolidated financial statements of the company. This represented the worldwide consolidated financial results reported by the companies to their shareholders as the end product to their economic endeavors for the year 1973 and is the prescribed starting point for the measure of the earnings of the global consolidated group.

2. The next step involved the determination of the income tax figure related to the pre-tax net income already determined. The tax figure provided the essential starting point

for examining the relative tax weight borne by the reported pre-tax net income on the financial statements.

3. Given the effective tax rate on the financial statements computed in the prior steps, our research then reconciled the difference between that effective rate and the statutory rate of 48 percent. This analysis enables one to see the reasons why the tax provision in the financial statements vary from the expected starting point - the U.S. statutory rate - and begins the exposition of the erosion of the U.S. tax base.

4. The next step involved working out the breakdown of the tax provision per the financial statements between the portions related to current taxation and deferred taxation. Furthermore, this analysis enabled us to segment the current and deferred portions further by determining the U.S. federal and foreign tax parts of the tax provision. In so doing, we then get closer to the comparison of the amount of U.S. federal tax and the pre-tax net income figure per the financial statements.

5. At this stage, we then bridged the gap between the financial statement and the tax returns actually filed by these corporations for the period comparable to the financial statement. In so doing, we see the role that the inclusion of the results of foreign subsidiaries (consolidated) and foreign affiliates (equity pick-up) make on financial statements while being left

out of the consolidated tax return - with its impact on the tax base.

6. Given the reconciliation of financial statement net income to the Schedule M book income per the tax return, we move further along the telescoping income flow and expose the adjustments to Schedule M book income of the companies that lead to the determination of the taxable income base on which the U.S. federal tax is computed.

7. From the taxable income standpoint, we then examine the manner in which the U.S. corporations actually compute their U.S. tax before credits, giving effect to the impact of such variations as capital gains rates and multiple surtax differentials.

8. With the determination of U.S. tax before credit, we now view the impact that foreign tax credits and investment tax credits make on the actual tax cash flow burden these corporations incurred, relating that to the original figure - the pre-tax net income per financial statement.

At the completion of these detailed procedures, we have succeeded in following the trail of U.S. tax burdens, both domestic and foreign, from the tax which would be due if U.S. corporations paid their tax at statutory rates based on income as computed for reporting to shareholders, through the various levels

accounting for the diminution of the tax base, to the final figure of U.S. tax that these U.S. corporations actually had to pay to the U.S. Treasury for the given fiscal periods. We will now examine how these detailed procedures were applied in the case of specific U.S. corporations and, in so doing, highlight the variations that are meaningful to our study of the impact of foreign tax burdens.

Company "A"

This particular company conducted activities in some 38 countries around the world with those overseas endeavors accounting for more than 47 percent of the net sales and approximately 33 percent of the global net income. Thus, it represents a situation for evaluation that is meaningful from an international standpoint.

The consolidated financial statement for its fiscal year ended June 30, 1974 reflected a global net income before tax of \$56,668,000. This was composed of after-tax net income of \$25,204,000 plus provision for taxes of \$31,464,000 representing a 55.5 percent ratio of tax to pre-tax income. However, the pre-tax income figure was inflated by minority interest in subsidiaries of \$746,000 so that the effective tax rate was actually 54.2 percent per the financial statements. At the outset then,

we see a situation wherein the tax provision was at a higher rate than the statutory rate of 48 percent. The difference was accounted for as follows:

	<u>Amount</u>	<u>Rate</u>
Statutory Tax	\$27,201,000	48%
-Foreign income taxes of subsidiaries in excess of U.S. 48% rate	1,429,000	2.5%
-Unrealized loss on foreign exchange not deductible for tax purposes	1,113,000	2.0%
-State income taxes, net of federal tax benefit	768,000	1.4%
-Amortization of intangibles not deductible for tax purposes	538,000	1.0%
-Other, net	<u>(329,000)</u>	<u>(.7%)</u>
Effective tax rate	<u>\$30,718,000</u>	<u>54.2%</u>

From this reconciliation, it can be seen that the foreign element to the effective tax rate resulted in it exceeding the U.S. statutory rate. This suggested that foreign tax burdens impact quite significantly on the financial result of the company. But to really appreciate this, one has to delve into the composition of the tax provision in the financial statements to see what portion is affected by deferred tax accounting and what portion represents current taxes due.

Current

-U.S. Federal	\$ 9,986,000
-State and Local	1,477,000
-Foreign	<u>14,992,000</u>
	<u>\$26,455,000</u>

Deferred

-U.S. Federal	\$ 4,110,000
-Foreign	<u>153,000</u>
	<u>\$ 4,263,000</u>
Total Provisions	<u><u>\$30,178,000</u></u>

At this point, the telescoping of the tax base - at least from the standpoint of the U.S. tax system - begins to appear. First of all, we see that \$4,263,000 or 16.1 percent is represented by deferred tax, i.e. tax expense that will not materialize to any tax jurisdiction in the current period. Furthermore, the current portion \$1,477,000 or 5.6 percent is really state and local tax burdens, i.e. revenues that are not part of the quantity we are seeking to measure. Finally, we see that \$14,992,000 or 56.7 percent of the current tax provision is composed of taxes due to foreign taxing jurisdictions. This gives us an important insight into the relative impact that foreign tax burdens have for this corporation on a currently due and payable basis.

From the foregoing then, we see that only \$9,986,000 or 33.1 percent of the total tax provision per the financial statement is represented by U.S. federal tax currently due. This

figure represents 17.6 percent of the pre-tax net income per the financial statement.

Continuing with the inter-relation of financial statements and tax returns, we find that the \$56,668,000 pre-tax net income is compared with the Schedule M book income before tax of \$39,300,000 or 69.4 percent. This differential of \$17,368,000 was accounted for by the following:

Foreign tax	\$15,145,000
State and Local tax	1,477,000
Minority interest	746,000
	<u>\$17,368,000</u>

That is, the pre-tax net income figure per the financial statements were inflated by these items so that they were the only reconciling items. This meant that there was a fairly close correlation of financial statement net income and Schedule M net income for this corporation.

In the next analysis, we then examined the relationship between Schedule M income and taxable income and found that the latter figure exceeded the Schedule M income by a substantial amount. The reconciling items consisted of the following major items:

Schedule M Income	\$39,300,000
-Gross up of foreign dividends	12,450,000
-Dividends from subsidiaries carried on books at equity	14,883,000
-Foreign income tax claimed as a credit	1,524,000
-Adjustment of depreciation to effect guidelines	239,000
-Non-deductible amortization of intangibles	442,000
-Equity in losses of subsidiaries	137,000
-Tax exempt income	(394,000)
-Earnings of subsidiaries	(9,720,000)
-Unrealized gross profit on installment sales	(3,948,000)
-Decreases in various book reserves	(4,598,000)
-Deduction of costs disallowed in prior years	(231,000)
-Other	<u>(27,000)</u>
Taxable Income	<u><u>\$50,057,000</u></u>

As can be seen, the taxable income figure exceeded the Schedule M income by 27.4 percent which is a rather unusual phenomenon. However, the detailed reconciliation above is informative. It reflects that this company actually withdrew dividends from its unconsolidated (foreign) subsidiaries which exceeded its share of the earnings of such subsidiaries. A further reason for the

disparity is the fact that dividends from foreign subsidiaries must be "grossed up" for the foreign tax credit and added to taxable income. This requirement added over \$12 million to net income in arriving at taxable income. The foreign taxes themselves also have to be added to Schedule M income since they are claimed as a credit on the tax return. These areas involving the earnings and taxes of foreign subsidiaries account for a high degree of the disparity between Schedule M income and taxable income and gives this analysis an interesting twist - while still being revealing for our study.

Having now reached the taxable income stage of this taxpayer, we still have to see the extent of U.S. tax actually paid. Since this corporation had a net operating loss carryover from prior years of \$463,000, the taxable income base was actually \$49,594,000 and the U.S. tax before credits was 48 percent of that figure or \$23,799,000. This is 41.9 percent of the financial statement pre-tax net income.

However, as the foreign tax was a substantial factor in the reconciliation between Schedule M income and taxable income, it now plays a significant role in the determination of tax payments actually due the U.S. Treasury. This corporation had available foreign tax credits of \$1,524,000 direct credits

and \$12,477,000 deemed paid credits for a total of \$14,001,000. Of that figure, only \$13,710,000 was actually used due to the limitation on the foreign tax credit. Thus, this corporation had a modest excess credit in this period of \$291,000 or 2.1 percent. Thus, the foreign tax credit accounted for over 57 percent of the U.S. tax liability and significantly neutralized the U.S. tax due.

After giving effect to an investment tax credit of \$175,000, the net U.S. tax payment actually required was \$9,895,000. This was less than 42 percent of the U.S. tax before credits - and only 17.5 percent of pre-tax net income per financial statement. Thus, despite the fact that this corporation repatriated a significant amount of the earnings of foreign subsidiaries - an event not normally seen - the foreign tax burdens served to substantially offset the U.S. tax that would normally be due on such earnings. Thus, even though taxable income even exceeded Schedule M net income, the net effect in terms of U.S. tax revenue was significantly reduced thus reflecting the impact on U.S. tax revenues of this multinationality.

Company "B"

This corporation concentrated a substantial portion of its activities in the international area with foreign operations accounting for approximately 21 percent of its total sales and 48.9 percent of net income for the fiscal period ended March 31,

1974. It had significant operations in 24 countries in addition to its United States activities. In some of the overseas activities, however, it incurred losses which seemed to reduce its global profitability but produced no tax benefit in the United States or in other foreign countries. Furthermore, unlike the Company "A" situation just discussed, Company "B" did not extract significant dividends from its foreign subsidiaries. As a result, there was a significant disparity between net income per the financial statements and the Schedule M net income, with a resulting erosion of the tax base for U.S. tax purposes.

The corporation and its subsidiaries reflected a global net income before tax of \$40,430,000 on which the effective rate of tax was \$18,339,000 or 45.3 percent. This closely approximated the statutory tax rate at 48 percent of \$19,406,000 but the divergence was accounted for as follows:

	<u>Amount</u>	<u>Rate</u>
Statutory rate	\$19,406,000	48%
-State and local taxes	939,000	2%
-Income of overseas subsidiaries taxed at less than 48%	(2,495,000)	(6%)
-Other	489,000	1%
	<u>\$18,339,000</u>	<u>45%</u>

This indicates at the outset that a significant factor in the overall tax picture of this company is the lesser tax rate

on the earnings of foreign subsidiaries which are included in the global earnings picture for financial statement purposes but on which no additional U.S. tax has been provided because of the company's intent to reinvest them abroad relatively indefinitely.

Given this 45 percent effective rate, our research delved into the make-up of its individual components and found the following:

Current

-U.S. Federal	\$9,495,000
-State and Local	1,806,000
-Foreign	<u>10,875,000</u>
	\$22,176,000

Deferred

-U.S. Federal	<u>(3,837,000)</u>

Total Tax Provisions	<u>\$18,339,000</u>

As can be seen, although 45 percent of the pre-tax net income was reflected as a tax provision, \$1,806,000 or 9.8 percent represented state and local taxes and \$10,875,000 or 59.3 percent represented foreign taxes. Therefore, from a U.S. Treasury standpoint, \$9,495,000 or 23.4 percent of the pre-tax net income represented U.S. Federal tax currently payable. This highlights the significant role that foreign tax burdens play in this corporation's affairs. In fact, if the deferred federal tax deficit is offset against the current federal tax provision, the net U.S. federal tax provision is only \$5,658,000 or 13.4

percent of pre-tax net income per financial statements - a significant erosion of the tax base.

Because of the predominant role that foreign operations played in this corporation, it was not surprising to find that Schedule M net income was \$19,564,000 or 48.4 percent of the financial statement income. The reconciliation of this great disparity was produced as follows:

Net Income Per Financial Statements	\$40,430,000
Adjustments:	
-Minority interest in subsidiaries	(786,000)
-State and Local taxes	(1,806,000)
-Foreign income taxes	(10,875,000)
-Deferred federal tax deficit	3,837,000
-Earnings of foreign subsidiaries	(10,437,000)
-Other	(799,000)
Schedule M Net Income	<u>\$19,564,000</u>

Basically, it can be seen that the difference consists of the earnings of foreign subsidiaries and the foreign income taxes imposed on those earnings. Therefore, in the case of this company, a major telescoping of its tax base is accounted for by the foreign influence including the foreign tax burdens that ensue therefrom. Having now arrived at the Schedule M income figure, our study probed into the reconciliation between that figure and the taxable income of the corporation. However, here we did not find a significant disparity - that is, there was a close correlation between Schedule M income and taxable income.

Schedule M Net Income	\$19,564,000
-Difference between book and tax bad debt deduction	111,000
-Trademark expense deferred	120,000
-Foreign tax of foreign branch	297,000
-Unrealized loss on foreign exchange	693,000
-Royalty income deferred on books in prior year	(300,000)
-Amortization of gain on real estate deferred on books in prior years	(165,000)
-Amortization of trademark expense	(120,000)
-Other	(361,000)
Taxable Income	<u>\$19,839,000</u>

From this analysis of Schedule M adjustments, it can be seen that there are no startling changes. The reconciling items are ones we would expect to find in the tax returns of most corporations of significant size, once there has been the significant adjustment we saw earlier in going from financial statement net income to Schedule M net income.

Starting with taxable income of \$19,839,000 on its tax return, this company computed a tax before credit of \$9,505,000 or 48 percent. From that figure, it claimed foreign tax credits of \$465,000 and investment tax credits of \$291,000 so that it had actual U.S. tax to pay of \$8,749,000 or 44.1 percent of taxable income. More importantly, however, was the fact that its tax paid had only eroded to 21.6 percent of the net income before tax on its financial statements. Thus, our study revealed from this analysis how the U.S. taxable income base erodes when a U.S.

corporation generates a significant earnings base abroad and retains those earnings abroad relatively indefinitely. Compared with Company "A", we see that whether a company repatriates a high degree of its foreign earnings subject to a high foreign tax rate or plows back foreign earnings that have incurred a low foreign tax rate - the negative impact on the U.S. Treasury is the same.

Company "C"

This corporation did not have a widespread foreign operation but did claim foreign tax credits for foreign taxes incurred on income generated directly. Its foreign subsidiaries incurred more losses than profits so it provided the means for analyzing how this type of foreign activity impacted on its overall tax burden and see the extent to which its tax base eroded.

The corporation had worldwide consolidated pre-tax net income of \$36,121,000 on which it provided tax of \$16,314,000 or 45.1 percent. Examining this tax provision figure more closely produced a reconciliation with the expected tax expense based on the 48 percent statutory rate. This reconciliation produced the following results:

	Amount	-283- Rate
Computed expected tax expense	\$17,338,000	48%
-Investment tax credit	(2,822,000)	(7.8%)
-Amortization of goodwill - non-deductible	1,172,000	3.2%
-State and local income taxes, net of Federal tax benefit	1,238,000	3.4%
-Other, net	<u>(612,000)</u>	<u>1.7%</u>
Total tax provision	<u>\$16,314,000</u>	<u>45.1%</u>

As can be seen from this analysis, this corporation had a significant reliance on the investment tax credit. As we will see, this accounts for a substantial diminution of the U.S. tax revenue due from this company. However, analyzing the composition of the tax provision gives us even further insights into the telescoping of the tax base.

Current	
-U.S. Federal	\$10,166,000
-State and Local	2,380,000
-Foreign	1,998,000
	<u>\$14,544,000</u>
Deferred - Federal	1,770,000
	<u>\$16,314,000</u>

Here, it can be seen that the tax provision consists of state and local taxes to the extent of \$2,380,000 or 14.6 percent. While this does reveal a tax revenue due, its inclusion in the tax provision unduly inflates that figure for purposes of our research and has to be excluded. Furthermore, the \$1,998,000 of foreign tax which is 12.2 percent of the total tax provision indicates tax revenues that reduce the total profit base of this company but serves to erode those revenues due the U.S. Treasury.

Even more importantly for our examination of the narrowing of the tax base, we see that over 14 percent of the U.S. federal tax provision consists of deferred tax - namely, tax due on profits that will not ripen into taxable income until future years. Therefore, the current federal tax provision, after giving effect to these adjustments, is only \$10,166,000 or 28.1 percent of pre-tax net income per financial statements.

At this point, our reconciliation of financial statement net income and Schedule M net income revealed the role that foreign operations play in the operations of the tax factor for this corporation.

Starting with the pre-tax net income of \$36,121,000, our research found that foreign subsidiary losses had eroded financial statement income by \$2,017,000 which was added back in arriving at Schedule M net income. On the negative side of the reconciliation, state and local income taxes of \$2,380,000 and foreign income taxes of \$1,998,000 reduced pre-tax net income on financial statements to arrive at the Schedule M net income before tax of \$33,760,000. This consisted of the following on Schedule M:

Net Income before tax	\$33,760,000
Federal income tax	<u>13,935,000</u>
Net Income after tax	<u><u>\$19,825,000</u></u>

Now that we have followed the reconciliation from financial statement to Schedule M and seen the impact that foreign losses and taxes have made on the income flow, we must see how the taxable income base flows from the Schedule M starting point.

Schedule M Net Income	\$33,760,000
-Amortization of intangible - non-deductible	5,650,000
-Foreign income taxes claimed as a credit	1,240,000
-Pension and profit sharing - non-deductible	370,000
-Write-off of worthless assets - non-deductible	180,000
-Tax exempt income	(266,000)
-Capital gains and losses	(2,790,000)
-Gain on involuntary conversion	(900,000)
-Federal interest expense on prior years' tax examinations	(3,184,000)
-Terminated contract expense	(584,000)
-Tax versus book depreciation	(5,908,000)
-Amortization of licenses written off	(592,000)
-Charitable contributions	(1,300,000)
-Other	(216,000)
Taxable Income	<u>\$25,460,000</u>

Based on the foregoing, our research disclosed that taxable income was only 75.4 percent of Schedule M net income and approximately 70 percent of pre-tax net income per financial statements. This indicates a substantial erosion particularly since foreign subsidiaries had a net loss which served to reduce financial statement net income.

Now, our task was to discern how this eroded tax base translated into tax revenue by examining the tax calculation. Based on the taxable income figure of \$25,460,000, this corporation calculated a U.S. tax before credits of \$11,964,000 or 47 percent. The slight erosion from the statutory rate was due to the alternative calculation for capital gains. At this point, the tax credit for foreign taxes and investment credit substantially reduced the U.S. tax due as follows:

U.S. Tax before credits	\$11,964,000
Less -	
-Investment tax credit	(3,616,000)
-Foreign tax credit	<u>(1,240,000)</u>
U.S. Tax Actually Due	<u><u>\$7,108,000</u></u>

This reflects that 30.2 percent of U.S. tax was offset by investment tax credits and 10.4 percent was removed by foreign tax credits. The result was that the actual tax due was 59.4 percent of U.S. tax before credit and only 19.6 percent of pre-tax net income per financial statements. As a result, we find here a corporation that - despite foreign losses in its subsidiaries that reduced its consolidated financial statements income - its schedule of net income was considerably eroded so that taxable income only constituted 70 percent of financial statement income. Furthermore, investment tax credit and foreign tax credits pushed down the U.S. tax actually to be paid to 19.6 percent of pre-tax

net income per financial statements.

These case studies have provided in-depth insights into how multinationality of U.S. corporations has served to erode the tax base and produced a telescoping effect from significant financial statement income to modest U.S. tax revenues. Such factors as:

- Enlargement of pre-tax net income per financial statements due to minority interests, and earnings of foreign subsidiaries;
- Inclusion of state and local income taxes in financial statements under the tax expense;
- Reflection of foreign tax burdens in financial statements under the tax provision;
- Inclusion of deferred tax expense in the tax provision per financial statements;

have all served to account for a considerable disparity between current federal tax expense and pre-tax net income.

Further research reveals an additional telescoping of the tax base from financial statements to Schedule M net income and from the latter to taxable income. In addition to the extraction of foreign subsidiary and affiliate earnings, our research revealed an entire range of Schedule M adjustments that brought the taxable income figure down as low as half of the pre-tax net income per financial statements.

Finally, our research exposed the role of tax credits

in reducing the U.S. tax as calculated on the tax returns actually filed. Here, we saw that when all is said and done, the U.S. tax actually paid to the U.S. Treasury is less than one-fifth of the pre-tax net income per financial statement - a truly significant erosion result.

CHAPTER X

TECHNIQUES ADOPTED BY U.S. CORPORATIONS FOR PLANNING UTILIZATION OF FOREIGN TAX BURDENS FROM AN INTERNATIONAL STANDPOINT

Up to this point of our study, we have seen the nature and extent of the impact of foreign tax burdens on U.S. based multinational corporations. We have viewed those impacts from a variety of perspectives in order to be able to glean meaningful and representative insights into the way U.S. corporations are affected by the foreign tax burdens on their operations abroad.

We have viewed the incurrence of foreign tax burdens, not only in broad prospective using published data from U.S. government sources, but more importantly, we have delved into the intricacies of the manner in which foreign tax burdens are incurred by U.S. corporations on their foreign operations as well as the way in which U.S. corporations have, in fact, coped with these foreign tax burdens from a tax planning standpoint. We examined the manner in which these foreign tax burdens are incurred by U.S. corporations from the standpoint of whether they are sufficiently severe to produce excess foreign tax credits in an absolute sense. We have also viewed the data from the

standpoint of the extent to which foreign tax burdens imposed by specific countries have been of such a magnitude as to completely offset the U.S. taxation on the income coming from those countries. This research was just the beginning of a more intensive search into the causal relationships that result from these foreign tax impacts.

We have looked at the manner in which these foreign tax burdens affect the operations of U.S. corporations in given industries. We have also undertaken the study of the manner in which corporations in the United States of varying sizes undergo exposure to foreign taxation and the way in which, through their corporate maturity stages, these U.S. corporations adapt to foreign tax burdens and actively utilize these foreign tax burdens in their international tax planning. We have seen how this tax planning is affected by the various types of foreign source income generated by U.S. companies abroad. In addition, we have made our research so precise as to isolate the impacts that tax treaties make separate and apart from the interaction of the foreign tax credit mechanism, in order to discern the true role that each play in the problem of avoiding double taxation. Furthermore, we have seen how each part of this interrelated mechanism is used to enable U.S. corporations to more effectively utilize

excessive burdens that occur because of the differentiation in tax rates between foreign countries and the United States.

We have looked at the interaction of these foreign tax burdens from the standpoint of their effect on potential excess tax credits because of the accumulated earnings of foreign subsidiaries of U.S. companies which may some day be repatriated and be subjected to even greater foreign taxes than those to which they have been exposed to date. In fact, our data base enabled us to make significant recomputations of the tax burdens of the foreign subsidiaries of U.S. corporations in such a manner as to be able to appreciate more fully not only the significance of the foreign tax burden imposed to date, but also the potentials for additional foreign tax burdens on retained earnings of the foreign subsidiaries of U.S. companies.

We have seen how these relationships impact on the developing country population throughout the world through our analysis of the extent to which the foreign tax burdens incurred by U.S. corporations are generated in those geographic areas as well as the extent to which income from developing countries becomes more or less attractive to U.S. corporations because of the potential excess foreign tax burdens. In addition to the impact of the foreign tax burden on the developing countries and, in turn, their impact on U.S. based multinational corporations, we

saw how the interaction of the U.S. tax rules on taxation of foreign income generated by U.S. companies - both directly and through foreign subsidiaries - coupled with the interworkings of the foreign tax credit and the tax treaties have an impact on the balance of payments flows of the United States.

Delving still further into the underlying causal relationships for foreign tax burdens, we looked at the differentiation between the U.S. and foreign tax rates and even more importantly, we were led to an examination of the rationale for the differences in effective foreign tax rates in matters which are extremely important in connection with the true appreciation of the workings of the limitations set forth in the U.S. foreign tax mechanism. Finally, after all of these analyses were made, in order to enable us to appreciate the impact of the foreign tax burdens on U.S. based multinational corporations from a tax standpoint, we provided a comparison from an interdisciplinary standpoint. We did this by reviewing the impact that is made by foreign tax burdens on U.S. based multinational corporations from an accounting standpoint. This latter analysis enabled us to obtain a more meaningful insight into the overall appreciation of the foreign tax burden impacts because of the similarities and disparities it disclosed between the reporting of tax burdens

on earnings of these corporations from a tax and accounting point of view.

All of this research has now led us to the point where we are able to distill from the wealth of technical data provided by the comprehensive data base made available for this research, those intricate interworkings that have been developed and are actually being used today because of the foreign tax burden impact on U.S. corporations. That is, we are able to extract from our study the techniques adopted by these U.S. corporations for adapting to and utilizing these foreign tax burdens.

A. Techniques for the Avoidance of Foreign Tax Burdens

Because of the rather significant trend toward increasing foreign tax exposures by U.S. based multinational corporations and also because of the increasing difficulty such corporations face in utilizing all of these foreign tax levies as credits against U.S. taxation, our research discovered that a prime objective is the tax planning for these foreign tax burdens. As we have seen, the first step in tax planning for foreign tax burdens for U.S. corporations is considered to be the avoidance of having to suffer these foreign tax burdens. That is, in reviewing the U.S. companies in our data base from the standpoint of size and industrial complexion as well as country exposure, we noted that their first and foremost approach to the matter of

foreign tax burdens is the attempt to avoid having to incur foreign tax burdens in the first instance. This is because the companies very often find themselves in the position where their activities in the United States have brought them to a point where they expect certain tax results. By avoiding the incurring of foreign tax burdens in the first instance, they can conduct their operations without the complications of foreign tax involvements. As a result of this, companies approach doing business in an international environment in such a way as to avoid having to pay foreign tax burdens at all. We found they approach this from several standpoints:

1. Avoidance of Doing Business in a Foreign Country

One of the primary techniques which was discerned from our analysis of the foreign tax burdens imposed on U.S. corporations was the initial avoidance of doing business in foreign countries. While this may appear to be a rather fundamental point, this is important to note because it enters into almost every decision that a U.S. corporation makes when it thinks of penetrating a foreign country.²²⁷

The technique consists of looking at the extent to which goods can be exported to a foreign country, or investment

227. J. H. Christiaanse, "Tax Harmonization in European Common Market", 24 Tax Executive 24 (1971).

of funds can be made in a given country, or services can be undertaken in a given country, or leasing or licensing can take place in a given country without the foreign country considering it to be significant enough to subject the U.S. corporations to their tax burdens. The extent to which these various activities can be conducted in foreign countries successfully without the imposition of foreign tax burdens is of course something that must be investigated by U.S. based corporations on a country by country basis. A number of U.S. corporations operate in countries which, either on the global system of taxation or territorial principle, have provisions in their tax laws which require that any enterprise doing business in their country - however doing business is defined - is subject to the local country's system of taxation. The basic presumption is that remunerative activity must take place before taxation is imposed. This is not always the case in connection with activities conducted by U.S. corporations in their foreign operations. For example, we found situations in which companies conducted functions which were different and distinct from those which are normally considered to be productive of income.

If a U.S. company engages in the production of goods with the marketing of those goods taking place in a given country, one would normally presume that it would be subjected

to local country taxation or at least be exposed thereto.

However, where a U.S. corporation establishes a research facility in a country - involving the expenditure of sums of money and human effort - this may not be directly productive of profits.

The question arises as to whether that company is doing business in the foreign country in the sense required to subject it to taxation. This is the type of approach we found U.S. corporations examining to see if they could conduct some of their activities in a foreign country, where that is desirable from a business standpoint, but yet avoid those activities or utilization of assets from maturing to a point where they would be considered doing business in the foreign country in a commercial sense.

A further example would be the establishment of personnel in a foreign country merely engaged in the acquisition of raw materials to be exported out of the foreign country. Purchasing efforts in and of themselves may not be deemed to be of sufficient business involvement to result in the U.S. company doing business in the foreign country. While some countries would consider purchasing to be a business enterprise requiring the payment of taxation, others would look at it as being only one portion of an incomplete transaction; the later selling of the purchased goods or utilization of those goods in a further manufacturing process being required in their country before

taxation would be imposed.

Another example of engaging in activities in foreign countries but avoiding the imposition of foreign taxation would be the raising of capital. Because of the extensive need for funds in conjunction with overseas extensions of U.S. companies or even expansions in the United States, the late 1960's and early 1970's have seen the advent of foreign borrowing by U.S. corporations. To a great extent, the impetus for these foreign borrowings was given by the advent of the Foreign Direct Investment Program in 1968 which, in effect, required U.S. based multinational corporations to finance their outflows of direct investment capital to foreign affiliates by means of borrowing outside the United States. While this program has been suspended, the period involved in our research indicated a high degree of compliance with the Commerce Department program was met by the foreign borrowing techniques.²²⁸ To the extent that U.S. corporations engaged in activities in foreign countries consisting of the accumulation of capital, we have another illustration of activity being conducted abroad but generally not of a sufficiently extensive nature to have the foreign country consider

228. Foreign Direct Investment Program - Selected Statistics, (U.S. Department of Commerce, Office of Foreign Direct Investments December 1973), pp. 2-5.

the U.S. corporation to be doing business.

Of particular interest in this very rudimentary form of foreign tax burden avoidance is the concept of doing business with or doing business within the foreign country. The concepts of doing business with a country encompasses the idea of the exporting of goods or services to a country but not being a sufficient penetration of that country to give rise to taxation. This concept arises in the case of the United Kingdom where U.S. corporations will manufacture products in the United States and sell them in the United Kingdom market. Under United Kingdom concepts of taxation, this is equivalent to doing business with the United Kingdom. However, they do not impose taxation in the United Kingdom unless the U.S. pattern of commercial transactions have such regularity and substance as to be considered as actually conducting the business within the United Kingdom. Thus, we can see instances where U.S. corporations can conduct considerable amount of trade with various countries but yet do it on a basis whereby they are not really engaged in business in that country. Exporting type operations have been one in which U.S. corporations have been able to function very successfully in an international environment by avoiding taxation in the first instance.

Continuing the example used above in connection

with the moving of physical products into a country without being subjected to foreign taxation, U.S. corporations seeking to penetrate a market have apparently utilized the technique of appointing independent contractors in foreign countries for handling the marketing of such products until such time as the market or the efforts of the independent party reach a stage where the quantum increase in results can only be achieved through the U.S. corporation directly involving itself in the marketing effort. This technique has found attraction, not so much from a tax standpoint as from a normal business standpoint. That is, the appointing of dealers or distributors in countries for the purpose of acting on their own behalf for the benefit of the U.S. corporations seeking to make its products available in the local market.

An extension of our research revealed this technique is used for the appointment of not only independent contractors from a marketing standpoint, but also from a manufacturing standpoint. That is to say, where a particular country offers labor cost advantages, U.S. companies have at times appointed independent manufacturing contractors to make goods to the specification of the U.S. company for the purpose of either selling them in the local market or for exporting to the United States or third countries. The business advantages of this

concept would, of course, be low overall costs of production. The tax implication is that the U.S. company is, in effect, utilizing resources of the foreign country without itself being subjected to foreign tax burdens. In a sense, there is an illusory tax burden in that the foreign party very often will have to consider its own tax burdens on profits to be earned in the price to be charged to the U.S. corporation. In a sense, then, it can be looked at as a disguised foreign tax avoidance approach because of the fact that the U.S. corporation is bearing the economic effects of the foreign taxation without actually reflecting it in its own foreign tax credit posture.

A further method of avoiding doing a business in a foreign country is through the mechanism of licensing the foreign party to produce products using intangible assets, such as patents, owned by the U.S. corporation. This technique is used from a commercial standpoint in those situations where the U.S. party wishes to avail itself of the manufacturing capacities of a certain country, but by the same token, it does not feel it wishes to expend the resources to establish its own manufacturing operations. Very often the use of licensing operations is the midway point in the expansion process of U.S. corporations overseas. That is to say, the process of going from direct exports

to independent marketing contractors, to independent manufacturing contractors, to independent licensees to direct involvement by the U.S. company anticipates a period of time in which the U.S. company will seek to generate a certain return on its investment on intangible assets without necessarily having to involve itself in a full scale manufacturing enterprise at the present time. This was seen in our research in connection with the expansion of not only U.S. corporations going abroad for the first time, but also established U.S. companies entering a new geographic area. For example, companies already established in North America and Europe might find this approach desirable in connection with the Far East or Latin America. The royalty charges for the utilization of intangible assets, however, are often subjected to withholding taxes in foreign countries. Consequently, this modus operandi may be a means of avoiding doing business in a foreign country, but cannot be viewed as being a means whereby foreign tax burdens can be eliminated completely. In a sense, this is also true in those situations where capital is advanced to foreign parties with the extraction of interest in lieu of using the capital for direct operations in that country.

2. Avoidance of Foreign Permanent Establishment

We found an extension of the techniques utilized by U.S. corporations for planning their foreign tax burdens in the area of sheer avoidance of foreign tax burdens is to penetrate a foreign country in such a way that the U.S. corporation may be recognized as doing business in that country but utilizes the privileges of tax treaties which provide exemption from the taxation of industrial and commercial profits unless they are earned via a permanent establishment in that country. Companies at times will make economic penetration into a foreign country in such a manner as to raise questions as to whether it is doing business in that country and as such, is subject to taxation in that country. The subjective standard of doing business is one that varies by country, both from the standpoint of the substantive rules and the administration of the tax. Consequently, tax treaties permit companies to engage in an extensive range of activities within foreign countries, but yet avoid taxation as long as they do not do so by means of a permanent establishment.²²⁹

Examining this somewhat more closely in the case

229. Draft Double Taxation Convention on Income and Capital, Report of the OECD Fiscal Committee, (Organization for Economic Cooperation and Development, 1963), Article 5.

of our research, we found numerous instances where U.S. companies were penetrating foreign countries but were not doing so in a sufficiently permanent manner as to constitute a permanent establishment. To illustrate the point, one technique that is used is to operate in a foreign tax treaty country using an agent that does not have the authority to contractually bind the U.S. company. By removing the authority to contract, U.S. companies are able to conduct activities of a marketing nature in a foreign country but yet not have that result in foreign taxation.²³⁰

A U.S. corporation can often establish a location with personnel in a foreign country to perform purchasing functions in tax treaty countries and not incur foreign tax liability.²³¹ By the same token, the mere dissemination of information about a product in a tax treaty country is able to be done and still not subject the U.S. company to tax action.²³²

A still further technique utilized by U.S. companies in connection with foreign countries is the establishment

230. Draft Double Taxation Convention on Income and Capital, Report of the OECD Fiscal Committee, (Organization for Economic Cooperation and Development, 1963), Article 5(4).

231. Draft Double Taxation Convention on Income and Capital, Report of the OECD Fiscal Committee, (Organization for Economic Cooperation and Development, 1963), Article 5(3)(d).

232. Draft Double Taxation Convention on Income and Capital, Report of the OECD Fiscal Committee, (Organization for Economic Cooperation and Development, 1963), Article 5(3)(a)-(b).

of a so-called cost-basis subsidiary. There are instances where a certain cycle of activity must be conducted in a foreign country to a point where it is not feasible to expose U.S. corporations to the risk of incurring significant foreign taxes. It is also necessary to recognize the fact that there is sufficient permanence to the operation to warrant paying some taxes to the foreign jurisdiction. A technique that has been developed is the creation of a local subsidiary in the foreign country serving the purpose of housing the personnel needed for the operations and providing this as a service to a U.S. corporation on a reimbursement of cost. To this extent, it produces a situation where foreign profits can be controlled and the requirement for personnel in the foreign country can be met. In those situations, for example, where personnel may be needed to perform services in a given foreign country, cost companies of this type seem to be utilized in such a manner so as to control the amount of foreign profit reported and foreign tax burdens incurred locally.

3. Utilization of Intermediate Corporations to Achieve Foreign Tax Economies

An extension of the technique of limiting the U.S. corporation's penetration into the foreign market so that foreign tax liabilities would not be due is the use of intermediate corporations for establishing operations in a foreign

country. In its simplest form, this technique consists of a U.S. corporation's establishing a new U.S. subsidiary whose sole function is to enter into a foreign country and conduct activities which the parent deems desirable. The purpose of using the separate corporate entity is to limit the exposure of the U.S. corporation to foreign tax and jurisdiction by having a U.S. subsidiary conduct the activity and yet control its profit. This enables the U.S. subsidiary to file requisite tax returns in a foreign country, reporting its income always with the understanding that if the foreign country delves too deeply into the total activities of the company, it is always able to show its entire financial picture without exposing the major U.S. corporation to the foreign tax.

A more sophisticated use of this technique involves the incorporation of intermediate corporations in foreign tax treaty jurisdictions. It is a well known fact that countries such as Switzerland and the Netherlands have established a broad range of foreign tax treaty networks.²³³ Consequently, a subsidiary of the U.S. company established in those countries enables the U.S. company not only to protect itself from exposure of foreign tax by buffering its activities through the use of an

²³³. R. J. Nelissen, "Tax Policy in Netherlands", 12 European Taxation 229 (1972).

intermediate company, but also companies organized in these countries have available to them a myriad of tax treaties to which these countries are parties.

Moving one step further in the utilization of intermediate companies, we found situations in which U.S. corporations have established subsidiaries in so-called tax haven countries. While there is no clear cut definition of tax haven, there are several criteria which make a country so classified. Some countries do not impose any taxation at all, so are clearly tax havens. Other countries do levy taxation on income generated in the country where the company was established but not on foreign profits. For this reason, tax havens have been utilized in the past because of lack of taxation of international earnings.²³⁴ It should be pointed out at this stage that under the legislation enacted in the United States by the Revenue Act of 1962, certain earnings of such tax haven subsidiaries could be imputed to the U.S. corporation on a current basis.²³⁵ However, tax havens now provide an interesting alternative in the opposite direction; namely, reducing the foreign tax burdens incurred by U.S. corporations so that they are in a position to more fully utilize

234. I. T. Wender, "The Use of Tax Haven Corporations", University of Southern California Tax Institute 253 (1959).

235. Section 952 of the Code.

foreign tax credits. Another way of expressing the same idea is that, when a U.S. company sees itself approaching excessive foreign tax burdens, it can use low taxed foreign source income generated through tax havens to absorb these potential excess tax burdens.

4. Capitalization Techniques for Foreign Affiliates

One of the approaches that have been developed for the avoidance of foreign tax burdens has been the judicious use of debt equity ratios in foreign affiliates of U.S. corporations. That is, if the U.S. corporation is contemplating placing a certain amount of capital in a foreign subsidiary corporation, the funds might be used to subscribe for outstanding capital stock of the subsidiary. However, such capital used by the subsidiary to generate profits will often be subject to the corporate rate of tax in the country where operations are conducted and, after paying that corporate tax, profits will generally be subjected to a dividend withholding tax when repatriated to the U.S. corporate shareholder.²³⁶ As we saw in an earlier portion of our research, one common reason for excess foreign tax burdens in a given country is the combination of deemed paid

236. G. Bale, "Tax Reform Bill and Problem of Income Fluctuation", 19 Canadian Tax Journal 487 (1971).

credit for underlying foreign taxes of subsidiaries coupled with the dividend withholding tax. Consequently, to more properly control foreign tax burdens, some U.S. corporations have moved to the approach of only putting a certain amount of capital into a foreign subsidiary in the form of capital stock and advancing the balance of the funds in the form of debt. The ability to extract tax deductible interest from the foreign subsidiary in place of what might normally be considered dividend income gives the U.S. parent the opportunity to provide the U.S. company with a technique for avoiding foreign taxes. Thus, instead of incurring foreign taxes at the corporate level and the dividend withholding tax level, this approach would only produce withholding tax on the interest, thereby providing foreign source income subject to a lesser rate of foreign tax. In an environment where the objective is to minimize foreign tax burdens in the first instance, this technique has much attraction for U.S. based multinational corporations.

A further technique in the capitalization area is the utilization of multiple corporations. Some countries levy corporate taxes on a graduated tax basis.²³⁷ The technique

237. See Mexico Income and Commercial Receipts Tax Laws, (Commerce Clearing House, Inc., Chicago, 1972), pp. 101-107.

which was in force so long in the United States of dividing profits into multiple subsidiaries and subjected to lower bracket taxes has been utilized by U.S. companies abroad. The concept here is to divide profits in a given country into two or more economic units subjected to the foreign tax at the lower tax brackets. In so doing, the overall objective is achieved of reducing the foreign tax burden in the foreign country which a single corporation would ultimately have to use as foreign tax credit.

5. Charges for Intangibles to Foreign Affiliates

U.S. companies have established many affiliates in foreign countries. The Internal Revenue Service has been quite aggressive during the 1960's and into the 1970's in making certain that any assets that U.S. companies make available to their subsidiaries abroad be on an arm's length basis.²³⁸ That is, the U.S. tax rules make certain that under Section 482 of the Code, the U.S. corporation does not transfer to foreign affiliates the use of intangible assets where the latter does not pay an arm's length price for the use of those intangibles. At one time, U.S. corporations were being challenged by the Internal Revenue Service for not charging

238. Summary Study of International Cases Involving Section 482 of the Internal Revenue Code, U.S. Treasury Department, January 8, 1973.

their foreign corporations for the intangibles. Now, they have found that it is to their advantage to utilize this approach in order to reduce the overall foreign tax burden in their foreign subsidiary operations. Here the approach is that, if a given amount of profit is building up in a company and being subjected to foreign tax at the corporate level and also by withholding taxes when dividends are declared, it will usually be better to negotiate a licensing agreement with the foreign subsidiary so that the foreign subsidiary would pay royalties for the use of intangibles. Assuming the royalties in question are deductible in the foreign country, it permits the extraction of certain amounts of income from the foreign subsidiary on a pre-foreign tax basis.

A sophisticated twist on this technique also involves the use of tax treaty provisions which exempt royalty payments from foreign withholding taxes.²³⁹ To the extent that the United States has a tax treaty with a given foreign country, it would permit charging a royalty deductible at the foreign subsidiary level and exempt from foreign withholding tax under the U.S. tax treaty. If the United States does not have a tax treaty with the country, U.S. corporations have utilized intermediary

239. See United States Tax Treaties with Austria, Belgium, Denmark, Finland, Germany, Greece, Ireland, Italy, Luxembourg, Netherlands, Norway, Pakistan, Sweden, Switzerland and the United Kingdom.

corporations established in countries which do have tax treaty relationships with the country from which the royalties would be paid.

6. Service Charges to Foreign Affiliates

As a corollary to the charge for royalties for the use of intangible assets, another technique we discovered is charging for services provided by U.S. corporations to foreign affiliates. In the environment that has existed since the early 1960's, whereby U.S. corporations were scrutinized closely in connection with services that parent companies were making available to foreign subsidiaries, the burden was placed on those U.S. companies to make sure that they made arm's length service charges for the services they were rendering.²⁴⁰ Once again, this turned out to be the beginning of a technique utilized by companies to reduce foreign tax burdens on foreign income that was subjected to higher rates of tax abroad when one took into consideration taxation at the foreign subsidiary level and dividend withholding taxes. Here again, the approach consists of charges for services rendered by the U.S. companies for the foreign subsidiary with the payment of the charges by the subsidiary being deductible. The difficulty in this approach is that, in certain countries such

240. Duerr, Tax Allocation and International Business, (The Conference Board, New York 1972), pp. 29-43.

as those in Latin America, the territorial principle of taxation makes difficult the deductibility of payments for services where the services are rendered outside the country.²⁴¹ To the extent that a foreign party (the U.S. company in this instance) were to contend that the services should be deducted because they were rendered within the country, it raises a question of the recipient possibly being subjected to tax in the foreign country because it rendered those services in the country. To a certain degree, charges for finance, managerial, scientific, production, marketing and similar services are being utilized to reduce foreign tax burdens and assist U.S. based multinational corporations in tax planning for foreign tax burdens.

B. Planning for Utilization of Potential Excess Foreign Tax Burdens

The second portion of our analysis of the techniques adopted by U.S. corporations in planning for the utilization of foreign tax burdens disclosed that the steps described above for the sheer avoidance of foreign tax burdens have only been modestly successful or will be so in the future. That is, notwithstanding the attempts by U.S. corporations to minimize their foreign tax burdens, we have seen from our research that, in many instances,

241. C. Shoup, The Fiscal System of Venezuela, (The Johns Hopkins Press, Baltimore 1959), pp. 43-47.

foreign tax treatment of foreign income of U.S. corporations is such as to produce built-in situations where foreign tax burdens will exceed U.S. tax limitations; at least on that item of income. We found U.S. corporations are aware of this and take steps to make certain that, to the extent possible, they will be able to accommodate excess foreign tax burdens generated on certain income against the U.S. tax that would otherwise be due against foreign source income from other areas. Thus, it is assumed that foreign taxes cannot be reduced on all types of foreign source income to a point where they will be accommodated against U.S. taxation on that specific income. As a result, it becomes a question of what steps can be taken to see that they can be absorbed against the U.S. tax burdens of the U.S. company in total.

We found that planning in this area revolves around certain key factors. The first factor in this regard is the amount of gross income the U.S. corporations are able to generate having its source in foreign countries, or at least outside the United States. As we have seen in the discussion of the foreign tax credit mechanism in Chapter I, the limitations on the foreign tax credit in the per country area requires U.S. corporations to be able to determine the amount of foreign source gross income by country. Those companies using the overall

limitation method, however, need only show that the U.S. company is generating gross income from sources outside the United States. An example of the difference in the two methods would be income not generated in a specific country, but on the high seas, such as shipping income. Such income would not necessarily be attributed to any particular country, but would be considered foreign source income for the overall limitation purposes.²⁴²

The second key factor in the utilization of potential excess foreign tax burdens is the amount of deductions claimed by the U.S. corporation on its U.S. tax return, which are attributable to the foreign source gross income generated by the corporation. This factor is important since it determines the subtraction from the foreign source gross income in arriving at foreign source taxable income. The reason this latter factor is important is that the basic concept of the foreign tax credit is to permit a U.S. corporation to claim foreign taxes as a credit only against the U.S. tax attributable to foreign source taxable income. To the extent that deductions on the U.S. tax return are attributable to and subtracted from foreign source gross income, they reduce the amount of foreign taxable income on which U.S. tax would be paid. Since the latter number is the

²⁴² Rev. Rul. 72-495, 1972-2 CB 414

basic limitation factor, one can see that strategies dealing with the determination of deductions attributable to foreign source gross income are important in planning for the utilization of potential excess foreign tax burdens.²⁴³

The third factor which is key to the matter of utilizing potential excess foreign tax burdens is the planning which deals with the structural aspects of overseas operations. The first two factors assume a given corporate structure for the U.S. corporation in connection with its foreign operations. Given that structure, foreign source gross income and deductions attributable thereto, are two areas in which tax planning strategies can be developed. Given that particular structure, if the strategies are still not sufficient to provide the absorption of all foreign taxes as credits, the U.S. corporation must then look to restructuring considerations in connection with their foreign operations so as to put the U.S. corporation in a better overall position to absorb excess foreign tax credits.²⁴⁴

1. Gross Income Strategies

²⁴³. "Multinational Firms Resist the Treasury in Major Tax Battle", The Wall Street Journal, September 13, 1974, pp. 1, 18.

²⁴⁴. W. Lamp, "When Section 367 Rulings Are Needed in Reorganizing Foreign Operations", Practical Problems in Taxation of Foreign Operations, (The Journal of Taxation, Inc., New York, 1965), pp. 163-192.

From the foregoing summary, we saw that the amount of foreign source gross income which a U.S. corporation is able to generate is a key factor in its foreign tax credit planning. Tax planning by U.S. corporations assumes that they will be generating a certain amount of gross income in its operations and the question becomes one of determining what portion of it is attributable to foreign sources. In determining the amount of gross income the U.S. corporation will be considered to generate from foreign sources, the source of income rules contained in the Code are a significant factor. In many foreign countries, the rules for determining source are not as specific as they are in the Code. The Code has opted for certitude in prescribing specific objective standards for determining source of income. As examples, as a general rule, interest income is deemed to have its source at the situs of the obligor; dividend income is deemed to have its source at the situs where the corporation is organized; service income is considered as having its source where the services are performed. In the case of the purchase and sale of personal property - whether it be inventories, fixed assets, securities or any other personal property - the place where the sales take place is the determining factor; and as a general rule, the place of sale is considered to be where the title to the goods passes. In the area of rentals and royalty

type income, the income is generally considered having its source where the property - whether tangible or intangible - is used.²⁴⁵

While these are oversimplifications of a rather technical area of the Code, the key point is that the U.S. Congress has seen fit to make the rules for determining source of income as objective as possible. As in many cases where objectivity and simplicity are the rule, it is possible for simplistic rules of this type to be utilized for planning purposes by corporations in a manner which makes the results more clearly ascertainable. Consequently, U.S. corporations are able to approach a potential excess foreign tax burden situation by reviewing their gross income to see how it might be possible to rearrange it to make income which is presently not from foreign sources fit that category for purposes of foreign tax burden absorption. Our research delved into these techniques in some detail and all results are described below.

(a) Manufacturing-type Income

In the case of manufacturing type income, it is more difficult to make shifts in source of income because the basic rules in the Code prescribe that income from

²⁴⁵. Section 861(a)(4) of the Code.

manufacturing is deemed to have its source primarily where the goods are manufactured. Consequently, in order to have gross income from manufacturing generate foreign source income, U.S. corporations would have to shift the physical location of the manufacturing operations outside the United States. Since this is quite cumbersome, this is not a technique that is used by U.S. corporations on a large scale because of its physical disadvantages. However, one aspect of this technique that is utilized is the possibility of moving sub-assembly or component assembly work outside the United States in order to have at least a portion of the manufacturing effort generated in a foreign country. While companies may not generally look at the tax factor in this particular area as being a key feature in determining where manufacturing facilities are located, the tax element can become important where a potential excess foreign tax burden exists. In ranking all of the considerations for the location of a manufacturing operation, the existence of potential excess foreign tax burdens are being considered by companies particularly where it becomes a factor in determining the overall yield on investment.²⁴⁶

²⁴⁶. Heller and Kaufman, Tax Incentive for Industry in Less Developed Countries, (Harvard Law School, International Program in Taxation, Cambridge, Massachusetts, 1963), pp. 24-38.

We also found this particular facet of evaluating manufacturing relocations dovetails with searches by U.S. corporations for foreign tax subsidies offered by foreign countries. In certain instances, in order to increase their industrial base, foreign countries offer exemptions from their foreign taxation for periods of time when persons manufacturing in their country will either agree to provide a certain amount of employment for local labor or where the product is manufactured for export so as to not effect the local economy. These foreign tax subsidies coupled with the fact that manufacturing in these countries produces foreign source income provide an attractive means of giving U.S. corporations an opportunity to increase their foreign source gross income by manufacturing abroad. This manufacturing does not necessarily mean that the goods are replacing ones that would be manufactured in the United States. However, one example of goods manufactured outside the United States mainland which often return to the mainland for marketing is Operation Bootstrap in Puerto Rico. Because Puerto Rico is within the U.S. tariff wall, much of the products manufactured there are returned to the United States for marketing purchases.²⁴⁷

²⁴⁷. H. J. Rudick and G. S. Allen, "The Aspects of Operations Under the Puerto Rican Tax Exemption", 7 Tax Law Review 403 (1952).

(b) Marketing-type Income

In the marketing area, we found more techniques which U.S. corporations can employ for achieving additional foreign source gross income in order to improve their ability to absorb potential excess foreign tax burdens. The basic tax rule is that income from the purchase and sale of personal property by U.S. corporations has its source where the sale takes place. Consequently, where U.S. corporations can structure export subsidiaries which are able to purchase and sell inventory, the sale of the inventory outside the U.S. would give rise to foreign source gross income for purposes of foreign tax burden absorption. A classic example of this type of structure is the Western Hemisphere Trade Corporation. A fair number of these companies are structured in such a way that they are utilized to purchase production of the parent or a sister subsidiary in the United States for resale in the Latin American market. The requirements in the Internal Revenue Code for qualifying as a Western Hemisphere Trade Corporation are such that at least 95 percent of the income of the company must be from foreign sources. The rules dealing with source of income in the marketing area serve the purpose of enabling the U.S. corporations structured in this manner to qualify for Western Hemisphere Trade

Corporation treatment.²⁴⁸

As in the case of the foreign tax subsidy situation described above under manufacturing, there is a dual advantage to structuring such an operation from a marketing standpoint. In the case of the Western Hemisphere Trade Corporation, there is the overall tax saving in that the effective U.S. tax rate of the Western Hemisphere Trade Corporation approximates 34 percent as compared to the regular U.S. corporate tax rate of approximately 48 percent. In addition to that absolute U.S. tax saving, the structure enables a company to qualify its gross income as foreign source income. To the extent the company is included in a consolidated U.S. corporate income tax return, its gross income can be utilized to absorb excess foreign tax burdens that might be generated elsewhere in the family of U.S. corporations.²⁴⁹

It is true that the consolidated tax return regulations prohibit the utilization of the income of a Western Hemisphere Trade Corporation between the 34 percent and 48 percent range to absorb excess foreign tax credit. However, there is still the income earned in the zero to 34 percent range which

²⁴⁸. J. R. Krahmer, "Federal Income Tax Treatment of International Sales of Goods: A Reevaluation of the Title Passage Test", 17 Tax Law Review 235 (1962).

²⁴⁹. Section 1503(b) of the Code.

can be used for this purpose. If one further assumes that export operations of this type are often not making sufficient penetration into the foreign country to require taxation within that country, the Western Hemisphere Trade Corporation approach has several attractions.²⁵⁰

Even if a company is not structured in such a way as to qualify as a Western Hemisphere Trade Corporation, a U.S. subsidiary with export operations is still able to generate foreign source gross income for purposes of absorbing excess foreign tax burdens. In essence then, the marketing area is one that provides a certain amount of attraction in terms of creating foreign source gross income for utilizing potential excess foreign tax burdens.

It should be noted at this point that the profits of a Domestic International Sales Corporation (DISC) cannot be used in the manner described above to absorb excess foreign tax credits. A DISC does provide a mechanism whereby profits generated from the export of U.S. manufactured products gives special tax treatment to its shareholders. However, at the time this legislation was enacted, it was noted that income

250. P. Seghers, "The Western Hemisphere Trade Corporation - What It Is and How to Use It To Advantage", 42 Taxes 582 (1964).

of a DISC could not only have the advantage of providing tax deferral on half of its earnings, but that it could enable U.S. corporations to absorb otherwise unusable foreign tax credits against the income of the DISC taxable to its shareholders. As a result, a provision was put into that legislation prohibiting the DISC income from absorbing what would otherwise be excess foreign tax credits. This particular point in the legislation reflects certain policy considerations which arose at the time this legislation was being enacted. That is, it provided a special set of foreign tax credit limitation rules on DISC income by segregating that income from the normal rules which give U.S. corporations the ability to aggregate foreign source income for purposes of claiming foreign tax credits.²⁵¹

A further ramification of this foreign source income strategy as applied to marketing type income is the necessity to meet arm's length pricing tests under Section 482 of the Code. With regard to marketing type income, the rules of Section 482 require that the income that is attributable to a marketing type operation must be supportable by arm's length relationships, not only between the marketing company and the parent company or supplying affiliates, but also between the

²⁵¹. Section 904(f)(1)(B) of the Code.

marketing company and foreign affiliates. It must be recognized that, in order to make this strategy workable, the U.S. corporation must see that its marketing affiliate has sufficient economic resources to warrant attributing to it the income which the corporations desire to have treated as foreign source income. Consequently, we found this strategy is one that requires an extensive amount of restructuring of the operations of the company. Yet it is one which provided significant potential for improving the ability to utilize excess foreign tax burdens.

(c) Service-type Income

Service type income is also utilized by U.S. corporations for absorbing excess foreign tax burdens. The U.S. tax rules indicate that the source of service type income is the place where the service is physically performed. In order for U.S. corporations to utilize service type income to absorb excess foreign tax burdens, they have to see what services which might be performed in the United States could be performed abroad. There are numerous instances where U.S. corporations provide services to their foreign affiliates. In past years, this has become an area of significant investigation by the Internal Revenue Service since the arm's length requirements of Section 482 require that the U.S. corporation charge foreign

affiliates the same fee for their services as they would charge unrelated parties for which they might render these services. Because of the significant attention this matter has been given by the Internal Revenue Service over more than a decade, we found most U.S. corporations are well familiar with this requirement.

A key factor in treating this as foreign source income, however, is the determination of where the services are performed. To the extent that the U.S. parent corporation performs services for its foreign subsidiary in the United States, it would not qualify as foreign source income. This can serve to aggravate the foreign tax burden problem where the foreign country imposes a withholding tax under their local tax rules on the theory that as long as the payer of the service is in that country, there is a requirement to withhold, which is the situation in many Latin American countries.²⁵²

We found that this provides a reverse type of situation in that, rather than help a potential excess foreign tax burden situation, it can serve to create one. Furthermore, charges for services by U.S. companies to foreign affiliates are

252. J. P. Crockett, "Tax Pattern in Latin America", Readings on Taxation in Developing Countries, (The Johns Hopkins Press, Baltimore, 1964), pp. 153-166.

meeting greater restrictions on the ability of the foreign affiliate to deduct those for local purposes. To the extent that the foreign subsidiaries do not get a deduction, but the income is taxable in the United States; there is a rather significant overall tax burden increase to the U.S. corporate family.

From the foregoing, we learned that while service type income can be used, (and is, in fact, being used in certain instances by U.S. corporations for purposes of improving their excess foreign tax burden problems) there are numerous pitfalls.

(d) Investment-type Income

We found one area in which foreign source income can be generated with a lesser degree of inconvenience to the overall operating aspects of the U.S. company involves investment type income. Dividends, interest and capital gains can often be generated through the movement of capital. This is more convenient than the dislocations required by shifting manufacturing, marketing, or service operations as described above. Therefore, the use of cash funds in various areas of the world to generate foreign source income does provide a technique for corporations facing excess foreign tax burdens.

Dividends generally are considered as having their source where the paying corporation is incorporated.

Dividends from foreign corporations will only be considered to be income from U.S. sources where the foreign corporations are directly engaged in business in the United States, a situation that does not often exist. Similarly, interest income is deemed to have foreign source primarily where the obligor is a foreign corporation. Assuming the foreign corporation has no substantial operations in the United States, this is a medium for generating foreign source income for U.S. corporations. In the area of capital gains, the rules pertaining to the purchase and sale of personal property described earlier, generally apply. Consequently, where sales of assets take place outside the U.S., the profit from such activity will generally be considered foreign source income and provide a means of absorbing potential excess foreign tax credit.

From these factors, we found that U.S. corporations might be encouraged to make investments in foreign corporations - either related or unrelated - in order to generate dividend income which can be used to absorb foreign tax burdens.

In order to utilize foreign investment in the interest income area to absorb potential excess foreign tax burdens, U.S. corporations are hindered by legislation enacted in 1962 requiring that interest received from foreign sources -

other than from affiliates of U.S. companies - be calculated on a separate basis for foreign tax credit limitation purposes. This gave recognition to the fact that companies were in fact utilizing interest income from sources, such as Canada, to absorb excess foreign tax burdens from other areas. The essence of this legislation was to permit the interest income to be utilized for foreign tax credit limitation purposes to absorb only the credits for foreign taxes imposed on that specific income. This was the beginning of a policy change in that a per-item type limitation was instituted. As a result, it is not possible for U.S. corporations to utilize interest income from unaffiliated companies to absorb excess foreign tax credits. It is possible, however, for this technique to be employed where the interest comes from foreign corporations in which the U.S. corporation owns at least a 10 percent voting interest. Consequently, the technique is available to a more limited degree.²⁵³

A further area where we found investment type income can be used to generate foreign source gross income is that involving capital gains. As we have seen, the purchase and sale abroad of personal property produces foreign source income. Consequently, where a U.S. corporation is in a potential

²⁵³. Section 904(f)(2)(C) of the Code.

excess foreign tax burden situation, it might be advisable from a tax standpoint for it to consider the sale abroad of property where the gain could be made foreign source income. It should be noted that it need not be foreign securities; the only requirement is that the property which is purchased be sold outside the United States. In this particular connection, the expiration of the Interest Equalization Tax in mid-1974 produced a situation where the hinderance for trading in foreign securities produced by this tax will no longer be a disincentive for U.S. corporations. It may therefore be that the removal of this discouragement will provide U.S. corporations with a greater incentive to utilize the purchase and sale of foreign property, particularly securities, to improve their foreign gross income situations.²⁵⁴.

Our research disclosed one final point in the area of investment type income involving the matter of gains on foreign exchange transactions. Because of the substantial amount of fluctuations of foreign currencies, U.S. corporations have found themselves in a position of dealing with foreign currencies to a greater degree. To some extent, these have been

²⁵⁴. On July 30, 1974 the Interest Equalization Tax under Section 4911 of the Code officially expired from the statute.

truly protective measures to buffer the U.S. corporation from currency fluctuations that would erode their business profits. In other cases, it has involved speculation by U.S. corporations on fluctuations in the international monetary market. In either event, the buying and selling of foreign currencies is looked at primarily - from the source of income standpoint - as the purchase and sale of personal property. As a result, the gains generated by U.S. corporations from the purchase and sale of foreign currency can provide a means of generating foreign source gross income. To the extent a transaction in foreign exchange produces a loss, a sale outside the United States would be considered a foreign source loss and provide greater difficulty for the absorption of foreign tax burdens. This particular development has been further refined to a point where entering into future transactions in foreign exchange has been considered a property right. To the extent the forward exchange contract has a built-in potential gain because of the devaluation or reduction in value of currency, the sale of the contract outside the U.S. can produce foreign source gross income for purposes of absorbing foreign tax burdens.²⁵⁵

255. International Flavors and Fragrances, 62 TC No. 26 (1974).

(e) Income From Intangible Assets

A further technique we found U.S. corporations use to provide foreign source gross income relates to the licensing of intangible assets such as patents, copyrights and similar property. In this particular area, an important distinction has to be made as to the nature of "know-how".²⁵⁶ The term know-how has received wide use but very little definition. In essence, the discussion of the term means a combination of the use of property rights and services. To the extent that know-how relates to services, the source of income treatment depends on that for source of service income. To the extent know-how represents property rights, it can be treated the same as patents, copyrights and other property rights of an intangible nature. The source of income rules in the Code say that income for the use of an intangible asset of this type outside the U.S. produces foreign source gross income. To the extent that U.S. corporations can charge royalties to parties for the use of property of this type outside of the United States, it would produce gross income which would be treated as foreign source income. That is, where the charging of royalties to foreign affiliates

²⁵⁶. Rev. Rul. 64-56, 1964-1 (Part 1) CB 133, as amplified by Rev. Rul. 71-564, 1971-2 CB 179.

(as required under Section 482) is done, if the royalties so charged are deductible at the foreign corporate level and produce foreign source gross income to the U.S. company, it is a means for improving the foreign tax credit limitation picture. As in the case of investment type income, royalties often receive favorable foreign withholding tax treatment under the U.S. tax treaty network. Consequently, to the extent that U.S. corporations are able to charge royalties to subsidiaries located in countries with which we have a tax treaty, there is a possibility of receiving foreign source income incurring little, if any, foreign tax burdens.

Furthermore, there is no requirement that, to get this kind of beneficial results, the royalties need be charged to related companies. U.S. companies can license a foreign company or even a U.S. company and generate foreign source gross income, as long as the royalties are received for the right to use the intangible asset in a foreign country. Thus, there is an impetus to licensing in order to generate foreign source gross income.

Where the transfer involved is not a license but rather the movement of the entire property right to the recipient company, this is considered for U.S. tax purposes as

being tantamount to a sale of personal property. To the extent that the property would be of a type that was purchased by the U.S. corporation, the rules dealing with purchase and sale of personal property would apply. That is, to the extent that the sale was made abroad, it would be considered foreign source income. However, where property was developed through research in the United States, the tax treatment apparently would be analagous to the manufacture in the United States and sale abroad.²⁵⁷ This provides a problem for the U.S. company in connection with the transfer of intangible property rights that it has developed in the United States. Transfers of this type may not improve the foreign tax credit position since they would not be productive of solely foreign source gross income. Consequently, we found the major use of gross income strategies in this area would be via licensing to foreign parties wherever the use is made of the intangible asset outside of the United States.

(f) Leasing-type Income

A corollary to the licensing approach for generating foreign source income is leasing of tangible property. Rentals received by U.S. corporations for the use of property

²⁵⁷. S. Auderleth, "Overseas Licensing of Patents and Other Intangible Property", (Prentice-Hall Tax Ideas, Englewood Cliffs, New Jersey, 1971), pp. 24361-24367.

outside of the United States is considered foreign source gross income. Unlike the case of royalty income, however, U.S. companies generally find that rental income does not receive a very beneficial foreign tax treatment. Our research showed that normally, foreign countries will impose a withholding tax on gross rentals which would very often be more than the U.S. tax on a net rental income. Consequently, rental income is looked upon, in many cases, as being productive of excess foreign tax burdens as opposed to being helpful in absorbing them.²⁵⁸

Furthermore, leasing in general is being looked at as a method of producing overall U.S. tax losses when one takes into account not only the cash flow operating costs to the U.S. companies but also the depreciation on the equipment and interest for financing the lease. As a result, leasing is an area that is productive of overall tax losses in the United States. Similarly, leasing in the foreign area tends to produce foreign source losses which are detrimental to the foreign tax burden situation. Therefore, our research has indicated that, in overall gross income strategies, leasing is not often thought of as a major advantage.

²⁵⁸. J. Guttentag, "Tax Aspects of Foreign Operations", 10 Wayne Law Review 529 (1964).

2. Strategies Regarding Allocations of Deductions to Foreign Source Gross Income

The basic ingredient for computing foreign tax credit limitations is the determination of the amount of United States tax on foreign source taxable income. In this particular case, the word "taxable" income is the key factor. This is because the foreign tax credit limitation formula consists of multiplying the U.S. tax (before foreign tax credits) by a fraction, the numerator of which is the foreign taxable income over total taxable income. Foreign taxable income in turn is a function of foreign gross income and the deductions attributable to that foreign gross income.

We have discovered how U.S. corporations adopt strategies for improving their foreign tax credit limitation position by trying to increase their foreign source gross income. There is a certain amount of variety in those techniques but our research found they are not as complicated as that involving the deduction factor. There is some clarity in the gross income area due to the objective standards in the source of income rules as to what is and what is not foreign source income. There is no such clarity in the U.S. tax rules dealing with the determination of the deductions attributable to foreign source income. Consequently, there is a greater deal of difference

in thinking from the standpoint of U.S. corporations and U.S. government as to what expenses are attributable to foreign source gross income for purposes of computing foreign tax credit limitation.

The rules for determining the allocation of expenses were initially proposed in 1956 as regulations under Section 861 of the Code. It took over a year for those regulations to be finally adopted in October of 1957 even though they only outlined in very simple terms, the principles that (a) deductions properly apportioned or allocated to an item of gross income will be directly attributable to it and (b) deductions which could not be definitely allocated to an item or class of gross income will be ratably apportioned. No specifics were given as to how this was to be accomplished.²⁵⁹ In 1966, the Treasury Department promulgated new proposed regulations. Those regulations were under study until 1973 when in June of that year they were withdrawn. This presented significant confusion to the area of foreign tax credit limitation in that, even though the proposed regulations did not have any official authority, they were in fact being used by corporations and government officials in tax examinations to resolve the questions of foreign tax credit limitation.²⁶⁰ In June of 1973, new proposed

²⁵⁹. Treas. Regs. Sec. 1.861-8(a).

²⁶⁰. Proposed Regs. Sec. 1.861-8.

regulations were promulgated which have received a great deal of comment by taxpayers. It now appears that these regulations may be substantially altered. The difference in these proposed regulations and those of 1966 from the final regulations which were adopted in 1957 is that the two sets of proposed regulations went into greater detail as to how specific items of deductions are to be attributed to items or classes of gross income.

At the present time, there is rather substantial confusion which may account for the somewhat low relationship of deductions to foreign source gross income based on actual company figures. Our research found the relationship of deductions to foreign source gross income does not correlate with the relationship of deductions to total gross income of U.S. companies. This does not mean to imply that the relationships should be the same. However, there is wide disparity and, because of confusion in the area, there is latitude for planning in connection with foreign tax credit limitations for the use of excess foreign tax burdens by adopting strategies involving the allocation of deductions. Consequently, one of the tangible results of our research has been the identification of this disparity and the recognition that the confusion in the area gives rise to planning strategies in the area of absorbing potential excess foreign tax credit burdens.

(a) Manufacturing Costs

In connection with the costs of manufacturing products, the majority of the U.S. manufacturing corporations have accounted for their costs in a manner whereby there is relatively little controversy over the matching of costs and revenues. Costs of sales of inventory is used to reduce sales in arriving at gross profit from sales. Gross profit from sales is the gross income figure for purposes of gross income determinations under the Code. Consequently, in the area of manufacturing, for product costs there would be very little controversy in determining the amount of gross income. To the extent, however, that certain goods are manufactured for foreign markets and others are manufactured for U.S. markets, there would even be a disparity in product costs. As a result, this would have an impact on determination of costs attributable to foreign gross income. Our research indicated that this does not appear to be used as a strategy by U.S. corporations; rather, product costs are fairly much accepted as given. There is, however, general discussion and controversy over the types of expenses that are properly includable in product costs for U.S. inventory purposes. The Treasury Department has over many years investigated this question of what costs should properly be included in inventory. It is

only within the recent past that final regulations in this area have been promulgated and, even in these instances, there are variations in determination of costs that go into the computation of product costs.²⁶¹

(b) Marketing Costs

In the area of marketing costs, we found some strategies are adopted by U.S. corporations in determining the amount of foreign source taxable income. Assuming that gross profits from sales have been determined for a given product, the question becomes what marketing costs must be allocated to those products for purposes of determining foreign taxable income on foreign sales. As we saw earlier, there is the possibility of generating foreign source gross income from purchase and sale of personal property. A major factor then becomes what marketing costs are attributable to those export sales.

In the marketing area, companies generally consider that international or export markets are more marginal in nature. That is, products are developed and markets are developed primarily to serve U.S. customers. Once the product has been perfected and marketing techniques have been developed, U.S. companies feel there is only a marginal or incremental

²⁶¹ Treas. Regs. Sec. 1.471-11.

amount of costs involved in merchandising and marketing the product in the foreign area. Consequently, in determining the amount of expenses attributable to foreign source sales income, some strategies involve cost analyses that allocate to the foreign source export sales only the incremental marketing costs attributable to it. This would account in part for differentials between marketing costs attributable to total gross income of the U.S. company and those attributable to foreign source gross income.

(c) Financial Costs

In the area of financial costs, there is a considerable degree of confusion in the rules dealing with the allocation of costs to foreign source income. Specifically, there has been a general feeling that money is fungible. As a result, some feel it is not possible to directly relate the costs of raising certain amounts of money with the specific utilization of those amounts. Viewed in another way, although there may be some instances where there would be direct connections between the incurrence of interest costs on raising certain funds, the utilization of those funds in the U.S. or in a foreign environment blurs the ability to trace the costs of those funds to the income earned from their employment. The general thinking has been that such causal connections would be difficult to administer. As a result, taxpayer practice as well as Treasury Department

regulations seem to lean more in the direction of apportioning costs of money on some formula basis as opposed to trying to match them directly.²⁶²

In the international area, specifically, as it relates to foreign tax burdens, this makes feasible the development of strategies whereby interest costs on funds that may have been raised for U.S. companies' needs are put in a pool of funds with those interest costs then apportioned to foreign source income on some formula basis. In the past, this formula seems to have been the ratio of gross income from foreign sources to total gross income either from an overall standpoint or from the standpoint of foreign and total gross income arising from the employment of these resources. Where gross income ratios are used, the denominator - namely, the U.S. corporation's total worldwide gross income - is often a significantly large figure. Thus, the ratio of foreign source gross income to total does not result in the allocation of a great deal of interest costs to foreign source gross income.

One particular instance in which costs of money are a substantial factor in the overall foreign tax burden formula is that of banking and financial institutions.

²⁶². Proposed Regs. Sec. 1.861-8(a)(5).

In that industry, the costs of money are a significant factor. In researching the foreign tax credit limitation by types of industries, we saw that the banking industry did show a tendency towards excess foreign tax credits although not as high as might be expected considering the overall basis upon which interest abroad is subjected to taxation. To some degree, these techniques for allocation of interest costs employed by the banking industry has resulted in its ability to absorb substantial foreign tax credits.

(d) Research and Development Costs

An item which is almost equally important with financial costs are the costs of research and development incurred by U.S. corporations engaged in international activities. In this particular case, there is the basic difficulty in matching costs and revenues because of the chronology in which research and development costs are incurred and the fruits of the labors are realized. The tax regulations are structured in such a way as to require the matching of all costs in the current year to all income in the current taxable year. They do not take into account the realization that there are costs incurred in a given year which may really be related to income in future years. From a pure accounting standpoint, this raises the question

as to whether the outlay in question should be considered a period cost or rather should be considered one which is to be capitalized in part and allocated against revenues over its estimated future life. This is the point at which the research and development costs depart in their treatment for tax purposes from classic economic treatment. Section 174 of the Code provides an election whereby U.S. companies may write-off in one year these research and development costs which might be considered under accounting concepts to relate to more than one taxable period. This particular section creates a problem whereby costs which are incurred in a given year - and are permitted to be written off completely for tax purposes - are to be related to income of the current year although there is no causal relationship.

Our research discussed that the research and development cost area is one which begins with a basic inconsistency because there is no logical causal relationship of the expenditure to the income. Given that factor, in many instances, U.S. companies have allocated to foreign source income for foreign tax credit purposes only costs in the current year which are in fact related to the foreign source income in question. To the extent that the new 1973 proposed regulations would require an allocation of all research and development costs, we noted

there would be potential problems of significant magnitude for such industries as the pharmaceutical industry.²⁶³

One area in which planning strategies exist for foreign tax credit limitation purposes is to have the research and development effort conducted outside the United States so that the expenses involved would not be attributable to foreign source income for foreign tax credit purposes. There have been instances in which U.S. companies have diversified their research and development efforts abroad to meet requirements of foreign governments. The foreign tax credit implications of this research and development cost allocation problem presents additional rationale for having research and development expense activity conducted abroad. Some companies feel that this might have an added benefit in that the pressures of the U.S. tax authorities to charge royalties to foreign subsidiaries for use of parent company intangible assets would be modified to the extent that the entities doing the research and generating the intangible assets would be outside the United States. Some U.S. corporations look at this as a possible way of counterbalancing the approaches by U.S. tax authorities by being able to contend that, if royalties are to be charged from the United States to foreign subsidiaries in these circumstances, then royalty expenses

²⁶³. Multinational Firms Resist the Treasury in Major Tax Battle", The Wall Street Journal, September 13, 1974, pp. 1, 18.

should be permitted the U.S. corporations for tax purposes where the foreign subsidiary develops the intangibles and allows the U.S. parent to use the intangibles.²⁶⁴

(e) General and Administrative Expenses

One of the least defined expenses in terms of relationship to gross income is the general and administrative expenses of many companies. The tax regulations present problems in this regard in that these types of expenses generally are not directly related to any item or class of gross income. As a result, since there is no direct causal relationship to foreign source gross income, some companies take the position that these expenses should not be allocated against foreign source income to the detriment of their foreign tax credit limitation. On the other hand, arguments are made by the tax authorities that, since there is no direct relationship of this expense to U.S. source income, they should be allocated and apportioned among U.S. and foreign source income on some formula basis. This particular expense produces potential problems for foreign tax burdens. This is because these types of expenses are very often not deductible in arriving at the foreign tax base for computing the foreign tax burden in the foreign country. Most

²⁶⁴. P. Farber, "Significant Side Effects of Section 482 Adjustments", Proceedings of Public Technical Meeting, (Institute on U.S. Taxation of Foreign Income, Inc., New York, 1965), p. 141.

countries will not permit the deduction against income in their country for expenses of this type which have such a tenuous relationship to the income in question. Consequently, these expenses bear significantly on the foreign tax burden question.

One specific area of contention is the extent to which dividends from foreign subsidiaries which are fairly autonomous should bear any allocation of general and administrative expenses. The U.S. tax regulations proposed in 1966 which were withdrawn in 1973 indicated that where dividends of this type have very little in the way of U.S. effort related to them, only a small amount of U.S. expense need be allocated. However, the structure of the present proposed regulations on which much adverse taxpayer comment has been made indicate that, where an expense cannot be directly related to an item of income, it should be spread over all items of income on some reasonable basis. Therefore, U.S. corporations in their tax planning analyze these costs and try to directly relate them to U.S. source income for purposes of providing relief from foreign tax credit burdens.

(f) Bases for Allocation and Apportionment of Deductions

The final area dealing with the strategies for allocation of deductions to foreign source gross income is the matter of bases for allocation and apportionment of the

foregoing types of expenses to foreign source income. We found one standard formula has been the ratio of foreign source gross income to total gross income. Expenses of certain types might be more reasonably allocated to foreign and U.S. source gross income on different bases. The regulations give cognizance of the fact that a reasonable basis of apportionment consistently applied by the taxpayer will be respected by the tax authorities. Consequently, U.S. corporations seeking to present the best picture from the standpoint of foreign tax credit limitation have searched out various methods for allocation of expenses and sought to utilize them to avoid the allocation of too great an amount of expense to foreign source income.

In this connection, the regulations recently proposed have noted that, where there are disparate types of income, cognizance has to be given to that factor in apportioning expenses. For example, where research and development costs are to be allocated to U.S. and foreign source income, an allocation based on gross income ratios may not be proper. That is, where foreign source income in this area consists of royalty income and U.S. source income consists of gross profit on sales, there would have to be some restructuring of these disparate types of income in order to avoid allocations based on inappropriate methods. U.S. corporations have still to come to grips with this concept in filing tax returns.²⁶⁵

²⁶⁵. Proposed Regs. Sec. 1.861-8(a)(3).

3. Structural Considerations in Planning for the Utilization of Foreign Tax Burdens

After reviewing the strategies utilized by U.S. companies in absorbing excess foreign tax credits, we saw that companies at times were not able to generate sufficient amounts of foreign source gross income nor control the allocation of deductions to their foreign source gross income in sufficient degrees to avoid excess foreign tax burdens or at least the potential thereof. Consequently, they were forced to reconsider ways in which the present structure of their foreign operations were conducted in order to plan for the utilization of foreign tax burdens.

(a) Foreign Subsidiaries and Deferral of U.S. Taxation

We found the initial step in this planning usually consisted of utilization of foreign subsidiary entities because of the deferral of U.S. taxation on the earnings of such subsidiaries until such time as they are repatriated to the U.S. in the form of dividends. The deferral of U.S. taxation in these instances permits the U.S. corporation to have the element of timing under its control from the standpoint of repatriation of foreign earnings. We saw that in those instances where excess foreign tax credits were produced, in many cases it was due to the deemed paid credit coupled with foreign withholding

taxes on dividend income. The indication was that companies would avoid situations where they would be subjected to deemed paid as well as foreign withholding taxes on dividends. We also noted that the foreign tax on foreign subsidiary earnings of U.S. corporations are, on the average, somewhat lower than the U.S. corporate tax rate. This means the existence of foreign subsidiaries with low tax rates as well as those with high tax rates. To an extent then, if U.S. corporations can control foreign subsidiaries whose earnings are deferred from U.S. taxation until repatriated, the U.S. corporations will be in a position to decide the most appropriate period when dividends should be paid from foreign subsidiaries having low tax burdens in order to absorb excess foreign tax credits. As a general rule, where foreign tax burdens are a problem, one strategy involves restructuring using foreign subsidiaries so as to give the U.S. corporation the ability to time the distribution of earnings of foreign subsidiaries and control the utilization of foreign tax credits.

A further element in restructuring foreign subsidiaries involves the recognition that not all earnings are remitted to the United States, not even eventually. It is a rare instance that one finds all the earnings and profits of foreign subsidiaries being repatriated to the United States even

over the long run. This is because foreign subsidiaries need a certain amount of capital to meet their ongoing needs as well as expansion. The recognition of this factor - that a certain percentage of earnings will be plowed back even in the long run - gives further impetus to the sheltering of foreign earnings in foreign corporate entities. In this way, the U.S. company can selectively extract earnings from foreign subsidiaries in a manner which gives them the most advantageous use of foreign tax burdens.

As we saw in our research, if all of the earnings of foreign subsidiaries of U.S. companies were distributed, there would be a build-up of excess foreign tax credits. Consequently, the utilization of foreign subsidiary structures can tend to create an overhang of potential foreign tax burdens. Although it is true that all these earnings will not be paid out of the foreign subsidiaries, a significant pay-out would produce excess foreign tax burdens in many cases. This, then, raises the question as to whether the need of structuring foreign subsidiaries to utilize excess foreign tax burdens creates a balance of payment problems from the standpoint of forced retention of earnings.

We found a basic strategy in the utilization

of foreign tax burdens has as its objective the creation of pockets of low taxed foreign source income which can be paid out as dividends to the United States corporation so as to be able to absorb potential excess foreign tax burdens. One extension of this strategy is the planning to accommodate distributions from countries where current repatriation is desirable. For example, the Federal Republic of Germany has a two-tier tax system which levies a much lower rate of German tax on distributed profits. A U.S. corporation with a subsidiary in Germany would want to repatriate the profits on a current basis so as to keep the German rate of taxation at its lowest point. The knowledge that these distributions would be made in order to keep German taxation at a low point would not necessarily mean the desire to have those dividends flow to a U.S. corporation thereby losing the advantage of deferral. Consequently, intermediate foreign subsidiaries are sometimes used in order to keep the German tax down but still provide a deferral strategy.²⁶⁶

(b) Utilization of U.S. Subsidiaries

Another use of structural considerations we found in planning for foreign tax burdens would be the utilization

266. Taxation In The Federal Republic of Germany - World Tax Series, (Harvard Law School International Program in Taxation, Commerce Clearing House, Inc., Chicago, 1963) Section 12/2.1, pp. 624-629.

of U.S. subsidiaries in a consolidated U.S. tax return. We mentioned the fact that the tax regulations require the allocation of deductions to foreign source gross income as a requisite for computing the foreign tax credit limitation. This must be computed on a company by company basis in the consolidated U.S. tax return. The Internal Revenue Service has issued published pronouncements to the effect that, in computing the foreign tax credit limitation in a consolidated return, the amount of gross income from foreign sources and the deduction attributable thereto are to be determined on a company by company basis.²⁶⁷ This particular rationale has worked to the disadvantage of U.S. based multinational corporations that have utilized international finance subsidiaries to borrow substantial funds in the Euro-dollar market. This is because these borrowings have been structured in such a manner - to avoid U.S. withholding tax on the interest - as to require the use of a separate U.S. subsidiary. These U.S. subsidiaries have a high degree of their gross income from foreign sources so that when they, in turn, pay interest expense they are not required to withhold U.S. taxation on the interest payments to foreign parties. With this type of U.S. corporate structure required, a U.S. corporation is created

²⁶⁷. Treas. Regs. Sec. 1.1502-4(d)(1).

with a high degree of gross income from foreign sources but with also a very substantial degree of interest expense. Because of this, there is an automatic allocation of these expenses to gross income for the computation of foreign taxable income. The net effect of this on U.S. corporations has been a reduction of their limitation for foreign tax credit purposes.

A strategy for utilization of U.S. subsidiaries consists of adopting this approach where U.S. subsidiaries can be created with a low ratio of expenses to gross income but where a subsidiary has a high degree of foreign source gross income. Consequently, the creation of U.S. subsidiaries for export operations for licensing operations and for financing operations have been considered by companies in order to try to utilize situations where, in a consolidated tax return, there is the ability to structure a U.S. subsidiary with a low ratio of expenses to foreign source gross income.

(c) Foreign Acquisition Implications

Where the restructuring of existing operations is not productive of a complete answer to the utilization of foreign tax burdens, we found some U.S. companies have moved into the area of foreign acquisitions. One approach that has been used where a company has potential for excess foreign tax burdens is the acquisition of foreign companies with foreign

earnings subjected to low rates of foreign taxation. The attraction in this particular case is that, if the overall acquisition is desirable from a business standpoint, the fact that there are accumulated earnings having suffered a low rate of foreign tax would not be detrimental. This is because the earnings can be repatriated to the United States without U.S. tax on the dividends through the utilization of the excess foreign tax credits that have accumulated in the acquiring company.

There is a corollary to this acquisition aspect. Where a U.S. company does not have excess foreign tax credits, it may still be desirous of searching for acquisitions of foreign corporations which have been subjected to high rates of foreign tax. This is because the foreign taxes paid by the foreign corporations prior to their acquisition by the U.S. company are still available as deemed paid credits to the U.S. company upon the distribution of the earnings. A U.S. corporation can acquire a foreign corporation which had a fair amount of cash and accumulated earnings subjected to foreign taxes and pay out those earnings without a significant amount of U.S. taxation because of the deemed paid credit. With the earnings thus repatriated, the company would be able to satisfy its obligations on the purchase price and have achieved a boot strap acquisition of

the foreign subsidiary through the medium of utilizing foreign tax credits.

(d) Foreign Reorganization Implications

The final area we examined in restructuring of operations for foreign tax burden purposes involves the avoidance of multiple tier structures through reorganizations. We have seen that deemed paid credits through various tiers of foreign subsidiaries tend to proliferate the amount of foreign tax burdens. In order to avoid the potential for excess foreign tax burdens, U.S. companies look to avoid numerous tiers of foreign subsidiaries because of the excess foreign tax burden problems they impose. Consequently, reorganizations by U.S. based multinational corporations of their foreign operations are not uncommon. In addition to the avoidance of multi-tiered structures, reorganizations have been created by using holding companies abroad for foreign subsidiaries.

The use of holding companies abroad produced by reorganizations give the benefits of deferral described earlier. Although there are provisions in the Code enacted in the Revenue Act of 1962 that would impute to U.S. shareholders dividends from second tier subsidiaries to first tier holding companies, holding companies have been structured so as to have a sufficient

degree of operating income to buffer the imputation of the dividends to the U.S. shareholders.²⁶⁸ An alternative for the very substantial U.S. based multinational corporations is the minimum distribution relief which essentially permits the avoidance of the 1962 Revenue Act imputation provisions where the worldwide effective foreign tax rate of the subsidiaries is at least 90 percent of the U.S. tax rate.²⁶⁹

In essence, then, the reorganization of foreign structures to permit the use of holding companies allows for a flow of funds for U.S. companies in the international area to produce the least amount of foreign tax burdens while yet respecting the deferral of U.S. tax. In tax planning for multinational corporations, the general rule appears to be that where the foreign subsidiary is engaged in business in a high tax rate country, its ownership is directly by the U.S. parent or some U.S. affiliate. However, where the rate of tax is low, it suggests an advantage of structuring the organization so as to come under a holding company to take full advantage of the U.S. tax deferral aspects described earlier.

One problem area in the reorganization of

268. Section 954(b)(3) of the Code.

269. But, this relief was abolished by the Tax Reduction Act of 1975, Section 602(a), which repealed Section 963 of the Code.

foreign structures to reduce foreign tax burdens is the requirement to get rulings from the Internal Revenue Service in advance of the transaction.²⁷⁰ In order to prevent tax avoidance where a foreign corporation is involved in a reorganization, Section 367 of the Code requires that the taxpayers get an advance ruling that tax avoidance is not involved. If the advance ruling is not obtained, then even though the underlying transaction has in fact met the requirements of a tax free exchange, it will not have the tax free attributes that a reorganization would enjoy. While this may not seem to have much application to reorganizations of foreign corporations, in fact, it does since the Subpart F provisions of the Revenue Act of 1962 treat any exchanges of shares of foreign affiliates in a reorganization as producing capital gains on exchanges of securities which would be imputable type income.²⁷¹

Given the fact that an advance ruling is required, the guidelines issued by the Internal Revenue Service for granting such rulings are such that to effectively reorganize foreign corporate structures requires a so-called "toll charge".²⁷² This involves paying a U.S. tax on the unremitted earnings of the

270. Section 367 of the Code.

271. Rev. Rul. 64-157, (1964-1 Part 1) CB 139.

272. Rev. Proc. 68-23, 1968-1 CB 821.

foreign subsidiaries. In a way, this requirement retards the ability of U.S. companies to restructure foreign operations. As a result, there are instances where foreign structures exist which are productive of a higher foreign tax burden than might normally be the case because the price of restructuring to achieve foreign tax economies may mean the payment of U.S. tax on the accumulated earnings of the foreign subsidiaries.

C. Planning for Utilization of Foreign Tax Burdens

We have now reached the point of our study whereby we have been able to distill from our data base a series of trends indicating the impact that foreign tax burdens are making on U.S. based multinational corporations. We have seen this from the standpoint of excess foreign tax credits, carryovers of foreign tax credit burdens, industrial classifications, size of U.S. companies, countries in which various burdens occur, the impact of tax treaties, the relationship of expenses to foreign gross income, as well as the examination of types of income that are productive of high foreign tax burdens, the relationship of foreign tax burdens in developed and less developed countries, and the impact of foreign tax burdens on a balance of payments considerations. We have analyzed the varying foreign tax rules in major countries accounting for the disparities in foreign

tax burdens, and the differences in the foreign tax burdens on U.S. corporations from a tax and accounting standpoint.

Based on these examinations, we were able to examine more closely the approaches which U.S. corporations have been using to respond to these impacts of foreign tax burdens on their overall foreign operations. We have seen how they work from a gross income, deduction and structural standpoint. It is now fitting for the culmination of our research that we look at some particular case study situations to see how tax planning for utilization of foreign tax burdens is done by particular companies in specific areas.

In order to provide more precise insight into the approach used by U.S. corporations in managing their foreign tax burdens, it is important to delve into the problem of a given company's approach to the problem. Our data base provided us with that intimacy and, as a result, we will now look at the specific case studies of certain companies in the data base in order to give the statistical conclusions we have reached a firm rooting in particular company experiences. In so doing, our study provides a look into experiences of U.S. companies which governmental studies cannot provide.

1. Specific Case Studies

(a) U.S. Banking Institutions

Our study indicated that in the case of a particular company in the banking industry, one major problem which it faced was the fact that its foreign tax burdens were incurred through withholding at the source by foreign countries on interest payments from foreign corporations.

The fact that the U.S. banking institution was subjected to foreign taxation by withholding on gross income produced a situation whereby it had to analyze the amount of foreign taxable income generated using U.S. tax standards. One of the main points noted in this analysis was the interest cost attributable to the foreign source income. Under the concept of the fungibility of money, the company was able to ascertain that the overall cost of funds when related to the total funds raised provided a low average cost of funds taking into account demand deposits without interest costs. That cost was substantially less than the cost of lending. As a result, there was a sufficient spread between the gross income from lending and the cost of money to provide a margin of foreign source gross income less interest expense deduction to accommodate the foreign tax on a withholding basis.

In connection with the bank's foreign branch operations, there were certain situations where income of a foreign branch was matched off against the cost of the branch. The operating expenses of the branch were attributable to the foreign source gross income of the branch. However, it was also noted that branches were used to raise funds for lending back to the United States head office. As a result, in computing the expense of the foreign branches attributable to income, there was taken into account the income on the funds that were sent back to earn U.S. source income. In essence, then, the total expenses of the foreign branches were not attributed to foreign source income but rather only the portion attributable to the U.S. destined funds were allocated to U.S. source income.

In the area of leasing, the U.S. bank found that leasing operations in foreign areas were a detriment to their foreign tax burden situation because of the fact that they created an excess of deductions over foreign source gross income. Since this bank used the overall method for computing its foreign tax credit limitation, this had the effect of reducing its foreign tax credit limitation. Because of legislative changes in this area in 1971, there is a rule whereby leases of this type involving U.S. manufactured goods can be structured in such a way as to be considered tantamount to a loan to a U.S.

obligor.²⁷³ Advantage was taken of this statutory provision so as to treat this income not as foreign source loss from rentals, but rather U.S. source income from lending of funds. This, in effect, removed the leasing losses from the foreign tax credit limitation which would otherwise have been detrimental to the bank.

An additional area where foreign tax burdens arise was in the so-called net loan situation. That is, it is not unusual for U.S. banks to make loans to foreign parties with the contractual understanding that the foreign parties bear the cost of all foreign taxes. Notwithstanding this private arrangement between the two parties (the borrower and the lender), the foreign tax law cannot be changed by this private contract. Consequently, for U.S. tax purposes, these banks will often increase the actual amount of interest income they earn by the amount of foreign tax attributable to it, and claim the foreign tax as a credit. This has a tendency to increase the total amount of foreign tax credit being claimed even though the contractual arrangement contemplates a different rate of return. In this case, the foreign tax credit becomes an additional benefit to the U.S. banking institution.

273. Section 861(e)(1) of the Code.

In connection with the bad debt deduction which is a significant item in the computation of overall taxable income of banking institutions, this bank used the flexibility in computing the amount of bad debt deduction attributable to foreign source income by taking into account the amount of foreign loans that were actual write-offs. In this particular case, the bank was only adding to their bad debt reserve the amount of actual write-offs. To the extent that actual write-offs overseas were at a low point, it reduced the amount of bad debt deduction considered attributable to foreign source income for purposes of the foreign tax credit limitation.

In the foreign exchange area, this bank viewed the transaction as a purchase and sale of personal property where the foreign currency was sold abroad so that the treatment of the gains served to enhance the ability of the banking institution to absorb any potential excess foreign tax credits.

This particular financial institution generated more than 70 percent of its taxable income from foreign sources, with the income being spread over more than twenty different countries. Its U.S. tax before credits was offset by foreign tax credits to the extent of 84 percent, by investment tax credits to the extent of 7 percent, leaving a U.S. tax to

be paid of about 8 percent. The bank's effective foreign tax rate was 35.6 percent made up of directly paid foreign taxes to the extent of 75.6 percent and deemed paid credits to the extent of 24.4 percent. The bank did not have any carryovers of excess foreign credits from prior years. The conducting of operations through a United Kingdom branch provided a high amount of the direct foreign taxes paid, accounting for some 80 percent of the total taxes paid. Those taxes paid in the United Kingdom through the operation of a branch was at a rate of 50.9 percent. The reduction in the effective tax rate from this point was due in great part to the fact that it made loans directly to borrowers in countries imposing a low withholding tax. This generated foreign interest income with a foreign tax rate at a low level. This enabled it to average down its foreign tax on foreign taxable income so as to absorb the higher rates incurred in the United Kingdom.

In connection with these direct loans made abroad, there was a ratio of expenses to foreign source gross income of approximately 38.4 percent with the reciprocal of 61.6 percent representing the profit margin for purposes of the foreign taxable income calculation. A further complexity in the foreign taxable income computation was the fact that one of the

domestic subsidiaries had a net foreign source loss because of the excess of the deductions of the company over foreign gross income. This had the effect of reducing the foreign taxable income in the consolidated tax return even though the particular subsidiary generated almost 30 percent of the foreign tax burdens through direct and deemed paid credits. In essence, this situation whereby foreign countries impose their taxation notwithstanding the fact that the U.S. company has a loss using U.S. standards, aggravates the ability of U.S. companies to absorb these credits. In this particular case, the financial institution was able to achieve this objective by the generation of low taxed foreign source income from direct lending from the United States to foreign obligors. Some of the specific mechanisms whereby this is achieved is discussed above in Section B of this chapter on "Planning for Utilization of Potential Excess Foreign Tax Burdens."

(b) U.S. Insurance Corporation

In the investigation of a particular U.S. company in the insurance industry, it was noted that the structuring of their foreign operations are such that it would have foreign subsidiaries which were admitted to the practice of insurance in foreign countries. However, it utilized reinsurance

of local country business in order to achieve foreign tax economies.

In the case of the insurance corporation, we noted that exposure to foreign tax burdens exist primarily because of the taxes that must be paid by subsidiaries in countries where the insurance is written. The rules regarding insurance taxation in the United States are extremely complex. As a general rule, the tax burdens that U.S. corporations in the insurance industry have paid on their U.S. operations have not been as high as U.S. companies overall.²⁷⁴ Consequently, one part of the foreign tax burden problem is the erosion of the U.S. tax base because of the multiple ways in which U.S. tax liabilities are calculated.

For this reason, the ability of such companies to engage in reinsurance contracts utilizing companies in low tax environments is an advantage in planning to keep their foreign tax burdens low. In this particular case, we noted that subsidiaries in low tax countries were reinsuring some of the coverage that the foreign subsidiaries were entering into directly. This gave the company the ability to average down the effective rate of foreign tax that the company was paying on its overall operations. Its ability to move insurance coverages around the

²⁷⁴. Section 821-826, 831-843 of the Code.

world through reinsurance was a prime factor in the ability of this company to keep its foreign tax burdens down to a level which could be absorbed within the limitation.

In the case of the particular insurance company examined, the company's taxable income base was computed on the basis of taxable investment income which was substantially reduced by insurance underwriting deductions. The company conducted activities in many foreign countries, and its foreign taxable income accounted for some 56 percent of the total taxable income. The company's effective foreign tax rate amounted to 41.1 percent with the major portion coming from the United Kingdom and from Canada. The effective foreign tax rate was composed in major part of direct taxes paid by the U.S. company directly to foreign countries with very little in the way of deemed paid credits.

There was a minor portion of the foreign tax burdens consisting of excess foreign tax credits for prior years. In the current year, the insurance company used not only all of the current years' foreign taxes as credits but also absorbed almost all of its carryover from prior years. The use of an offshore tax haven subsidiary permitted it to average down what would have been an unabsorbable amount of foreign tax for U.S. foreign tax credit purposes.

(c) U.S. Natural Resource Corporation

The problem of this particular company in the oil and gas industry was a combination of the ability to minimize its overall U.S. tax burden through utilization of percentage depletion and intangible drilling costs coupled with the fairly high rates of foreign tax that were being imposed by foreign jurisdictions on the basis of taxable income calculations which did not coincide with U.S. bases of taxation. The company in question did demonstrate an excess foreign tax credit which was accounted for in part by the fact that the tax liability in the foreign countries in which it was operating were computed in part by posted pricing. We saw earlier in our study how posted prices worked and this was the situation in the case of this particular company. The particular areas in which this company was operating resulted in a fairly substantial excess of foreign taxes over U.S. taxation on the oil and gas operations.

This particular company was using the per country limitation on the foreign tax credit. As a result, it was able to separate the losses in certain countries from the high taxed profits it was generating in other countries. If the overall limitation had been used, there would have been an even greater excess of foreign tax credit. This is because

losses in certain countries would have offset the foreign taxable income in the profitable countries. In the course of our analysis, it did seem that the company in the natural resource industry was in a quite different position vis-a-vis most of the other companies in our data base so as to really have separate consideration as far as foreign tax burdens were concerned. That is, this industry's combination of methods of computing the U.S. tax base coupled with the very peculiar methods of computing foreign tax burdens put it in a category of foreign tax credit considerations apart from most other industries.

This particular company had an effective U.S. and foreign tax rate of 33.7 percent computed by relating the tax before credits on the tax return to net income per books before the provision for federal income taxes and foreign income taxes. Of that tax figure, approximately one-half was accounted for by foreign taxes. These figures can be compared with those produced by the "Analysis of Tax Data on Seven Major Oil Companies" prepared for the Senate Permanent Subcommittee on Investigations and released by Chairman Henry M. Jackson (D. - Washington) in December 1974. In Senator Jackson's study, the effective tax rate of the seven major oil companies for the years 1968 to 1972 ranged from 22.4 percent to 33.1 percent. In those years, the

foreign income tax component of the effective tax rate varied from 78.5 percent in 1970 to 88.6 percent in 1969. In general, however, it can be said that the erosion of the tax base for the resource companies seems to be quite different than that which exists for U.S. companies in general, and that the foreign tax burden seems to extinguish a substantial amount of their total tax burden. The particular company for our review carried excess foreign tax credits into the current year and generated additional excess credits in the current year before carrying it forward into later years. At the present time, it has not been absorbed (these excesses) which indicates that the foreign taxes being generated by this company exceeds the U.S. tax being generated related to the foreign taxable income. The company uses the per country limitation because losses are generated in other countries in which it is conducting exploration work. This means there would be an even greater excess foreign tax burden if the overall limitation were utilized; a requirement that will begin in 1976 due to the Tax Reform Act of 1975.

(d) U.S. Pharmaceutical Industry Corporation

In reviewing the situation for this particular company, we noted that foreign taxes played a substantial role in its overall operations. The company had opened significant

manufacturing operations outside the United States and conducted operations in the major countries of the world including countries which offered tax incentives for manufacturing. In computing its foreign tax credit limitation, we noted that a certain amount of research and development costs were attributed to foreign source income but not in relation to the overall ratio of research and development costs to gross income. In addition, the company had a rather substantial cost of funds but did not allocate a substantial portion of them to foreign source income because of the fungibility theory discussed earlier in our research. The ratio of foreign tax to foreign source income was higher from a tax standpoint than the ratio of foreign tax to foreign source income from an accounting standpoint. From an accounting standpoint, the operations conducted by the company showed a rather significant difference between the effective foreign tax rate and the 48 percent U.S. statutory rate.

This particular company conducted operations in Mexico, Canada, Australia, South Africa, Argentina, Switzerland and the Netherlands. It generated approximately 22 percent of its income from foreign sources and it had an effective foreign tax rate of 34.9 percent. Its foreign tax credit did not consist of any carryovers from prior years. Rather, it consisted of

46.4 percent direct credit and 53.6 percent deemed paid credit from foreign subsidiaries. In examining the relationship of foreign tax to foreign taxable income, it was noted that the relationship of deductions to foreign gross income was approximately 11 percent. That is to say, the ratio of foreign taxable income to foreign gross income was 89 percent, an extremely high ratio. Had this ratio not been so high, then there would have been exposure for this company to have a significant excess of foreign taxes over U.S. tax. This particular insight into the relationship of deductions to foreign gross income reflects a particularly unsettled area in the U.S. tax system relating to the utilization of foreign tax burdens as we saw it in Chapter I. This computation of foreign taxable income is extremely intricate and one which needs a considerable amount of research in its own right.

(e) U.S. Shipping Corporation

In connection with the review of companies in the shipping area, we noted an extremely low foreign tax burden. Companies in this industry do not appear to have exposure to a significant degree of foreign taxes. Similarly, a provision in the Code protects them from imposition of U.S. taxation on their foreign operations.²⁷⁵ Consequently, in reviewing the case 275. Section 883 of the Code.

study for this particular company, its overall tax burden is low because of the ability to incorporate ships under foreign flag, have them owned by foreign corporations and have them operate effectively on a low or tax free basis in most countries of the world. The companies in this industry do not generally find themselves with a significant foreign tax burden situation and, as in the case of this company, are able to produce substantial amount of foreign source income without incurrence of substantial amounts of foreign tax.

This particular company in the shipping business generated over 30 percent of its income from foreign sources. The effective foreign tax rate on its foreign source income was 21.3 percent which is a fairly low effective rate. The company conducted this activity throughout the world in various forms but generated the majority of its foreign tax in Australia, Canada, Mexico, New Guinea, Philippines, as well as numerous Latin American countries. The companies' foreign tax burdens consisted of 18 percent from direct credits, 67.2 percent from deemed paid credits with the balance from carryovers from prior periods. The company had excess credits from Australia which it was able to utilize in the current year. It had excess credits generated in the current year as well as carryovers from Canada. It was not

able to utilize all of the taxes incurred in the Philippines in the current year and, consequently, had carryovers to succeeding periods from the current year. In essence, however, this company was able to carryover a fairly significant portion of its foreign tax credits and utilize them in the current year. Because of its overall low effective foreign tax rate, the company did not seem to be particularly burdened by its foreign taxes incurred.

(f) U.S. Entertainment Industry Corporation

In the case study conducted on a company in the entertainment industry, several particular points were noted. This company incurred foreign tax burdens because of the fact that taxes imposed by foreign countries on distribution of theatrical productions in their country are imposed on a negotiated tax basis. For example, in many cases, the countries are not in a position to compute a true net income figure for the costs of producing and financing a motion picture film and demonstrating it around the world. Consequently, the basis for assessment of foreign tax is very often the result of arbitrary assumptions of expenses related to gross incomes and the computation of tax on that figure. As a result, these companies are often in a position of having to negotiate with foreign governments on a

periodic basis as to proper amounts of deductions attributable to income they generate. As a general rule, the foreign taxes are being levied in a good number of instances on a quasi-gross income calculation. Thus, there is the danger of excess foreign tax credits. Furthermore, the particular company in question was in a situation where the U.S. tax base had been eroded by operating losses. As a result, the U.S. tax base against which the company was applying its foreign tax credits was reduced below the normal relationship of U.S. tax to U.S. income, reflecting the overall shifting of profitability in this industry in general. There is the extremely high cost of producing theatrical entertainment without the assurances that it would be profitable. This particular company reflected a high foreign tax burden due in great part to the combination of the basis for imposing foreign taxes and the U.S. tax base reduction.

This particular company generated 86.9 percent of its taxable income from foreign sources, thus indicating a substantial amount of activity abroad. The foreign tax rate was 49.9 percent which resulted from activities conducted in the United Kingdom, Canada, Mexico, Australia, South Africa, Ireland, Argentina, Puerto Rico, Costa Rica, El Salvador, Japan, Brazil, Guatemala, Germany, New Zealand, Colombia, Venezuela, Chile, Peru,

Spain, Philippines, Portugal, Uruguay, Taiwan, Ecuador, Switzerland, Jamaica, Dominican Republic and Netherlands. Of its tax burdens, 84 percent consisted of direct tax credits; 6 percent deemed paid credits and 10 percent consisted of carryovers from prior periods.

Because of the high effective rate, the company continued to have carryovers from the prior years into the future years but it was able to absorb all the tax occurred in the current year in its foreign tax credit mechanism. Because of the variety of income in the current year, it was able to blend excess credits in such countries as El Salvador, South Africa, Japan, Brazil, New Zealand, Peru, Chile and Netherlands against excess limitations from other countries.

(g) U.S. Computer Industry Corporation

This particular case study pointed up several interesting elements in the foreign tax credit area that applies to this industry. As a general rule, in the international area the company preferred to sell its equipment but found that leasing is the approach that has to be used for competition purposes. That is, the state of the science of computer usage has grown to such an extent that customers prefer to lease equipment. In that way, they are able to keep up with technological changes as they

take place. This, then, requires the formulation of foreign subsidiary structures because the payments of lease rentals across borders produces a rather substantial foreign tax burden based on gross income. This particular company had subsidiary companies in each major country around the world where its computers were being utilized. The company's foreign subsidiaries were basically not paying a significant amount of foreign tax in relation to their gross income because of the depreciation write-offs of the equipment that was owned by foreign subsidiaries for leasing to customers. The U.S. company's foreign source income was generated to a substantial degree by withholding of tax on interest and royalty payments from affiliates in the foreign countries. In reviewing the data of this company, we noted its biggest exposure to foreign tax credit limitation was the amount of research and development costs that were being allocated to foreign source gross income even though there was no causal relationship between the research and development costs of the current year and the royalties being received in the current year. This was the case of a company which was still in process of trying to penetrate markets in certain areas of the world in competition with another U.S. corporation which had a dominant position in most of the countries where this company was trying to establish some market

penetration. Consequently, the international aspects of the business was not as profitable in this particular time as it might be so the overall foreign tax burden problem was not as complex.

This particular company generated income from Australia, Austria, Bahamas, Belgium, Canada, Denmark, England, France, Israel, Italy, Japan, Korea, Mexico, the Netherlands, Norway, Portugal, Puerto Rico, Spain, South Africa, Sweden, Thailand, Taiwan, Viet Nam and West Germany. Its foreign taxable income consisted of over 90 percent of its entire taxable income, thus indicating a significant amount of activity abroad. Its effective foreign tax rate consisted of only 18.7 percent which was due in great part to the fact that much of its income is received directly from foreign affiliates through leasing and financing transactions. Of the foreign taxes available for credit, over 83 percent was direct credits with the balance being deemed credits. There were no carryovers from prior periods and because of the low effective rate, the company was able to utilize all the credits in the current year. The company did have excess credits on an individual country basis in Belgium, Mexico, Taiwan and Australia. However, the excess limitations in other countries of a group offset the potential excess credits from these countries.

(h) U.S. Multi-Industry Corporation

In one of our case studies, we noted a company that was in several industries with each industry contributing a fairly significant portion to the overall operations. Basically, the company was receiving a fairly substantial amount of foreign tax credits primarily from the deemed paid credits from foreign subsidiaries. The multi-industry corporation, therefore, had to keep its foreign tax burdens from going into excess because of deemed paid credits through licensing of intangible assets and extraction of profits in the form of interest payments from subsidiaries. The combination of royalty and interest income, subjected to very low rates of foreign tax, were enough to absorb the excess credits generated by dividends carrying deemed paid credits. The company used tax treaties to a significant degree to avoid withholding taxes on royalty and interest payments as suggested in earlier parts of our study.

This company generated 39.1 percent of its income from foreign sources and generated it in over 40 countries. Its effective foreign tax rate was 37.4 percent which was substantially within the U.S. effective rate on foreign source income of 47.8 percent. Its foreign tax credit consisted of approximately 59 percent from direct taxes paid or accrued

and 41 percent from deemed paid credit sources from subsidiaries. The company has no carryback or carryover of foreign tax credits and was able to utilize all of the credits incurred in the current year within its foreign tax credit limitations. The company did generate excess credits on a per country basis in Canada, Germany, India, Mexico, but was able to absorb them in the excess limitations of other countries in which it generated its income. The excess credits which were created were due to deemed paid credits on dividends from subsidiaries in the countries indicated above. However, the substantial income from subsidiaries which it received in the form of royalty and interest income more than absorbed the excess credits from dividends.

(1) U.S. Real Estate Corporation

This company was engaged in the development and sale of real estate as well as the operation of real estate oriented facilities. Its foreign tax posture was predicated in part on the fact that its basic problem was in coordinating the tax basis from the foreign country with the U.S. tax basis. That is, foreign countries were assessing tax on the basis of sales of real estate without taking into account many of the costs incurred on activities in the United States in developing the designs for the property. As a result, the company was in an

excess credit position primarily because of the inability to get the U.S. costs accepted for foreign deduction purposes. Yet, these costs had to be allocated to foreign source income under the foreign tax credit limitation formula. The corporation further had the problem of overall U.S. tax write-offs. In the area of carrying costs, in order to be able to avail itself of U.S. tax deductions for potential foreign losses in the early years, it structured its operations in branch form. However, in computing overall foreign source taxable income, it had to offset against foreign source gross income the deductions for interest costs and other construction costs against its U.S. taxable income. While this gave it a reduction of tax liability in the United States, it also reduced the basis for limitation of foreign tax credits in the United States.

(j) U.S. Construction Corporation

This particular company was engaged in operations in a number of foreign countries and was incurring taxation in those countries on a formula basis. That is to say, the contracts were primarily with governmental bodies which provided for a certain contract price. The costs involved in the operation from a standpoint of overall U.S. tax deductibility were considerably higher than the costs permissible for computing

foreign tax liabilities. Consequently, the ingredients which we saw from the construction industry overall were embodied in this particular case study in that the exposure to excess foreign tax credit generally present in the industry were present here. A further major consideration was the fact that the company was on an overall limitation for its foreign tax credit but had experienced excesses of costs over revenues on certain foreign projects which had the effect of reducing the overall limitation.

In the case of this company in the construction industry, it generated income in Chile, Japan, Mexico, Korea, Canada, Taiwan, Brazil, Bolivia, Peru, Argentina, Australia and Zambia. Over 50 percent of its income was generated in foreign countries and, on it, incurred an effective foreign tax rate of 73 percent. The foreign tax which it generated per its tax return consisted of 40.1 percent direct credits, 39.6 percent from deemed paid credits and 20.3 percent from carryovers for prior periods. It incurred excess credits in most countries in which it generated income because of the manner in which foreign taxable income must be computed using U.S. standards. Statutory rates in most of the countries in which it was operating were less than the effective rate, because costs incurred outside the country of construction had to be allocated to the

foreign gross income for purposes of determining foreign taxable income in computing the foreign tax credit. This resulted in its reporting a lesser amount of foreign taxable income for U.S. foreign tax credit purposes than would have been reported for foreign income tax purposes. Furthermore, the company had U.S. losses which under the overall limitation, also reduced the U.S. tax base against which the foreign taxes could be used as a credit.

(k) U.S. Retail Corporation

A fairly substantial U.S. corporation involved in the retail business was studied to see the trends involved in its foreign tax credit position. Basically, the company was on a per country limitation and was having a classic relationship of taxes to income in the countries where it was paying tax. The reason for the per country limitation was that it had established extensive expansion operations overseas in the form of branches and was deducting the losses from those foreign branch operations for U.S. purposes. Even for foreign tax purposes, it was not reporting profits and so its foreign tax credit planning consisted of using the per country limitation to avoid the losses in certain countries from offsetting the foreign taxable income in other countries.

This particular company was generating 65.7 percent of its income from foreign sources. Since it suffered losses in certain countries such as Belgium and Italy, it utilized the per country limitation for purposes of its foreign tax credit limitation. Its effective foreign tax rate based on the aggregation of total taxable income to foreign tax burden was in excess of the 48 percent, U.S. statutory rate in that it totalled 62.4 percent. This foreign tax burden was composed of 15.1 percent direct credit, 81.7 percent deemed paid credit and 3.2 percent carryover from prior periods. Because of the high effective rates and the fact that it was still required to incur taxes in countries where it was generating losses, only 75.6 percent of the foreign tax burdens available for credit in 1972 could actually be utilized in that year leaving an excess credit of some 24.4 percent for future years.

(1) U.S. Consumer Product Manufacturing Corporation

The case study done on this company indicated a rather substantial amount of overseas subsidiary operation. Of particular interest in this particular case was the fact that the company had constructed a foreign tax credit repatriation equation in order to compute the basis on which it would be most favorable to it for repatriating dividends taking foreign tax credits into

account. This showed a degree of sophistication in timing of dividends from foreign subsidiaries for foreign tax credit purposes. The equation utilized by the company (reproduced below) shows the extent to which U.S. companies are going to manage their foreign tax credit burdens.

$$(1) \quad A = \left\{ \frac{D_1}{P_1 + D_2 - T_1} \right\} \times \left\{ T_1 + \left(\frac{D_2}{D_2 - T_2} \times T_2 \right) \right\}$$

$$(2) \quad B = \left\{ \frac{D_1}{P_1 - T_1} \times T_1 \right\} \times \left\{ \frac{D_2}{P_2 - T_2} \times T_2 \right\}$$

A = Foreign tax deemed paid in second tier situation

B = Foreign tax deemed paid in first tier situation

D₁ = Dividend paid by first tier subsidiary

D₂ = Dividend paid by second tier subsidiary

P₁ = Profit before taxes of first tier subsidiary

P₂ = Profit before tax of second tier subsidiary

T₁ = Tax paid by first tier subsidiary

T₂ = Tax paid by second tier subsidiary

This particular company generated 27.5 percent of its income from foreign sources and on that income incurred a foreign tax burden of 38.6 percent. It incurred its major taxes in Canada, Netherlands, Germany, Japan, United Kingdom, West

Germany and Italy. Because of an extensive foreign subsidiary network, its foreign tax burden was comprised of deemed paid credits to the extent of 84.6 percent with direct credits making up the balance of 15.4 percent. The company, through a proper blending of high and low tax rates in various countries, was able to avoid any foreign tax credit carryovers from prior years. Because of a series of second tier deemed paid credits from subsidiaries in Europe through a holding company in the Netherlands, it generated excess credits on the dividends from the Netherlands. It also generated excess credits from Japan on dividends from a Japanese company which it did not control but in which it had more than a 10 percent interest. Finally, its dividends from Canada also produced excess credits, but it was able to absorb these excesses by properly timing dividends from Germany and the United Kingdom, as well as royalty income which was received from various sources on which it incurred an effective foreign tax rate of only 7.8 percent. Consequently, via the blending of this low taxed income, it was unable to accumulate the amount of excess limitation it needed to absorb all excess credits.

(m) U.S. Textile Corporation

This particular company was engaged in significant activities outside the United States and produced losses

in foreign subsidiaries. As a result, it was experiencing overall losses from operations in Europe and Latin America. Competitive elements from the Far East had eroded the expected profit element and as a result, foreign tax burdens were not a significant factor for this company from a tax standpoint. This case study is noteworthy for the fact that, due to its foreign losses, its foreign tax burden for financial statement purposes was very high.

This particular company generated 37.4 percent of its income from foreign sources and on that foreign income, incurred an effective foreign tax rate of 46.5 percent. Of the foreign tax burden, 32.3 percent consisted of direct taxes paid or accrued and 67.7 percent consisted of deemed paid credits. The company generated income to a great extent through foreign subsidiary operations in Switzerland, South Africa, Canada, West Germany, Italy, Sweden, and France. Because of competitive conditions, it incurred losses in certain countries which made its foreign tax burden management problems more difficult. It also had a domestic subsidiary which received dividend income from several foreign affiliates and which also had substantial liabilities on which interest expense had to be incurred. This produced a situation whereby the effective foreign tax rate for

the subsidiary was 82.5 percent, thus increasing significantly the effective foreign tax burden in the consolidated return. This particular subsidiary gave rise to carryovers of excess credits from prior years and was not in a position to utilize all of its foreign tax burdens as tax credits. In fact, for the current year, only 58 percent of the foreign tax available could be used as credits on the return.

(n) U.S. Cosmetic Corporation

This corporation generates a substantial amount of tax credits from a wide range of foreign countries. Basically, the company was involved in manufacturing and marketing overseas in high as well as low tax rate countries. The income it generated was basically from dividends, profits from branches, royalty and interest income. The ability to use royalty and interest income to absorb excess foreign tax credits from dividends and from branches was a significant factor in its operation.

This cosmetics company generated income in Canada, Mexico, Dominican Republic, Venezuela, France, England, Spain and Trinidad. The company generated approximately 23 percent of its taxable income from foreign sources and had an effective foreign tax rate of 31.6 percent. This rate varied from a high

of 42.1 percent in the United Kingdom to 14.1 percent in Spain. The higher income tax in the United Kingdom was due to the fact that it conducted operations directly there by a branch of a U.S. company. However, the higher tax rate there was averaged down by the receipt of royalties and interest income from other countries with which the United States had a tax treaty. This company illustrates the overall control that U.S. companies have on effective foreign tax rates, even when conducting operations in many countries. The company did generate interest income from unrelated companies in Canada on which a separate foreign tax credit calculation had to be made. However, since the Canadian withholding tax was only 15 percent, it was also able to utilize all those taxes as credits.

(o) U.S. Food Processor Corporation

This particular company also had extensive foreign operations particularly significant in the United Kingdom. The fact that this particular company has extensive operations in the United Kingdom accounts for a high percentage of its overall foreign taxable income. It also had operations from shipping as well as income from foreign tax incentives in various parts of the world. On an overall basis, the combination of tax incentive income and shipping income were enough to enable it

to keep its overall foreign taxes from becoming excessive burdens.

This particular company generated foreign tax income in excess of 60 percent of its total taxable income. It carried on activities in a wide variety of countries including England, Canada, Australia, Italy, Japan, Mexico, Venezuela, Puerto Rico and Peru. Of its total available foreign taxes, it was able to utilize 81.2 percent in the current year which left an excess credit carryover of 18.8 percent. This meant that, in the case of this company, its foreign tax credit carryovers increased by 26.4 percent. Had it not been for income it generated in other countries as well as certain income from activities unrelated to its basic operations, its excess foreign tax credit position would have been much larger.

2. Achievement of Optimum Structure and Transaction Planning for Foreign Tax Burdens

(a) Structural Planning

From an overall standpoint, our study indicates that U.S. based multinational corporations plan for their foreign tax burdens by attempting to see that their foreign structures do not get too complicated from the standpoint of multiple tiers of subsidiaries. Foreign branches are not generally utilized to a great extent except where it may be required for a

1 particular reason such as percentage depletion in the oil and gas industry or when foreign losses are projected. The basic rule as we have seen is that a high tax rate subsidiary would be put fairly close to the U.S. company from an organizational standpoint since its income could be extracted without paying substantial U.S. taxes. A foreign company with lower foreign tax burdens might be structured so that its profits could flow to an intermediary holding company and be recirculated outside the United States without having to pay U.S. tax. These low tax rate subsidiaries always have their earnings available because of the deferral privilege in U.S. taxation and can be brought back to the United States to absorb excess foreign tax credits. In 1 certain instances, the shares of foreign subsidiaries as well as the operations of an export, licensing, leasing and financing operation could be conducted by U.S. subsidiaries which have a lower ratio of expenses to foreign source gross income. Furthermore, U.S. companies tend to look at foreign acquisitions from the standpoint of foreign tax credit posture of the subsidiaries because of the ability to acquire either low or high tax rate foreign subsidiaries from the standpoint of utilizing those tax credits most beneficially for foreign tax burden management.

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(b) Transaction Planning

There is a great deal of transaction planning involved in the foreign tax credit burden area. A combination of planning gross income to make it foreign source as well as the utilization of various methods for allocating deductions to foreign source income examined in this study are techniques utilized by U.S. companies to a great extent. These are the most used techniques by companies to keep their foreign tax burdens in control.

(c) Timing Element

The deferral of U.S. taxation on earnings of foreign subsidiaries provides the wherewithal for U.S. companies to time the repatriation of earnings so as to keep foreign tax burdens under control. Although the normal foreign tax credit rules permit a carryback for two years and carryforward for five years of excess foreign tax burdens, these carrybacks and carryovers do not commence until the excess foreign tax credits are actually triggered. The triggering of these credits depends upon the extent to which the income is put into the tax return of the U.S. corporation. This is where the deferral privilege gets its greatest utilization. If the U.S. corporation sees that earnings of foreign subsidiaries would suffer high foreign taxes in a given year, there is a tendency to defer the

payment of dividends in those years until they can be accommodated within a foreign tax credit limitation.

(d) Tax Treaty Aspects

U.S. corporations are able to accommodate foreign tax burdens because of the use of tax treaties in the sense that the income from tax treaties that are subjected to low or zero tax rates are used to absorb excess credits that may potentially be generated in other areas. To an extent this balancing of tax treaty benefits against excess credits from other countries produces a complicated series of interrelationships which provide an overall averaging ability of the U.S. corporation for managing its foreign tax burdens.

(e) Mathematical Sophistication

Finally, we have reached the point where companies have reduced their foreign tax credit management to mathematical expression so as to determine what is most beneficial from the standpoint of repatriation of profits. Considering the interrelationships involved, there are many permutations and combinations that can be undertaken. The mathematical formula described in one of the case studies is an example of the techniques which U.S. companies are using to control their foreign tax burdens via timing and repatriation of earnings from foreign subsidiaries.

CHAPTER XI

CONCLUSIONS AND RECOMMENDATIONS REGARDING THE IMPACT OF FOREIGN TAX BURDENS ON U.S. BASED MULTINATIONAL CORPORATIONS

We are now at the point of our study where we can draw conclusions and make recommendations regarding the impact of foreign tax burdens on U.S. based multinational corporations. These conclusions flow from the examination of the foreign tax burdens actually incurred by the U.S. corporations described in the earlier chapters of this study related to the underlying U.S. tax system presently in effect with regard to the treatment of U.S. tax burdens in conceptual terms. These conclusions are the result of examining the manner in which foreign tax burdens of U.S. corporations in the data base are sustained and the manner in which those corporations have developed procedures for dealing with these foreign tax burdens.

From the conclusions reached in the course of our study, certain recommendations flow in connection with the U.S. tax system as it relates specifically to the foreign tax burdens incurred by U.S. corporations. In the course of our review of

the conceptual background of the U.S. tax system, it was recognized that any set of recommendations in this complex area should be grounded in certain economic objectives that relate to the taxation of foreign income of U.S. based corporations. Consequently, one's recommendations in this area must reflect one or more of these interconnecting (and sometimes conflicting) governing tax principles such as:

International tax neutrality

Taxpayer equity

Inter-nation equity

National efficiency

Domestic economic growth

Income distribution

Balance of payments

Treatment of less developed countries

Because of these varying principles, there are both conflicts and consistencies among the tax policies that the United States could follow to achieve the various economic objectives.

The basis for the recommendations of our study is found principally in the concept of tax neutrality which seeks to avoid encouragement or discouragement of U.S. investments abroad. One basic premise of our study is that the United States should

generally not offer tax incentives to foreign investment. Neither world, nor national efficiency of resources used are served by such incentives. Although an exception could be made for incentives for investments in less developed countries, even then these incentives should be selective, tailored according to particular circumstances, and given with the cooperation and concurrence of the host countries. In this summary of conclusions and recommendations, we identify the specific tax policy that is of major concern in connection with the particular recommendation so that the reader will be able to follow our reasoning by seeing the flow of conclusions from the text of our study, see how the recommendations relate to the conclusions, and finally, identify the tax policy goal which forms a basis for the recommendation.

A. Summary of Conclusions and Recommendations

1. In the Section of Chapter III, entitled "The Relationship of Foreign and U.S. Tax Burdens of U.S. Corporations to Foreign Income", we saw that per the Treasury Department's statistics for the years through 1966, that there was indication of a substantial foreign tax credit when one considered the relationship of foreign taxes available for credit to the amount of foreign taxable income generated by U.S. corporations in general. While this published data inferred that there was a

significant potential excess foreign tax credit problem faced by the totality of U.S. corporations conducting international activities, the results of our research indicated that actual excess foreign tax credits were not a significant problem for a majority of U.S. based corporations. We reached this conclusion based on the analysis in Chapter III, entitled "Extent to Which U.S. Corporations Actually Suffer Excess Foreign Tax Credits". We saw from our study that only 11.2 percent of the companies actually incurred an excess foreign tax credit and that only 7.1 percent of the foreign tax burden incurred actually resulted in excess foreign tax credits.

Based on this conclusion, we recommend that the foreign tax credit mechanism in general be maintained in the U.S. tax system. The tax policy reasons for this recommendation is that the foreign tax credit mechanism when properly structured provides a high degree of tax neutrality. It generally insures that the U.S. tax applies to foreign income only at a rate equivalent to the higher of the U.S. and foreign rates. The foreign tax credit mechanism is significant and growing in importance for determining that foreign tax burdens are not a deterrent to U.S. investments abroad. Therefore, for international tax neutrality reasons, the foreign tax credit system should be preserved.

2. Based on our review of Treasury Department statistics in Chapter III, we saw that there has been a substantial increase in taxable income from foreign sources generated by U.S. based corporations for the period 1954 - 1966. During that same period, the foreign tax credit claims quadrupled. For the period 1966 - 1971, the last period for which aggregate published data is available for U.S. corporation tax returns, the foreign tax credit claimed by U.S. corporations again doubled. The analysis done in Chapter III using the data from our data base supports the conclusion that foreign tax burdens are increasing in importance to U.S. based multinational corporations, particularly with regard to their use as foreign tax credits by these corporations.

A recommendation that emanates from this conclusion as to the growing foreign tax burden imposed on U.S. corporations is that foreign countries should be made to share to some extent in the burden of double taxation. Inter-nation tax equity suggests that a portion of the cost of removing double taxation should be borne by the foreign countries. That is, if international tax equity, as opposed to domestic tax equity, is the criterion to be followed, the basis for encouraging foreign countries to charge higher taxes - because they can be absorbed with the U.S. foreign tax credit system - should be removed. Consequently, it is recommended that foreign countries that are charging high

taxes so as to create excess foreign tax credit burdens for U.S. corporations should bear the cost for disrupting international tax equity. Consideration should be given to negotiating tax treaties which would require the foreign country to recognize this responsibility by reducing its tax burdens imposed on U.S. corporations so as not to create double taxation, given the availability of the foreign tax credit to U.S. based corporations.

A second recommendation following from the increasing foreign tax burdens faced by U.S. corporations which are being used in great part to offset U.S. tax liabilities involves the range of foreign levies that can be utilized by foreign corporations as tax credits. We saw in Chapter I under the heading "Type of Foreign Taxes Eligible for Foreign Tax Credit Treatment" that basically two kinds of foreign taxes are creditable; income taxes and taxes paid in lieu of income taxes. We later saw in our discussion in Chapter V under the heading "Foreign Taxes By Industry" that certain industrial activities, such as the natural resource industry, tend to incur high foreign tax burdens which have been questioned by some as not being true income taxes available for foreign tax credit treatment. This was particularly true with reference to the discussion of Senator Jackson's examination of the foreign tax burdens of the major oil

companies of the United States.

Based on the above conclusion, it is recommended that closer scrutiny be given to the foreign levies that can be utilized by U.S. corporations as tax credits. Since our research has indicated that much controversy exists over the type of levies imposed on U.S. corporations and the way that they have been utilized as foreign tax credits, particularly in the natural resource industry, it would appear desirable for the Internal Revenue Service to embark on a program of issuing rulings on a current basis as to the availability of these foreign levies as tax credits. Since such rulings would be available to all personnel under the Freedom of Information Act, it would provide an open forum for consideration of the merits for using these levies as credits.

3. We saw in our discussion in Chapter I under the heading "Timing Considerations for Carryback and Carryforward of Excess Foreign Tax Credits" that there is provided to U.S. corporations a significant amount of latitude for eventually absorbing the foreign tax burdens which they cannot utilize in the year they are incurred. We also concluded from our research in Chapter III under the "Role of Foreign Tax Credit Carryovers as They Affect the Impact of Foreign Taxes on U.S. Corporations", that the carryovers of foreign taxes for a prior period are not an adverse factor when one considers the overall extent to which

U.S. companies are exposed to excesses of foreign taxes over U.S. tax attributable to foreign source income. Our study indicates that existing carryovers are being absorbed against current U.S. tax liabilities in many instances. In fact, our discussion in Chapter II of the actual utilization by specific companies of excess foreign tax credits in the current year as carryovers indicate that excesses in the current year are being utilized over a relatively short span of years in most cases. In general, then, we can conclude that even when U.S. corporations are generating an excess foreign tax credit in a given year, they can utilize the carryover provisions of the U.S. credit system to absorb excess foreign tax burdens.

Because the significant carryover provisions of the foreign tax system provide such latitude to U.S. corporations, it would appear that some reconciliation should be made between the deferral principle discussed in Chapter I and the carryovers of foreign tax credits. Given the fact that there is a basic deferral of U.S. taxation on the earnings of foreign subsidiaries, it would appear that the carryback and carryforward rules should be restructured to give recognition to the fact that deferral, in effect, already provides relief from timing problems. Therefore, at least in the case of deemed paid credits from foreign subsidiaries, it would not appear that relief via deferral as

well as foreign tax credit carrybacks and carryforwards are consistent with the concept of taxpayer equity principles. Put another way, it does not seem necessary where a U.S. corporation can defer the reporting of foreign tax burdens as deemed paid credits that it should also have available to it foreign tax credit carryover principles once it has decided to trigger the deemed paid credit. Doing so goes beyond the bounds of taxpayer equity.

A further point noted in our discussion in Chapter I dealing with the timing of foreign tax credits is that a deemed paid credit may be available for taxes incurred by foreign corporate entities prior to their control or even investment by U.S. shareholders. We saw in Chapter X under "Structural Considerations in Planning for the Utilization of Foreign Tax Burdens - Foreign Acquisition Implications" that U.S. companies have developed the approach of actually acquiring foreign corporations to activate the deemed paid credit from such acquired foreign entities.

Because of these results of our study, it would seem prudent to recommend that foreign tax burdens of foreign corporations should not be available as tax credits if incurred prior to control by U.S. corporate shareholders. Since tax neutrality attempts to remove the tax factor from impacting on

U.S. base companies so that they pursue their decision making process regarding investment of capital and generation of earnings based solely upon business considerations, we recommend the elimination of foreign tax burdens incurred by foreign companies prior to their acquisition by U.S. corporations from being available as U.S. foreign tax credits. This should apply both from the standpoint of the earnings of such acquired foreign corporations not being available to absorb excess foreign tax credits generated in other areas and the foreign taxes not being available to offset U.S. taxation on pre-acquisition earnings.

4. From our research in Chapter IV on "The Role That Particular Foreign Countries Play Regarding the Foreign Tax Burdens of U.S. Corporations", we saw the degree of flexibility which is afforded by the overall limitation of the tax credit mechanism. It permits a high degree of offsetting by U.S. corporations of the excess foreign taxes incurred in certain countries against U.S. tax that would otherwise be due on foreign source income of U.S. corporations generated in other countries. For example, in Exhibit F, we saw the relationship of the foreign tax limitation broken down by country. It indicated the extent to which some countries produce large excess credits or large excess limitations so that some countries are productive of the means whereby U.S. companies can absorb excess credits. From this, we

saw for example, that only about one-fourth of the potential excess credits ever do materialize as excess credits to the companies in the data base. Furthermore, we continued our research and concluded that the potential excess credits that could be produced by major U.S. companies are utilized to a great extent by being offset against excess limitations in other countries in which they conduct business. From these specific analyses, we found that this offsetting afforded by the overall limitation is essential to U.S. corporations if they are to avoid substantial excess foreign tax credits.

While the overall limitation is an appropriate means of providing relief from double taxation under the principle of tax neutrality, it would appear desirable to restrict the ability of U.S. corporations to use foreign income that suffers a lower rate of taxation to absorb excess foreign taxes from other countries where there is no causal connection between the income and the tax in question. Given the tax policy of international equity involving the general goal of an equitable division of tax revenues between the countries, the U.S. tax system should not vitiate a foreign country's relinquishment of tax revenues by taxing such income. However, we have seen in our research in Chapter X dealing with the techniques used by U.S. corporations

to generate income in certain countries which grant it tax relief, that such income may be used to absorb potential foreign tax credits from other areas. It would seem appropriate that this procedure be limited so that this foreign source income should not be available to U.S. corporations to absorb excess foreign tax credits in countries where business activities are unrelated.

In a related recommendation, some meaningful differentiation should be made between foreign tax burdens of developing and developed countries by the U.S. tax system. We saw in Chapter IV, Exhibit F, that U.S. corporations incur different amounts of taxation in developed and developing countries. In fact, we saw in Chapter VII that it is with the developed countries that the United States has generated most of its tax treaties. To the extent that U.S. tax policy wishes to assist the developing countries, some meaningful differentiation in the U.S. tax treatment of the taxes incurred in these countries is to be recommended. Less stringent limitations on the use of tax credits might be considered such as treating less developed country income as a group even though there may be no causal connection of the type recommended above. This would enable U.S. corporations to offset excess limitations and credits within the less developed country group without causal connection, a privilege

which we recommend removing from the taxes in developed countries. To the extent that the developing countries forego their income taxes in order to attract capital, a separate type of foreign tax credit limitation might be imposed, taking into account the foreign tax burdens which the foreign country has foregone. This could be done by treating the income related to the tax forgiveness as a separate class of income similar to that given to interest income and DISC income as discussed in Chapter I of our study.

5. In our discussion in Chapter V regarding the relationship of the foreign tax to the total U.S. tax liability of U.S. corporations, we concluded U.S. corporations of large size account for a substantial amount of the total taxes incurred by U.S. companies generally. We also concluded from our study that the larger corporations generate income in many more foreign countries than the average. In so doing, they are able to absorb a great deal of their foreign tax burdens by offsetting them against U.S. tax liabilities by means of the foreign tax credit system. Furthermore, the tax burdens incurred by U.S. corporations are concentrated in the small number of foreign countries, even though U.S. corporations generate income from many foreign countries. In Chapter V, under the heading "Foreign Tax Burdens of U.S. Corporations Analyzed by Size of U.S. Entities", we

concluded that U.S. corporations do not necessarily incur their foreign tax burdens in the same countries in which they generate their foreign income. We can therefore conclude that there are many more countries in which U.S. corporations generate foreign income than those in which they are incurring tax. In essence, we conclude that the foreign tax credit system is more useful to the large corporation because of its diversity of foreign income.

One recommendation that emanates from the fact that the foreign tax credit system is more advantageous to the large company than it is to the small is to simplify the foreign tax burden usage by smaller U.S. corporations. We saw in Exhibit G-2 that U.S. corporations of smaller size incur excess foreign tax credits to a greater degree than do the larger corporations. In our discussion of the techniques utilized by corporations to absorb excess foreign tax credits in Chapter X, we saw that more of them were available to the larger corporation than to the smaller corporation. Consequently, we recommend a simplified set of foreign tax credit rules be adopted for the smaller corporations. This would give recognition to the fact that these corporations cannot generate foreign source income in the multiplicity of countries or in the various industrial classifications

as do the large companies. Any encouragement to do so should be removed from the U.S. tax rules.

In addition to the recommendations for simplifying foreign tax credit usage for smaller U.S. corporations based on administrative simplicity, it would also appear desirable from the standpoint of tax neutrality that large corporations not have the incentive to utilize tax credit planning techniques which encourage their generating income solely for the purpose of absorbing tax credits either potential or actual. The purpose of the tax credit mechanism being to avoid double taxation, it should not be utilized in a manner which encourages U.S. corporations to generate income abroad for non-business reasons. Consequently, the U.S. tax rules should be changed so as to restrict utilization of excess limitations generated without a causal connection from a business standpoint to offset excess foreign tax credits.

6. In our research in Chapter V dealing with the foreign tax burdens incurred by U.S. corporations in different industries, we concluded that certain industries are more susceptible to incurring excess foreign tax burdens because of the rate of foreign tax to which they are exposed and the income base for computing foreign tax. As we saw, the natural resource

industry while accounting for a smaller proportion of the foreign income of the companies in the data base accounts for a fairly substantial portion of the foreign tax burdens. Other types of business activity such as transportation and wholesale - resale activities tend, on the other hand, to be productive of excess limitations which have a tendency to absorb excess credits. To the extent that a U.S. company is susceptible to excess foreign tax burdens because of the nature of its primary business activity, we also concluded from our study that it can ameliorate that harsh effect by engaging in other activities which are known to bear lesser foreign tax burdens. In fact, we saw this to be the case in our discussion in Chapter X of the techniques utilized by U.S. corporations to generate foreign source income for the purposes of absorbing excess foreign tax credits.

Because of the above conclusion, we recommend a restriction of the use of excess foreign tax burdens incurred by one industrial activity from being used to offset U.S. tax on unrelated activities of the same taxpayer. Granted that the overall limitation of the foreign tax credit mechanism seeks to treat the worldwide activities of the U.S. corporation as a unit, it does appear that, where a U.S. corporation is led by factors - such as potential foreign tax credits - to engage in other business activities that the foreign tax credit mechanism

be altered to meet the international tax neutrality policy actually intended. Consequently, it would seem appropriate if some limitation were placed on the present encouragement given the U.S. corporations to engage in other activities solely when other U.S. tax considerations are involved. As an alternative to the above recommendation, where national efficiency and revenue needs of the United States are involved, another recommendation would be to reconsider the use of the overall limitation and permit U.S. corporations to compute their tax credit limitations solely on the per country basis. As we saw in Chapter IV of our study, if the per country limitation alone were available, substantial excess foreign tax credits would have resulted for U.S. corporations. As a result, U.S. tax revenues would have increased based on this recommendation. This recommendation is considered as an alternative to the previous one as it is based on the policy of U.S. national efficiency as opposed to the causal connection by industrial activity suggested in the preceding recommendation based on international neutrality.

As a corollary to the above recommendation, it would also appear that, where the overall limitation is continued, consideration should be given to neutralizing the adverse impact that foreign losses have on the foreign tax credit limitation,

where the losses are the result of activities unrelated to those which had given rise to the foreign tax burden. That is, if unrelated activities giving rise to profits are to be set aside in computing tax credit limitations, losses resulting from such unrelated activities should also be separated to make the recommendations consistent. This recommendation emanates from the examination of specific corporations in Chapter III and the manner in which they generated excess foreign tax credits.

Because of the situation we saw in Chapter V, where a particular industry had peculiar foreign tax burden relationships (such as those which exist in the natural resource industry as indicated by our research), consideration should be given to see if the foreign tax credit mechanism is appropriate to that industry from the standpoint of the tax policy of national efficiency. That is, while keeping the tax credit mechanism in place as the general mechanism utilized by the United States as the means of providing unilateral relief for double taxation, one alternative to the present system would be to permit only certain industries to avail themselves of the foreign tax credit while permitting others to only deduct foreign taxes. Alternatively, the U.S. tax system could make the use of the foreign tax

credit mechanism related to those countries having peculiar foreign tax burden relationships dependent upon a negotiation of a bilateral or multilateral tax treaty with given countries such as the OPEC countries. This latter approach would coincide more with the per country limitation on foreign tax credits that is presently constituted in the U.S. tax law and would effectively put the per country limitation on a bilateral basis. The advantage of this recommendation is that it tends to deal with the problem of particular industry foreign tax burden problems on a more selective basis as opposed to changing the entire U.S. tax system because of particular industry operations.

Our study revealed that U.S. corporations often conduct more than one business activity internationally. This we saw from our discussion in Chapter V. In Chapter VI we saw that, with regard to the foreign subsidiaries of U.S. companies, the industries reflecting high foreign tax burdens at the subsidiary level vary significantly from those industries accounting for foreign tax burdens of the U.S. corporations as a whole. This led us to the conclusion that the relationship of foreign tax burdens to particular industry activities on the subsidiary level are not the same as that of the U.S. company as a whole. Thus, we can conclude that U.S. corporations adapt their business

activities to reflect different foreign tax burdens. To the extent that this is done in order to absorb foreign tax burdens, restrictions should be placed on the utilization of income from one industrial activity from offsetting excessive foreign tax burdens from another industrial category.

7. We saw from our discussion in Chapter VI that the foreign subsidiaries of U.S. corporations are a significant factor regarding the quantum of foreign taxes incurred by U.S. corporations on an international scale. In addition, we saw that the retention of earnings practices of foreign subsidiaries of U.S. corporations present latent excess foreign tax problems. Should the earnings that are retained be repatriated in the future, we concluded that significant foreign tax burdens would arise. We also concluded based on the results of our study of the relationship of effective and statutory tax rates of foreign subsidiaries in Exhibit I that, if the foreign subsidiaries paid statutory rates of foreign tax in the countries in which they generate their foreign income, they would have a substantial excess foreign credit potential. This indicates that, to the extent foreign governments begin administering their tax system in a more stringent manner or make changes in the substance of their law so as to broaden their tax base, it would present a more significant tax excess problem for U.S. based corporations. An

even more important conclusion which we ascertained from our analysis is reflected in Exhibit J. That is, the foreign tax burdens of foreign subsidiaries of U.S. corporations appear to be a definite factor in repatriation policies regarding the earnings of such subsidiaries. Our study indicates that present repatriation policies take into account the ability of U.S. corporations to utilize deemed paid credits from foreign subsidiaries so as to minimize or eliminate U.S. tax burdens.

Based on the foregoing conclusions stemming from our study, we recommend that the foreign tax credit system be modified when it reaches the point of tax exemption. That is, from the standpoint of taxpayer equity, the ability to use multiple tier foreign subsidiaries (down to the third tier level) seems to be inconsistent with the concept of deferral as it relates to the earnings of foreign subsidiaries. Since tax equity presumes the earnings of foreign subsidiaries of U.S. companies are subject to U.S. taxation when remitted to the United States, the existence of multiple tier structures seems to provide an indefinite deferral. This tends to frustrate the policy of tax equity when one considers the plowback of earnings revealed in our research. In situations where U.S. companies have not provided U.S. tax on foreign earnings of subsidiaries in financial

statements, it is because of their contention that it is their intention to leave these funds invested relatively permanently abroad. This permanent investment intention suggests that the deferral concept from a tax standpoint is, in fact, more like an exemption. From a tax equity standpoint, we therefore recommend the removal of present factors regarding foreign tax burdens affecting repatriation of earnings of foreign subsidiaries. This is recommended due to the adverse impact they create on the repatriation of foreign subsidiary earnings. We saw from our research in Chapter VI that this retention of earnings is due to the foreign tax burden element in the workings of the foreign tax credit to some extent. In addition to frustrating the policies of tax equity, it has an adverse balance of payments impact since it provides a tax reason for keeping earnings abroad and not repatriating them to the United States. A mechanism geared to reducing the quantum of available deemed paid credit based on the period of retention of earnings abroad might be considered since it would give consideration to the fact that, as the foreign earnings remain abroad, the foreign income taxes incurred on those earnings should also be limited in their use as foreign tax credits eventually.

A further recommendation would be to reconsider

allowing U.S. corporations to claim deemed paid credits on foreign tax burdens incurred by affiliates through the third tier, thereby restricting the flow-through of deemed paid credits through foreign corporations not controlled by U.S. shareholders. As we saw in our discussion in Chapter I, under the heading "Levels of Foreign Taxation Under Which U.S. Corporations Can Claim a U.S. Tax Credit", a deemed paid credit can come from foreign corporations down as low as the third tier and even though they are not controlled by U.S. shareholders. In addition, as we saw in Chapter V, dividend income provides the greatest amount of foreign tax burden, due in great part to the fact that deemed paid credits are available on foreign dividends from foreign corporations to U.S. corporations. Given the original idea of the deemed paid credit as equating a foreign subsidiary with a foreign branch, our research questions whether there is necessity for allowing deemed paid credits down through this low level of tiers.

To the extent that U.S. corporations would be permitted to restructure their foreign affiliate organization so that overall foreign tax burdens can be minimized, it would seem appropriate to limit the extent of deemed paid credits to the third tier. We saw in our study in Chapter X dealing with "Structural Considerations in Planning for the Utilization of Foreign

Tax Burdens", because of the necessity of obtaining advance rulings from the Internal Revenue Service before reorganizations of foreign subsidiaries will take place, and because of the existence of U.S. toll charges on such restructuring, U.S. companies are hindered to some extent from reorganizing their foreign structures, where in fact a reduction of foreign taxes is the motivation. We therefore recommend that where such motivation is present, U.S. tax rules should be adjusted so that reorganizations would be permitted without the hindrance of prior rulings. This would create a better environment for U.S. corporations to remove potential excess foreign tax credits from their considerations in business planning and foster national efficiency as a tax policy goal.

8. During the course of our research, we were led to a number of conclusions dealing with the role that tax treaties play in the foreign tax burdens of U.S. based corporations. At the outset, we concluded that tax treaties provide a significant degree of reduction of foreign tax for U.S. corporations by means of exemption of certain foreign income from foreign taxation and reduction of foreign tax on other income generated by U.S. corporations in tax treaty countries.

From our study in Exhibit K, we also saw that tax

treaties are generally of greatest benefit to the larger U.S. corporations since they are able to coordinate tax treaty relief with the foreign tax credit mechanism to the greatest degree. We saw from Chapter IV that large companies tend to generate their income in a greater number of foreign countries. In particular, they tend to generate income in countries with which the United States has tax treaties. Consequently, the larger corporations avail themselves more of tax treaty benefits. From our analysis in Chapter VII, we were able to conclude that U.S. corporations in the financial, service and manufacturing sectors obtain the greatest amount of tax treaty relief. This was due to the scope of their activities on an international scale as well as the fact that the nature of their income is of the type for which tax treaties generally provide the greatest relief.

Continuing with our conclusions regarding tax treaties, we saw from Exhibit L that tax treaties reduce the foreign tax on technological income and financial income to the greatest degree. Consequently, these types of income serve to absorb potential excess tax burdens of U.S. companies. Thus, another conclusion of our study is that there is a wide divergence in the type of relief tax treaties afford depending on the type of income that is involved. The types of income mentioned above are those which U.S. corporations generate in tax treaty

countries to obtain the greatest deal of tax treaty relief.

One of the most significant conclusions reached from our study is that tax treaty relief afforded by certain countries is being used by U.S. corporations to offset their U.S. tax liabilities otherwise due on non-tax treaty foreign income. From our analysis in Exhibit M, we saw the extent to which tax treaties affect the excess tax credits that U.S. corporations would generate if they were not in existence. On balance, we concluded that if the tax treaties were not in existence, a substantial amount of excess tax credits would be borne by U.S. corporations. However, in Exhibit N, we also saw that by reducing the amount of foreign tax in a tax treaty country, the tax treaty in effect provides a means for U.S. corporations to utilize tax treaty income to absorb excess credits in other areas. Therefore, we concluded that tax treaties are actually benefitting countries other than the ones with which the United States has concluded the tax treaty. Thus, we see that, although tax treaties are structured so as to give relief from excess foreign tax burdens of U.S. corporations on a transaction-by-transaction basis (as seen in Chapter I in our discussion of the U.S. tax treaty network as it affects U.S. taxation of foreign income of U.S. corporations) in fact, relief is secured on a global

basis in a manner independent from the tax treaty mechanism. This is because the United States gives unilateral double taxation relief in the form of the foreign tax credit which is the most important element to a U.S. corporation in obtaining double taxation relief. We can conclude, therefore, that the relief bargained for on a bilateral basis by the U.S. and a foreign country in arriving at a tax treaty is really made more a part of a global double taxation relief system by means of the foreign tax credit.

Because of the interesting conclusions which we are able to draw from our study in connection with the role of tax treaties, several recommendations can be made based on our research. First, we recommend that a periodic system of review should be instituted by the U.S. Treasury Department for the U.S. tax treaty network to see if tax treaties are providing the United States with the benefits it anticipated at the time of adoption. At the present time, there is no automatic revision or review of tax treaties. On the contrary, tax treaties once placed in existence tend to perpetuate themselves until some drastic changes in the internal law of one of the parties takes place. We do not believe this is an appropriate way of providing an evaluation of the tax treaty system, and does not take care

of the situations which develop whereby treaties are being used by corporations in a manner not originally intended. Periodic evaluation would help to prevent such results from getting out of hand and help to correct the unintended use of tax treaty benefits by non-tax treaty countries in the interest of national efficiency.

Secondly, to the extent that tax treaties are benefitting the larger corporations to a greater extent, a recommendation similar to Item 5 above for the simplification of the tax treaty system for the smaller corporations coupled with the limitation on the larger corporations using tax treaty income on which the tax has been reduced from absorbing excess foreign taxes from other countries without a causal connection, would be equally applicable here. It could be supported on the basis of tax neutrality.

Thirdly, to the extent that certain industrial activities tend to benefit more from tax treaty relief in a manner which is contradictory to tax neutrality, we recommend that restrictions be placed on the ability to use income which is generated in a different industrial activity because it generates lower tax treaty rates from being available for absorbing excess credits from other industrial activities.

Fourth, to the extent that certain types of income, such as royalties and interest, are utilized by U.S. corporations to absorb excess foreign tax credits from other types of income, the foreign tax credit system should be altered to eliminate the use of such excess foreign tax credits against tax treaty type income unless some logical causal connection can be shown by the taxpayer. To the extent that low taxed foreign source income is generated by U.S. companies in tax treaty countries for the purpose of absorbing excess credits, we recommend consideration be given to imposing limitations by type of income in the interest of international tax neutrality. This particular recommendation would produce significant restrictions on U.S. corporations and should be considered as a companion piece to the earlier recommendation of limiting foreign tax burden offsets along industrial activity lines.

Fifth, tax treaty benefits should be restructured so that they cannot be utilized by non-tax treaty countries. As we saw during the course of our research in Chapter VII, the benefits afforded U.S. corporations by tax treaties were, in fact, being utilized by U.S. corporations to offset U.S. tax on income from other countries. When two countries enter into a bilateral tax treaty, the general assumption is that the advantage

will be enjoyed only by those two countries. Consequently, the sharing of benefits by different countries raises the question as to whether there should be some means of eliminating the benefits to non-tax treaty countries. In the interest of national efficiency, the tax treaties themselves should spell out ways and means whereby the internal law will attempt to restrict those benefits to the countries who are signatory to the tax treaty.

Sixth, one of the deficiencies which we saw the tax treaties contain in our discussion in Chapter I on "Specific Provisions of U.S. Tax Treaties to Meet U.S. Objectives" is the lack of a uniform set of source of income rules. Given the tax policy objective of entering into tax treaties to seek double taxation relief, we saw there is a basic deficiency in the current tax treaty system in this area. Current treaties should add a separate article containing a mutually acceptable set of source of income rules so as to make the double taxation relief aspect of treaties more achievable within the current tax treaty network.

9. In the course of our study of the limitations imposed on the foreign tax credit mechanism in the U.S. tax law in Chapter VIII, we noted several conclusions that are worthy

of note.

First of all, the overall limitation is utilized by a high percentage of U.S. corporations in the data base. Its use would be basically detrimental primarily to companies in a natural resource industry whose interests lie primarily on the per country limitation. This conclusion from our study indicates that the U.S. tax reform proposal presented at the end of 1974 for using only the overall limitation would not adversely affect most major U.S. corporations. If only the per country limitation was available, we can conclude that U.S. corporations would be quite seriously affected by their foreign tax burdens.

Secondly, there is a meaningful difference between the statutory rates of foreign tax promulgated by foreign countries and the effective rates of foreign tax actually imposed. We concluded from our study that the effective foreign tax rate varies significantly because it is a function not only of the amount of foreign tax imposed by a foreign country but also the amount of foreign income computed using U.S. standards of tax based calculations. Consequently, the income base for foreign income tax is much broader when computed on U.S. standards than it is in the case of the foreign country itself. Thus, although foreign statutory rates in certain countries appear high, they

are not truly reflective of the effective rate of tax being imposed by those foreign countries on U.S. corporations.

Third, in the computation of the limitation on the foreign tax credit available to U.S. corporations, a significant degree of variation exists regarding the nature and amount of deductions claimed by U.S. corporations as being attributable to their foreign source gross income. This is reflected effectively in Exhibit O. Our study therefore concluded that the foreign taxable income in relation to foreign gross income is much greater than the worldwide ratio of taxable income to gross income. This suggests that an excess foreign tax burden situation might be more imminent for some U.S. corporations than is generally considered, if foreign income is not in fact more profitable than U.S. income.

Fourthly, legislative changes which have already been enacted toward limiting the flexibility of the foreign tax credit mechanism as discussed in Chapter I have required limitations to be computed by type of income. Although the overall limitation has reflected past U.S. tax policy of permitting significant offsetting of foreign tax burdens and foreign income, these exceptions to the overall principle in the case of interest income, mineral income, and DISC income appear to be valid departures from the general rule, given the fact that there should be some causal connection between foreign tax burdens and the U.S. tax on the foreign income on which they were levied. These

legislative enactments are consistent with the causal connections which our study is advocating and in our recommendations noted earlier.

Based on the above conclusions reached with regard to the limitation on the foreign tax credit observed from our study, several recommendations may be based. First of all, because of the problems created in the computation of effective foreign tax rate, we recommend using a modified U.S. effective tax rate in the foreign tax credit limitation calculation to take into account the fluctuation in the U.S. tax base. Considering the foreign tax credit burden utilization from the standpoint of taxpayer equity, one question we face is whether the present computation of a foreign tax credit limitation should be based on factors which assume for all practical purposes the U.S. tax rate on foreign taxable income of 48 percent. The mechanical application of the foreign tax credit limitation calculation produces a limitation amount by multiplication of a fraction consisting of country (or total) foreign taxable income over total taxable income times U.S. tax before credits. This presents a situation whereby foreign taxable income is being multiplied by a number which closely approximates 48 percent. Consequently, consideration should be given to computing foreign tax credit

limitations by multiplying foreign taxable income by the effective rate of U.S. tax.

A second recommendation with regard to the limitation of foreign tax credit would be to harmonize the basis for computing foreign taxable income under U.S. standards with that used by foreign taxing jurisdictions for imposing the foreign tax burden. One major problem our study disclosed for utilizing foreign tax burdens in the foreign tax credit mechanism is the manner of computing foreign taxable income. Based on our research, it appears that considerations should be given to computing foreign taxable income for the foreign tax credit limitation by giving recognition to foreign tax standards. At the present time, the computation of foreign taxable income is made by determining gross income and deductions under U.S. standards which is not the basis upon which the foreign countries levy the foreign tax in most cases. Consequently, the determination of foreign income becomes a prime factor in creating inconsistencies for the foreign tax credit mechanism as used in the United States. Consideration should be given to whether the basis for determining foreign taxable income should be conformed more closely to the foreign country standard based on the policy of tax equity.

A third recommendation in this area would be to

simplify the determination of foreign earnings and profits of foreign subsidiaries. The earnings and profits of foreign subsidiaries for U.S. foreign tax credit purposes are difficult to calculate for the taxpayer and difficult to audit for the Internal Revenue Service. It would appear that for administrative reasons, a more simple basis for formulating the determination as to foreign earnings and profits should be developed. In view of the general objective of the foreign tax credit, tax laws should seek to match the foreign tax levied with U.S. tax on foreign taxable income. Some attempt should be made to coordinate more closely foreign taxable income calculations with the foreign tax base in the foreign country.

One specific recommendation in connection with the computation of effective foreign tax rates would be to provide recapture of foreign losses at the time of incorporation of a foreign branch where U.S. corporations have incurred foreign losses and have been able to deduct them against a U.S. taxable income base. Consideration should be given to recapturing those losses if the foreign branch location giving rise to the losses is later incorporated. This would prevent the result that the losses be deducted currently while the future profits be shielded from U.S. taxation because of the deferral principle. Recapture of the loss could either be in the form of addition to revenue or

by using such losses to reduce the foreign tax credit limitation. This can be supported on the basis of the principle of tax equity.

A further recommendation would be to correlate the deductions of U.S. corporations attributable to foreign gross income and the ratio of total deductions to worldwide gross income. As we saw from our research, the amount of deductions which U.S. corporations attribute to their foreign source gross income is much lower than the overall relationship of total deductions to total gross income. To the extent that there are causal connections between such deductions and foreign gross income, better allocation rules than those presently in force would be appropriate. However, these rules should not be so structured that U.S. corporations are encouraged to perform their research efforts outside the United States, a result which we saw in connection with our examination in Chapter X of the techniques used by U.S. corporations to absorb excess foreign tax credits through the utilization of the allocation of expenses.

A further recommendation in connection with the foreign tax credit limitation is that the recognition of foreign losses should not adversely affect the foreign tax burden absorption where the income and losses are unrelated. Our research in Chapter X disclosed that at times U.S. companies will not

write off foreign investments due to the adverse impact of foreign tax credits. This was the case in our examination of the techniques used by U.S. corporations to avoid excess foreign tax credits. That is, to the extent that operations abroad are not proving successful, some companies may be reluctant to write off such investments because of adverse U.S. tax implications. To the extent that these investments do not have a causal relationship to foreign earnings, foreign tax burdens incurred should not be adversely affected by the foreign tax credit limitation. This recommendation is consistent with the policy of tax neutrality and with our other recommendations requiring the causal connection between income and taxes for purposes of the foreign tax credit limitation. In connection with our conclusion that specific statutory exceptions to the overall limitation based on interest income, mineral income and DISC income are appropriate in the circumstances designated, it would also seem appropriate to reiterate here the recommendation that income from foreign countries which reduce their tax burdens on U.S. company operations be respected within the foreign tax credit mechanism when the income comes back to the United States. That is, a foreign country that foregoes a certain amount of tax burden in order to attract capital and foreign investment should have that foreign

tax burden respected when the earnings on which it would have been imposed are repatriated back to the United States. It is our recommendation that this so-called tax-sparing be administered on a bilateral basis and administered under tax treaties, and that this income be removed from the overall limitation calculation on the foreign tax credit, where it is presently serving the function of absorbing excess credits from other countries.

10. In connection with our research in Chapter IX, we noted a significant disparity when comparing the impact of foreign taxes on U.S. corporations for tax purposes versus accounting purposes. We noted, for example, an overall erosion in going from financial statement income to income per Schedule M to taxable income. The erosion is quite pronounced when we related tax figures to the financial statement income per published financial statements and tax returns as actually filed with the actual U.S. tax paid where related to financial statement income being approximately half of the U.S. statutory rate.

When looking at the relationship of tax to income from a foreign standpoint, it was noted in Chapter IX that the ratio of foreign tax to foreign taxable income was quite high whereas the ratio of foreign taxable income for financial statement's purposes was considerably lower. It can be concluded, therefore, that U.S. corporations are able to claim

a significant amount of foreign tax to offset their U.S. tax liability because the relationship of foreign tax to income on the tax return is fairly high whereas foreign tax burden to income on financial statements of the U.S. corporation has eroded to a significant degree.

An additional conclusion reached from our research is that, if the retained earnings of foreign subsidiaries were remitted, there would be a significant tax to pay in addition to the net income before tax of these companies. This conclusion correlates with the conclusion reached in our discussion in Chapter VI on the significance of the foreign tax burdens of foreign subsidiaries of U.S. corporations which also indicated a significant additional tax liability.

As a result of these variations in the foreign tax burdens imposed on corporations from a financial accounting standpoint versus a tax standpoint, one recommendation of our study is that the disclosure of the reconciliation of the differences in the impact of foreign tax burdens from tax and accounting purposes be considered. In the reporting that is required by these companies, a greater degree of symmetry should be fostered between the impact of foreign tax burdens for tax purposes and accounting purposes from the standpoint of taxpayer equity. As

our research indicated, the ratio is greater on the tax return because foreign taxes have the greater benefit. The foreign taxes impact more heavily on the tax returns because their use as credits are more beneficial there. The foreign taxes impact to a lesser degree on the financial statements and as a result, do not erode the financial income to a significant degree as is found in the tax returns. Disclosures of these reconciling differences would be informative to the public and consistent with recent SEC pronouncements. Furthermore, disclosures of the amount of additional foreign and U.S. tax that would be required in connection with repatriation of foreign earnings of U.S. corporations would be appropriate in order to evaluate U.S. corporations from a tax equity standpoint. (cf. Appendix, pp. 442A - J.)

11. In our study in Chapter V, we found that the problem of excess foreign tax burden varied considerably by types of foreign source income generated. This required decisions to be made by U.S. corporations for absorbing potential excess foreign tax burdens. From our study, we reached the conclusion that dividend income produced the highest degree of foreign tax burdens because of the deemed paid credit element, whereas interest and royalty income tended to be the types of income used to absorb excess foreign tax credit. We can conclude from our research that the flexibility of the relief from double taxation afforded by

the U.S. foreign tax credit mechanism can encourage U.S. corporations to seek sources of foreign income subjected to low foreign tax burdens in order to be able to absorb double taxation problems.

We saw this in our study of the case studies of U.S. corporations in Chapter X. From this, we can see that the foreign tax factor does impact on the operations of U.S. corporations because of the potential for excess foreign tax burdens. Thus, due to the potential for excess foreign tax burdens, U.S. corporations utilize various techniques for absorbing these excess burdens as examined in Chapter X. They generate foreign source income from various activities, adjust the allocation of the deductions between U.S. and foreign source income on various bases, and organize foreign structures for their foreign source income needs. All in all, it can be said that the existence of potential excess foreign tax burdens have a significant tax impact on the tax planning of U.S. based corporations; and these have been specifically highlighted in the case studies which are contained in Chapter X. Because of these conclusions, there are several recommendations to be made with regard to the types of income that U.S. companies seek to generate. First, there should be some causal connection established between excess limitations

created on certain income and excess credits generated on others. From the standpoint of international tax neutrality, the ability to generate foreign taxable income with low foreign tax and the ability to absorb potential excess credits should not be encouraged. Secondly, reconsideration should be given to the ability to claim deemed paid credits through three tiers of foreign corporations, not only because of its inconsistency with the retention of earnings and lack of control of foreign corporations noted under Item 7 above, but also because of the excess credits which tend to be produced on dividend income. Third, the present rules which permit the use of holding companies abroad in order to treat its income as all from one source for purposes of utilizing foreign tax credit should be discontinued in the interest of tax equity. In connection with the preferential treatment afforded to certain U.S. corporations by the U.S. tax system, we recommend that these benefits should not be available to absorb foreign tax burdens by the foreign tax credit mechanism. As we saw in our research in Chapter I dealing with Possessions Corporations, there are some provisions of the U.S. tax law which provide benefits to foreign earnings. To the extent that a benefit is to be provided to such corporations, taxpayer equity consideration would suggest that it should not also result in

preferential tax treatment in connection with foreign tax burdens. Based on this tax policy principle, low taxed foreign income enjoyed by such corporations should not be available to absorb excess foreign tax credits from other areas and separate tax credit limitation laws should apply.

An additional recommendation in connection with this matter is that there should be a coordination of foreign taxes credit rates in consolidated tax returns. In computing the foreign tax credit limitation in the consolidated U.S. return, the foreign tax credit limitation is different from that which would exist if U.S. corporations operated by unincorporated divisions. Our recommendation would be to have a one corporation concept in the calculation of the foreign tax credit limitation regardless of whether U.S. corporations operated by domestic divisions or U.S. subsidiaries in the interest of tax equity.

12. A final recommendation is that one type of limitation of foreign tax credit is appropriate. The existence of the per country limitation and overall limitation together seems inconsistent. It would appear that, based on taxpayer equity considerations, only one limitation would be desirable. It is recommended that the taxpayer be permitted the overall limitation and the per country limitation be terminated. The recommendations

modifying the overall limitation noted earlier should, however, be enacted.

Furthermore, the foreign tax credit limitation should not be put on a per item basis. While some authorities suggest that foreign tax on a given item of income should be available only to offset U.S. tax on that item of income, this would not appear to be a satisfactory resolution to the problem of double taxation and utilization of foreign tax burdens from the standpoint of tax equity. This is because it does not provide a realistic answer to the application of credits. However, as suggested above, limitations should be imposed so that excess foreign tax credits in certain areas could be eliminated and not utilized on the broad scale found in our research.

B. The Role Provided by This Inquiry Into Foreign Tax Burdens of U.S. Based Multinational Corporations For Further Research

The research which has been performed in connection with our study of the foreign tax burdens of U.S. based corporations provides a meaningful transition from the broad based statistical studies conducted by the Treasury Department in the past, and the even more precise research which needs to be performed in the future by private and public organizations into the overall role of the impact of the U.S. based multinational corporations.

In the Chapter entitled "The Transformation of Wealth and the Crises of Understanding" in their book GLOBAL REACH, Authors Barnett and Muller conclude that there is a bias in the U.S. tax laws favoring foreign investment which should be systematically removed.²⁷⁶ That is, U.S. tax laws should not be used to encourage foreign investment. To an extent, our study has looked at this subject, in a more particular fashion; namely, from the standpoint of the extent to which foreign tax burdens of U.S. based multinational corporations actually do impact on those entities and the extent to which the tax system is non-neutral, because of the manner in which it accommodates those foreign tax burdens via our foreign tax credit system. To that extent, then, our study will already have provided a transition from the broad statistical analyses that have been made in the past to the researchers who have been looking at the multinational corporation on a broader scale whether they be academicians, governmental agencies, corporate trade associations, or transnational organizations such as the United Nations.

For the future, our study leads first of all to a further study of the role that foreign taxes play in the overall

276. Richard J. Barnett and Ronald E. Muller, Global Reach - The Power of the Multinational Corporations, (Simon and Schuster, New York, 1974), p. 363.

U.S. tax system by the Treasury Department, given the changes that have taken place in the composition of the foreign tax burdens since the current tax rules evolved from the tax policies that existed at the time of their enactment. In this respect, then, our study leads to a re-evaluation by the Administration of its tax policies with regard to the foreign tax burdens on overseas earnings of U.S. based corporations and should serve to give a clearer focus to their ideas on tax reform in 1975.

Secondly, our research leads to the legislative branch of the U.S. government and suggests an evaluation by the staff of the Joint Committee on Taxation of the U.S. Congress of recommendations for legislative proposals that have been put forth by various parties in connection with the role that foreign income should play in the U.S. tax system. Our study provides specific recommendations regarding the role that the more than \$6 billion of foreign taxes incurred by U.S. corporations should play with regard to our overall U.S. tax system.

Our study also leads to an evaluation by the Joint Committee Staff for the House Ways and Means Committee and Senate Finance Committee of proposals such as the "Tax Neutrality Act of 1975" proposed by Senators Church, Rubicoff and Haskell. This suggests, in part, the elimination of the overall limitation on

the foreign tax credit, based on national efficiency policy considerations which have to be evaluated in the light of the entire range of appropriate tax policies.

Our study also leads to a review by the Senate Foreign Relations Committee of the tax treaty system. In fact, it leads specifically to the points raised in our study regarding the manner in which the U.S. tax treaty network is being used to benefit non-tax treaty countries. This is because our research highlights the different roles that taxation plays in foreign countries and the extent to which U.S. corporations might be encouraged to seek out income from certain countries in order to absorb potential excess foreign tax credits from other countries. Furthermore, our study demonstrates the need for a review by the Senate Foreign Relations Committee of the role that tax treaties could play in providing relief and assistance to less developed countries without that relief being indirectly channelled into assistance for developed countries.

Another matter which should be considered as a result of our study is the dissemination of current statistics on foreign burdens of U.S. corporations. That is, we provide an incentive to the Treasury Department for publishing up-to-date information in this area so that those interested in

examining the relationship of tax rules to the tax policies used to design those rules can have the means of making an up-to-date evaluation of those rules and an indication of when those rules could be changed for shifting tax policies. It was only because of the availability of a private data base that allowed our research to move forward and achieve the necessary insights into the foreign tax burdens of U.S. corporations.

Our study provides insights for further study by the Treasury Department in connection with the computation of the limitation on the foreign tax credit. It should be helpful to the Treasury in its present deliberations on formulating tax regulations in this complicated area. This study should provide a valuable input to the Treasury Department for purposes of its formulating rules which seek to provide a harmonization of the U.S. legislative requirements for limitation on the foreign tax credit and the foreign country requirements for the tax basis upon which those countries levy their foreign taxes to be used in the United States as credits.

Our study of foreign taxes also provides meaningful input to those corporate trade associations which need to evaluate the role which their members are playing in the international tax sphere and the extent to which foreign tax burdens impact on them.

It is hoped that this study will be helpful adjunct to the research these associations do in connection with their evaluation of the nature and extent to which foreign taxes impact on these corporations so that their proposals will be grounded in sound tax policy considerations.

Our study also leads to a further examination of the correlation of the tax deferral principle in U.S. taxation and role played by foreign tax burdens from the standpoint of the timing elements of foreign tax burdens in the U.S. tax system. Much has been written on this subject in the academic environment with particular emphasis on needs for change. It is hoped that this study will be a meaningful addendum to this literature for those in private industry and government seeking meaningful tax reform based on sound tax policies as opposed to narrow self interests.

The study by the Multi-National Corporations Subcommittee of the Senate Foreign Relations Committee led to a need for a review of the foreign tax burdens incurred by U.S. corporations of various industrial classifications. The study that Senator Jackson reported on in December 1974 from his review of the tax data of seven oil companies has provided a beginning for looking at tax burdens of U.S. corporations by industrial groups.

Our research has expanded the research into a greater number of industries. It provides a meaningful beginning, given the fact that our study highlights the numerous variations in foreign tax burdens by industry. Therefore, our study leads to further research, particularly in the foreign tax burden area so that greater consideration can be given to possible remedial legislation.

On a broad scale, our study leads to further research of foreign tax burdens by accounting organizations with respect to the clients they have which operate on an international scale. Our study provides a foundation for such study based on the data available to the writer of this research. However, it should be considered a beginning to a broader scale examination to be conducted by accounting firms so as to ultimately give coverage to a nationwide review of the foreign tax burdens of U.S. corporations.

Our study also provides the means for other U.S. Government agencies, such as the Securities and Exchange Commission and Federal Trade Commission to view the reporting by U.S. corporations of their international activities with particular emphasis on the manner in which foreign tax burdens impact on those financial statements. This study should be a meaningful

adjunct to further research which needs to be done at the SEC level on the reconciliation of financial and tax reporting as well as an evaluation of the impact that foreign tax burdens make on U.S. corporations.

Finally, the study should provide a meaningful contribution to those organizations at the multinational level which are studying the relationships between developing and developed countries. In particular, this material should be helpful to the Department of Economic and Social Affairs of the United Nations which has embarked on a series of studies of the role that tax treaties should play between developed and developing countries. The insights into the techniques utilized by U.S. corporations for absorbing their foreign taxes as credits should be important for the further research to be done by the United Nations.

APPENDIX TO
CHAPTER XI RECOMMENDATION ON
EXPANDED FINANCIAL STATEMENT DISCLOSURE*

The significance of the recommendations regarding expanded disclosure can be better appreciated if they are viewed from a more detailed perspective. To do so requires that specific proposals be designed which would give effect to these general recommendations for expanded disclosure regarding the foreign tax burdens incurred by U.S. corporations on their income from foreign activities.

In setting forth the specifics of these recommendations, the objective is to give recognition to the important role that foreign operations are playing in the overall results of U.S. corporations as seen from the research performed for purposes of my dissertation. This would be done by reflecting the interrelationships of foreign and U.S. taxation on the foreign earnings of these companies in such a manner as to bring out the concepts developed in the research which formed the basis for this dissertation.

In order to achieve this end, I have set out below a series of detailed steps. The result of these steps would

* For original discussion cf. pp. 429 - 431.

be to provide a pattern of disclosure regarding the foreign tax burdens of U.S. corporations whereby the interrelations of those burdens and U.S. tax on foreign earnings of U.S. corporations could be periodically evaluated. The following spells out this disclosure pattern in detail:

1. The first portion of the disclosure pattern would be to have the U.S. corporation reveal separately in its financial statements the segment of its net income or loss before taxation which comes from foreign operations. In making such disclosure, several particular points should be noted:

(a) Some explanation should be made of what the U.S. corporation considers to be its "foreign" income. It should include such income as interest income from foreign obligors, dividends from foreign corporate entities, royalties and rentals for intangible and tangible property utilized outside the United States, technical service fees for services performed abroad and income from branch activities conducted abroad by U.S. corporations in the consolidated group. If income from the exportation of U.S. products is considered to be part of the foreign income, a statement to that effect would be required since differences

exist between the treatment of such income as foreign for accounting and tax purposes.

(b) The foreign income should also include the earnings of foreign subsidiaries and foreign affiliates whose income is reported on the equity method under the authority of Accounting Principles Board Opinion No. 18. The disclosure of net income from these sources should be set out separately from the data on foreign income earned directly by the U.S. corporate entities in the consolidated financial statements so as to provide the reader with a clearer frame of reference for examining foreign income which is subject to immediate U.S. taxation and income on which U.S. taxation is deferred because earned by foreign corporate entities.

(c) The principles for reporting these segments of foreign income should be consistent with the reporting of foreign operations specified in Accounting Research Bulletin No. 43, Chapter 12, and the proposals on Financial Reporting for Segments of a Business Enterprise which are being developed by the Financial Accounting Standards Board. In essence, it is envisioned that this aspect of the disclosure of foreign income of U.S. corporations be a logical extension of this financial reporting for

segments of a business with the emphasis being placed on the international segment of the business.

2. The second aspect of this detailed proposal would require the recognition of the difference between consolidated earnings from the accounting and tax standpoint. In arriving at consolidated net income before tax for accounting purposes, all eliminations of intercompany transactions are made. In order to more clearly portray the net income from foreign operations for tax analysis, intercompany transactions involving foreign subsidiaries should be reflected in the data. This would permit the reader to examine the net income before taxes which more closely approximates taxable income from foreign sources since foreign subsidiaries cannot be consolidated for U.S. tax purposes. This approach would give recognition to the fact that, at the time of reporting its earnings for financial statement purposes, the U.S. company has not yet filed its U.S. tax return and does not have the data for reconciling its income as reported on financial statements with the income that will eventually form the basis for its tax liability calculation.

3. The next step of my disclosure proposal would require the extension of the reporting for income taxes

contained in Accounting Series Release No. 149 to the area of foreign income as expanded via the foregoing steps.

(a) In computing the reconciliation between the amount of reported total income tax expense and the amount computed by multiplying the reported income before tax by the applicable statutory U.S. federal tax rate, my proposal would require that such reconciliation involving permanent differences be performed for each of the segments of foreign income set out earlier, i.e. foreign earnings of U.S. corporate entities, foreign subsidiary earnings and earnings of foreign affiliates reported on the equity method. So doing would reveal the interworkings of U.S. and foreign tax burdens as they relate to the foreign income as disclosed by the reporting company.

(b) The disclosure of the amount of foreign income taxes applicable to the segments of foreign income would be prescribed. This would provide an insight into the ratio of foreign as well as U.S. income taxes to the elements of foreign earnings as reflected by the reporting U.S. corporation and its subsidiaries.

(c) As a next step, the disclosure of the amount of the estimated effect on income tax expense of the various types of timing differences would now be expanded

to the segments of foreign income described earlier. These timing differences would be set out separately for U.S. and foreign income taxes so that one could analyze the amount of U.S. tax actually due in the current period on the various segments of foreign earnings of the U.S. corporation. This was an important aspect of the research performed in the course of the work done for my dissertation and this disclosure pattern would give meaningful insights into the impact of foreign tax burdens on U.S. corporations.

4. The final aspect of my detailed proposal would be to reflect the effect of the utilization of foreign losses for U.S. tax purposes. That is, to the extent that foreign losses are incurred which will reduce the U.S. tax burden on U.S. source earnings of the consolidated group, this would be disclosed by showing the tax impact generated by these foreign losses in the reporting of the U.S. tax on foreign earnings as well as U.S. earnings.

The culmination of these detailed proposals would be to breathe life into the insights developed by my research and into the relative impact that foreign tax burdens have on U.S. based multinational corporations for accounting and tax purposes. They are viewed as a logical extension of the proposals for reporting for segments of a business and

the reporting of income tax expense now required by the Securities and Exchange Commission. These specific recommendations would be meaningful since they would enable a reader of the financial statements to make important evaluations of the relative impact that U.S. and foreign tax burdens make on the growing portion of earnings that U.S. corporations are generating from their extensive international operations.

Finally, to bring these detailed proposals into clear focus, I outline below a pro-forma presentation as to how this information would actually appear in financial statement disclosure.

PRO-FORMA PRESENTATION OF U.S. AND FOREIGN TAX BURDENS ON FOREIGN EARNINGS OF U.S. CORPORATIONS

Domestic Earnings (1)	Total	Foreign Earnings			Percent of Foreign Earnings	Elimination Entries (5)	Consolidated Earnings	
		US Corps. Foreign Earnings (2)	Subsidiary Earnings (3)	Foreign Affiliate Earnings (Equity Method) (4)			Amount (6)	Percent of Pre-Tax Income
Net Income (Loss) Before Taxes (7)								
Computed "Expected" Tax Expense	(8)	(9)	(10)	(11)	(12)			
Increases (De- creases) in Tax Ex- pense Resulting From Permanent Differences (13)								
Tax Expense Per Financial Statements (14)								
Deferred Tax Expense Resulting From Timing Differences in the Recognition of Revenue and Expense for Tax and Financial Statement Purposes (15)								
Current Tax Expense (16)								
US Federal								
Foreign								
Total								

FOOTNOTES FOR PRO-FORMA PRESENTATION

1. Domestic earnings would consist of segments of business earnings which U.S. corporations and its U.S. subsidiaries generate from U.S. operations.
2. This portion consists of earnings of U.S. corporations and its U.S. subsidiaries generated from foreign source other than earnings of foreign subsidiaries and foreign affiliates whose earnings are reported on an equity basis.
3. This consists of earnings of foreign subsidiaries both remitted and retained.
4. This consists of earnings of foreign affiliates which are reported by U.S. shareholder(s) on an equity basis.
5. Elimination entries are reflected to reconcile domestic and foreign earnings to consolidated earnings.
6. This is consolidated net earnings as reflected in financial statement of income.
7. This reflects by columnar heading the components of net income (or loss) before tax effect.
8. Depending on number of segments of U.S. operations, this would reflect computed tax expense on net income (or loss) from U.S. operations.
9. This caption would reflect portions of computed tax expense at U.S. statutory rate on foreign earnings of U.S. corporate entities in the consolidated financial statements.
10. This reflects tax expense at U.S. statutory rate on pre-tax earnings of foreign subsidiaries included in consolidated financial statements.
11. This would consist of U.S. shareholder's portion of earnings of foreign affiliates whose earnings are

FOOTNOTES (continued)

reflected in the consolidated financial statements on the equity method of accounting.

12. The percentage which various tax figures would be to net income before tax from foreign sources would be reflected in this column.
13. Reconciling items due to permanent differences between accounting and tax income relative to categories of foreign earnings.
14. Tax expense per financial statement spread by type of foreign earnings.
15. Reconciling items of timing differences between accounting and tax income relative to categories of foreign earnings.
16. Actual U.S. and foreign income taxes related to categories of foreign earnings reported in consolidated financial statements.

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