REPORT ON THE TREASURY'S "SUBPART F" STUDY*

I. Introduction

In December 2000, the Office of Tax Policy of the U.S. Department of the Treasury released its long-anticipated study of the Code's subpart F regime: "The Deferral of Income Earned Through U.S. Controlled Foreign Corporations: A Policy Study" (the "Study"). The Study attempts to put in context the various arguments that support subpart F's approach to anti-deferral, as well as alternative arguments for deferral's repeal. Arguments over the proper scope of subpart F erupted after the issuance of Notice 98-11,[1] in which the Treasury announced its intention to promulgate regulations that would deny benefits claimed by the use of a hybrid branch to reduce foreign taxes. The basis for those regulations, later issued in proposed form, was that the hybrid technique violated subpart F principles.

The Notice and proposed regulations proved sufficiently controversial that the Treasury withdrew the proposed regulations in Notice 98-35.[2] In Notice 98-35, the Treasury announced its intention to study the issues raised by the withdrawn regulations and requested comments on the broader issue of the policy objectives of subpart F. To a significant degree the Study is an outgrowth of this controversy.

This report makes no substantive recommendations relating to the scope of subpart F. We do not express a preference for international tax rules based on principles of neutrality -- either "capital import" or "capital export" neutrality. Economic policy, tax

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[1] 1998-6 I.R.B. 18. The Tax Section filed its Report No. 927 commenting on Notice 98-11 in April, 1998. See N.Y.S.B.A. Tax Section , "Report on Notice 98-11," April 17, 1998 (the "1998 Report").

[2] Notice 98-35, 1998-27 I.R.B. 35.

policy and political considerations will drive a country's approach to taxing offshore income. The economic principles of capital import and capital export neutrality are not, *per se*, tax policy principles.

Although the choices to be made among international tax policy alternatives ultimately may be political choices, these political choices need to be informed by a thorough and evenhanded analysis of the tax issues that each choice presents. While the Study provides U.S. tax policymakers with a good backgrounder on the economic rationale underlying subpart F, the Study is not evenhanded in its explanation or analysis of the range of tax policy alternatives to the current subpart F regime. In this report, we attempt to set out some areas we believe the Study should have addressed more thoroughly, with a view to advancing an informed tax analysis.

First, we believe the Study should devote more attention to alternatives to subpart F, including territorial systems of taxation, worldwide taxation with low rates of domestic tax to attract capital and different approaches to the taxation of active income of foreign base companies. Many of the alternatives deserving of analysis are used by other countries. For this reason, the Study should devote more attention to the international tax principles employed by the United States' principal trading partners.

Second, the claims of U.S. multinationals that current U.S. tax rules inhibit their ability to effectively compete globally need to be addressed in the context of the tax rules applicable to foreign-owned businesses. The Study should address whether the Code's foreign base company rules, which generally terminate deferral where foreign income is deflected to a related party in a second foreign country, should be revised or repealed in light of the increasing sophistication of other nations' anti-deferral, transfer pricing and cross-border tax rules.

Third, the Study can afford to be, and should be, revenue neutral. We think it is fair to say that no one has a very clear idea of which U.S. tax rules currently generate the bulk of U.S. foreign source tax revenues. Those revenues might be traceable to the Code's source and character rules, to the basket limitations on the foreign tax credit and to the interest allocation rules. The revenue impact of subpart F may, in fact, be limited. We believe the Study needs to examine subpart F in the larger context of other U.S.

international tax rules. Subpart F cannot be analyzed in isolation. As we wrote over 25 years ago:

> The existing pattern of United States taxation of foreign manufacturing operations does not lend itself to simple understanding. It is rather a mass of great detail, resulting from years of legislation, regulations, rulings, cases, and "lore." To a large extent, the resulting pattern reflects experience, not logic. While change may be desirable, it should be undertaken with discipline, caution, and painstaking attention to detail—else the "cure" may be worse than the "disease."[3]

II. Policy Choices

The Study provides a thorough and convincing explanation of how the anti-deferral rules of subpart F represent a compromise between the Kennedy Administration's broader anti-deferral proposals and Congress's concern that U.S. multinationals not be unduly hampered in competing with businesses from outside the United States. However, in our judgment, the Study does not go far enough in its analysis of other policy choices that were then and are now available for the taxation of the foreign income of U.S. residents. We encourage the Treasury Department to expand Study by addressing alternative policy choices in a balanced and evenhanded way.

A. Repeal of Deferral

The Study addressed the alternative of repealing subpart F and ending deferral altogether. There are obvious merits of a system that eliminates the distinction between foreign income earned directly and the same income earned through a controlled foreign corporation.[4] Such a system, while not necessarily simple, would probably be simpler to administer than the system we have today. As a political (not tax) policy matter, such a system would be welcomed by purely domestic enterprises that might otherwise see the benefits of deferral as a tax subsidy available only to those who have the means and foresight to operate offshore.

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[3] N.Y.S.B.A. Tax Section, "Comments on Proposals for Legislation to Change United States Income Taxation of Foreign Manufacturing Operations," July 1975 (hereafter, the "1975 Report").

[4] For an excellent overview of that possibility, see Fleming, Peroni & Shay, "Deferral: Consider Ending It, Instead of Expanding It," 86 Tax Notes 837 (Feb. 7, 2000).

It is unclear whether deferral repeal would encourage capital to remain in the United States or whether it would provide multinational businesses with an incentive to switch residence out of the United States altogether. An interesting approach, mentioned in the Study only in passing, could be to repeal deferral but sharply decrease U.S. tax rates as a means of encouraging capital to remain in, and even to migrate to, the United States.

The repeal of deferral would, however, represent a drastic deprture from international norms; we are aware of no country that taxes all income of all controlled foreign corporations on a current basis. A thorough fiscal and economic evaluation of the effects of such a drastic change in our international tax rules should begin with an evenhanded review of current U.S. law and a thorough evaluation of the tax systems of our major trading partners and fiscal competitors.

B. Capital Import Neutrality, Territorial Systems and Foreign Rules

The Study could begin this expansion with a thorough analysis of the capital import neutrality principle. As drafted, the Study deals with capital import neutrality mainly by cursorily dismissing numerous reports that have sought to expand the analysis beyond Musgrave's seminal defense of capital export neutrality. The Study should address these later reports more thoroughly. It should then seek to balance the pros and cons of tax systems based, to a greater degree, on capital export neutrality with those based, to a greater degree, on principles of capital import neutrality.

Although much of the Study is devoted to the defense of the principle of capital export neutrality, the Study does not cogently explain why and to what extent this principle is relevant to deferral. The principles of capital import neutrality, which are essentially economic in nature, do not necessarily conflict with the goals of anti-deferral regimes, which are to inhibit avoidance of tax through the use of separate entities. Specifically, anti-deferral rules are not incompatible with tax systems based on the capital import neutrality principle.

As acknowledged by almost all of the United States' trading partners, anti-deferral rules are a necessary antidote to the problem created when the independent tax status of corporations is respected and the foreign income of controlled foreign

corporations is not taxable on a residence basis. Whether the residence country generally adheres to capital export or capital import neutrality precepts is irrelevant to its need to discourage its own residents from encapsulating easily mobile foreign income in low-taxed controlled foreign corporations. While many developed countries are willing to forego taxation of active foreign income (at least where earned through a foreign corporation), they generally are unwilling to extend that same privilege to passive income earned in "tax havens." In almost all countries, anti-deferral rules target low-tax regimes not a party to a bilateral tax treaty.

In reviewing the advantages and drawbacks of capital import neutrality as a guiding principle, the Study should devote greater attention to the workings of the tax systems in the many European countries that adhere to territorial systems based on a policy choice in favor of capital import neutrality. The Netherlands and France are examples of countries that explicitly have adopted generally territorial tax systems. In Germany, principles of worldwide taxation of German residents and their controlled foreign corporations often give way to purely territorial taxation under Germany's extensive network of tax treaties. The rules of these and other countries lean toward greater reliance on territorial systems, in part because the tax rules generally are simpler and in part due to competitiveness concerns.

A sub-Study could be undertaken to compare the anti-deferral rules of other countries to subpart F and to each other. That a study might seek to determine whether other countries are moving toward the U.S. model or away from it. For example, the United Kingdom, which traditionally has used a worldwide tax with foreign tax credit similar to that of the United States, recently amended its foreign tax credit rules to eliminate cross-crediting through so-called "mixer companies" formed offshore, a move that seems tilted in the direction of the U.S. model. However, new rules also have recently been proposed in the United Kingdom that, if adopted, would grant a broad participation exemption to dividends and capital gains received from foreign subsidiaries. In conjunction with the proposed participation exemption, it is also being proposed that the foreign tax credit system be replaced with an exemption from tax on dividends received from non-UK subsidiaries. The adoption of these proposals, which is

considered a real possibility, would move the UK a degree closer to the territorial regimes of several continental jurisdictions.

We are very far from suggesting the United States abandon its traditional international tax approaches in favor of untested (at least in this country) territorial or exemption system. What we are suggesting is that the Study be expanded to include a full and balanced survey of other countries' approaches to these issues as well as of those countries' attempts to meet the challenge of an expanding global economy. The Study presented, we think, an ideal opportunity for the Treasury to assist Congress in thinking through the consequences of applying old assumptions to new realities, perhaps pointing the way toward a new, multilateral and more workable international tax norm.

C. Foreign Base Company Rules

Unlike the core provisions of subpart F relating to passive (foreign personal holding company) income, the foreign base company provisions can be justified only by reference to capital export neutrality principles. These provisions rarely are found in the anti-deferral regimes of countries that adhere to capital import neutrality principles.

We find it surprising, especially in light of the Study's genesis in the debate over Notice 98-11, that no mention is made of the internal inconsistencies in the foreign base company rules. Given that one important purpose of the Study was to take stock of the continuing appropriateness of subpart F, the complexities and inconsistencies entailed in the foreign base company regime might have been analyzed more thoroughly.

As we noted in our 1998 Report, Code §954(c) generally requires a U.S. shareholder of a controlled foreign corporation to include as subpart F income dividends, interest and other specified receipts of the controlled foreign corporation, except those received from an active, related, "same country" corporation. Yet unlike the foreign base company rules of Code §§954(d) and (e), Code §954(c) does not incorporate a "branch rule" pursuant to which interest and other payments received by a controlled foreign corporation from a related branch in a different country can be taxed currently. This inconsistency, as we noted in the 1998 Report, could theoretically be resolved in one of two ways. First, the Code could be amended to do what Notice 98-11 attempted to do, such that a branch rule would be added in the context of Code §954(c). Alternatively, the

foreign base company rules could be eliminated, allowing the reduction of active foreign income for payments to related parties without triggering current subpart F inclusion.

A second inconsistency in the operation of the foreign base company rules relates to contract manufacturing. We are puzzled the Study did not devote serious attention to the contract manufacturing issue, which goes to the heart of the operation of the foreign base company rules. Although the government has acquiesced in court holdings that an unrelated contract manufacturer cannot be deemed a branch, it has taken the position that it will not attribute the manufacturing activities of a contract manufacturer to a controlled foreign corporation for purposes of the manufacturing exception from subpart F.

The risk to the government is that a court could disagree with its position, and permit the attribution of a contract manufacturer's activities to a controlled foreign corporation. This inherently unstable state of the law regarding contract manufacturing probably should be addressed by appropriate legislation. Unless the foreign base company rules are repealed, Congress should enact legislation specifically treating a contract manufacturer as a branch (or not).

Whether the inconsistency being addressed is in the operation of Code §954(c) or the contract manufacturing context, repeal of the foreign base company rules would simplify subpart F. We recognize that repeal of these rules would expand deferral and would likely reduce U.S. tax revenues.[5] Multinational corporations based in the United States, who can be expected to repatriate selectively from high-tax countries while choosing not to repatriate earnings from low-tax countries, would have an incentive to engage in transactions designed to shift income from high-tax to low-tax countries. However, the extent to which such tax planning might tend to reduce U.S. revenues would depend in part upon whether the foreign jurisdictions in which controlled foreign corporations operate can be relied upon to adopt—and enforce—anti-deferral and transfer pricing rules that prevent local taxpayers from artificially or inappropriately shifting

[5] While we have no expertise in financial modeling, we are aware of studies that suggest that a switch to the territorial or "exemption" system of taxation (as opposed to merely repealing the foreign base company rules) might increase, rather than decrease, U.S. tax revenues. At the least, the Study should review the extant scholarship in this area.

income to low-tax jurisdictions. Some members of the Committee believe that the tax systems of other countries have advanced sufficiently, since 1962, that the foreign base company rules are no longer needed.[6] Others are more skeptical, pointing out that repeal of the foreign base company rules might lose tax revenues and would have only an uncertain effect on global or U.S. economic welfare. There is general agreement, however, that any policy-based review of deferral and subpart F should explore these issues in more depth.

To suggest, as we do in this report, that the Study may have been deficient in scope is not to suggest that the United States, or any other country, should sit idly by while multinational corporations transform themselves into global expatriates earning globally homeless income. We are generally sympathetic with the government's concerns that tax planning such as that targeted by Notice 98-11 distorts the principles upon which international tax regimes are based. Nevertheless, the type of "tax planning" targeted by Notice 98-11 needs to be distinguished from the broader question of whether subpart F should be extended or repealed. Although the Study supports the view that subpart F was originally designed to prevent U.S. persons from exploiting harmful tax practices and regimes by deflecting income from one foreign country to another, we noted in our 1998 Report that the purposes of subpart F's foreign base company, related party and branch rules are difficult to ascertain and to reconcile. We suggest that, whatever the role of capital export neutrality as a theory justifying subpart F, the Study might profitably have justified the approach of Notice 98-11 as an independent rule.

III. International Competitiveness

The Study generally acknowledges the principle of capital export neutrality best achieves its goal of maximizing global welfare when it is more or less globally adhered to, but seems to understate the extent to which most developed countries continue to adhere to territorial principles based on capital import neutrality. When the Study suggests that deferral might be repealed, it ignores competitiveness concerns altogether.

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[6] The Tax Section suggested this conclusion in the 1975 Report: "Recently foreign countries have become sophisticated in reallocating income among controlled taxpayers." 1975 Report p.15.

Deferral repeal would place the United States well outside international norms. If deferral were repealed unilaterally by the United States, we believe a strong incentive would be created for multinational corporations to relocate permanently outside of the United States (though in many cases exit tax costs and other considerations may make that relocation unrealistic).

The Study should address the proposition that, because the United States does not tax a healthy proportion of U.S. income earned by foreign-owned enterprises, foreign-owned enterprises resident in countries that follow territorial principles may already compete "unfairly" with similarly-situated U.S. enterprises. As we said in our 1975 Report:

> It can. . . be argued that failure to impose United States tax currently on undistributed earnings of. . . United States-controlled foreign entities is to give those firms a tax advantage in their competition for the United States market with companies which manufacture within the United States and pay United States tax currently on their full earnings. . . . The difficulty with this latter argument is that it deals only with United States-controlled foreign operations. If it is in the interest of the United States to strongly encourage the manufacture of products for the United States market in the United States, this policy should be applicable to all manufacturing activities, not just those owned by United States persons. Limiting a disincentive to foreign manufacturing to United States-controlled enterprise would clearly be discriminatory in favor of foreign-controlled business.[7]

The competitiveness complaint often voiced by US-based multinationals is directed primarily to the foreign base company rules. In its essence, the complaint is that the U.S. Treasury should not be policing foreign tax systems and should not be concerned about structures that reduce only foreign tax. A strong case can be made that the U.S. Treasury should not be policing foreign tax regimes and should not be concerned about the ability of a U.S. person to reduce foreign taxes by means recognized as legitimate in the foreign country whose taxes are being reduced and available to foreign competitors. We also agree, however, with what we perceive to be the premise of Notice 98-11, namely, that U.S. taxpayers should not be able to reduce foreign taxes by the use of

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[7] *Id.* at 33-34.

hybrid entities, or by the use of other structures, that generally are not available to foreign competitors or that could not have been contemplated by foreign governments.[8]

The Study does not reflect the competitive impact on U.S.-based multinationals of foreign indirect taxes such as the value-added tax (VAT) imposed on the cost of goods and services in most countries, usually at rates between 14% and 18%. In distinct contrast to the United States, many, if not most, countries rely heavily upon VAT, social taxes, "green" taxes and similar indirect taxes to fund their governmental coffers. U.S.-based companies doing business and subject to tax in these countries may find that a majority of their local tax burden consists of indirect taxes. These taxes are not creditable against any U.S. tax. Moreover, the United States does not impose similar indirect taxes on foreign enterprises doing business here.[9] The net effect of this imbalance in treatment may be to hamper the ability of U.S. corporations to compete outside the United States on an after-tax basis, even assuming that they were able to reduce foreign income taxes to a minimum level.

It is difficult to analyze issues of competitiveness without first determining whether worldwide taxation systems should be modified to place less emphasis upon a corporation's "residence." The principle of capital export neutrality, for example, would seem most likely to maximize global welfare where the resident of the capital exporting country has its natural center of gravity in that country. The Study, however, does not

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[8] One approach to the problem addressed by Notice 98-11 might be to rewrite subpart F in a manner that denies deferral to income artificially deflected out of a foreign country while permitting deferral of income that the foreign country itself permits to be shifted offshore. As we noted at page 14 in our 1998 Report, "[i]f Congress chooses to retain deferral despite low rates of foreign tax, the manner in which the low rates are obtained may not be relevant, so long as the means of arriving at them are likewise available for local competitors." While no one should seriously object, in theory, to legislation extending subpart F to structures that allow U.S. taxpayers to reduce foreign taxes in a way that local businesses cannot, such a rule would entail judicial inquiry into foreign laws.

[9] Most states impose sales taxes, but their effect on international tax competition is likely insubstantial. Sales tax rates are relatively low, and the tax generally is imposed only on retail sales of tangible property at the consumer level.

examine the assumption that multinational corporations are "naturally" resident in a given country.[10]

While the assumption that a taxpayer's fiscal residence is at least semi-permanent and a natural outgrowth of its center of vital interests may be valid as applied to natural persons, it is not necessarily valid as applied to business entities. It is common for multinational corporations to be truly "resident" simultaneously in multiple countries, in the sense of having property, operations, management and employees there. For this reason, the United States has worked with other countries to develop multilateral APAs.

The residence assumption probably was more or less valid in 1962, when subpart F was enacted. At that time, most businesses were probably formed and headquartered in the country where the majority of their property, operations, management and shareholders were located or resident. Cross-border mergers and acquisitions were rare and publicly-listed corporations were much more likely to be listed only on an exchange in their "home" country. And, we believe it no coincidence that, in 1962, the United States was still by far the largest capital exporting country in the world.

At least two changes have occurred in the ensuing forty years that call into question the assumption of residence immutability. First, businesses "centered" in one country do not necessarily file their formation papers, or list their shares, in that country. More significantly, multinational corporations have developed to such a point that they

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[10] Prof. Michael Graetz made this point in a recent lecture and article, where he said:

> The fragility and manipulability of the residence of corporations suggests to me that U.S. international tax policy, to the extent possible, should reduce the tax consequences of determinations of residence for corporations. There are several policy implications that flow from this judgment. First and foremost, it implies priority of taxation of business income at source. In the case of corporations, we probably should stop talking as if our policy is worldwide taxation of corporate residents and as if any departure from such policy, such as taxing active business income of foreign corporations only when repatriated, is an aberration. 244. For a good example of such talk, see generally Treasury Subpart F Study, note 30, at x.

Graetz, "The David R. Tillinghast Lecture Taxing International Income: Inadequate Principles, Outdated Concepts, and Unsatisfactory Policies," 54 Tax L. Rev. 261, 323 (Spring 2001).

truly can be said to have no natural home or center of gravity. Today's typical multinational, whether incorporated in the United States or outside it, is likely to have property, operations, sales, management, employees and shareholders in many parts of the world, with interlocking dealings. Such a taxpayer is not necessarily "centered" anywhere, but more truly resembles a hydra. The so-called communications revolution seems likely to accelerate this trend. Permitting taxpayers to reflect their multiplicity of locations thus need not be viewed as a potentially abusive exercise in income compartmentalization, but as reflective of economic reality.

If a multinational enterprise is not "naturally" resident anywhere, but is present in multiple jurisdictions, the simultaneous assertion by multiple countries of the primary right to tax its worldwide income can create an unworkable system. By the same token, the uncritical application of capital export neutrality principles to taxpayers having substantial operations in multiple countries can have the effect of exceeding traditionally accepted limits upon a residence country's jurisdiction to tax. This occurs, for example, when the subpart F rules tax a U.S. resident shareholder on income earned by a controlled foreign corporation in a foreign country where the controlled foreign corporation is resident. Due to the restrictions on use of foreign tax credits, the group as a whole may often pay tax at a worldwide rate in excess of either the U.S. or the foreign rate of tax. If, in addition, the controlled foreign corporation earns income from a branch in yet a second foreign country, the concatenation of foreign taxes and subpart F's branch rules may in certain circumstances produce an overall tax that far exceeds any tax rate applicable in any country.

Territorial tax systems, including those that employ a participation exemption, do not give rise to this problem of overlapping assertions of jurisdiction to tax worldwide income. By permitting taxpayers to segregate income according to jurisdiction through separate subsidiaries, theseregimes reflect and accommodate the multiple locations of corporate enterprises.

In addition, formulary apportionment, which essentially treats all jurisdictions in which a taxpayer conducts business as "residence" jurisdictions with respect to their formulary share of its activities, can avoid the overlap problem. One approach to

mitigate over-reliance upon residence as the basis for taxation is suggested by the method of taxation prescribed under the Uniform Division of Income for Tax Purposes Act, or "UDITPA," which has been adopted in various forms by almost all of the states of the United States. The basic scheme of state taxation relies on residence as the primary basis only for taxing individuals and the passive income of corporations. The active income of corporations is apportioned based on factors, usually gross receipts, property and payroll or some combination thereof. Thus:

- Individuals are taxed primarily in their state of residence, with any taxes paid to another state on a source basis being eligible for credit in the residence state;
- Corporations are taxed on a residence basis only on non-business (*e.g.*, investment) income; and
- The business income of corporations is apportioned among the states in which a corporation (or in some states, a unitary group of corporations) carries on business, based on formulary factors.

We recognize, however, that implementation of such a system would be unlikely absent a multilateral acceptance that today faces many hurdles.

The over-extension of worldwide taxation principles may "incentivize" companies to locate offshore. Tax practitioners routinely counsel foreign business start-ups expanding into the U.S. not to form a U.S. holding company. Foreign business people often are surprised to learn that the United States does not provide tax exemptions similar to the participation exemption, a special holding company regime or other "parent-subsidiary" rules enabling a non-U.S. group of owners to coordinate its worldwide activities through a U.S. holding company on a tax-efficient basis. Consideration should be given to whether this no exemption structure is or is not in the best interests of the United States. Finally, we observe that the problem of defining residence, like subpart F's foreign base company rules, could have been used as the basis to address to the broader question of whether the United States should attempt to tax U.S. multinationals on all lightly-taxed or untaxed income earned offshore. For example, many have argued that the existing rules for taxing shipping and oil-related income under Code §954(f) and (g), as well as the proposed regulations applicable to the sourcing of space, ocean and

international telecommunications income under Code §§863(d) and (e), tilt too far in the direction of overtaxing the foreign source income of one's residents solely because other countries do not exercise the power to do so.

IV. Placing Subpart F in Context

The Study focuses almost exclusively on the subject of deferral, as analyzed through the lens of capital export neutrality. We believe the decision whether to retain subpart F in its present form, to repeal it or to modify it needs to take into account the myriad of other tax rules that affect the overall taxation of foreign operations of U.S. multinationals.

The Study acknowledges the limitation on the foreign tax credit set forth in Code §904 deviates from pure capital export neutrality. Pure capital export neutrality requires that taxes be a neutral factor in a taxpayer's decision of where to invest capital. The Code §904 limitation operates to discourage the location of U.S. capital in countries where effective tax rates exceed those of the United States.

The Study, however, does not provide much analysis of how the baskets of foreign source income to which Code §904 is separately applied might further undercut the goal of capital export neutrality by preventing taxpayers from avoiding double taxation, possibly counterbalancing the advantages associated with deferral. Nor does the Study reflect upon the manner in which the interest allocation rules[11] interact with deferral. In applying the Code §904 limitation, the liabilities and interest expense of an affiliated group are taken into account on an aggregate basis, but those of foreign affiliates are not included. Instead, the stock of a controlled foreign corporation is counted as a foreign asset. The absence of a look-through rule violates and principle of the fungibility of money and discriminates against foreign operations of U.S. multinationals in favor of domestic operations. The rule makes it more difficult for U.S. multinationals to compete against foreign-owned and local businesses in those situations where a leveraged investment is required to be made through a local entity treated in the

[11] Treas. Reg. § 1.861-8.

United States as a corporation (*e.g.*, a *per se* foreign entity). The rule therefore leads to tax-motivated self-help in an effort by taxpayers to even the playing field.

The various limitations on the use of the foreign tax credit, which seem to grow more complex each time they are revisited, are not justified by principles of capital export neutrality or indeed any principle other than the generation of revenue. It seems to us that at least one of the goals of the Study should have been to seek ways to harmonize and simplify the tax rules that apply to controlled foreign corporations and their U.S. shareholders. It would be interesting, for example, to contrast the degree of simplification expected were the deferral privilege repealed with that expected if a territorial system of taxing active foreign income were adopted. The repeal of the deferral privilege probably would need to be accompanied by significant expansion of the foreign tax credit, even to the point of repealing the Code §904 limitation. Conversely, adoption of a territorial system would almost certainly result in the disallowance of all foreign tax credits related to foreign source (excluded) income. Both of these alternatives probably would be much simpler than the system we have today.[12]

V. Conclusion

The Study should be expanded to address more completely whether and how subpart F should be modified. In doing so, the Study should examine the rules other countries apply to tax offshore income, as well as the U.S. international tax rules that operate in tandem with subpart F. The study should address the issues presented by relying upon corporate residence to tax worldwide income, particularly in light of recent developments in global commerce and communications.

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[12] We expect to submit a report on tax simplification in the near future, and expect that some of our suggestions there will implicate subpart F and related Code provisions.