WikiLeaks Document Release

http://wikileaks.org/wiki/CRS-RL31574
February 2, 2009

Congressional Research Service

Report RL31574

International Tax Provisions of the American Competitiveness and Corporate Accountability Act (H.R. 5095)

David L. Brumbaugh, Government and Finance Division

Updated September 20, 2002

Abstract. The American Competitiveness and Corporate Accountability Act (ACCAA; H.R. 4095) contains several provisions designed to restrict corporate tax shelters. The balance of the bill, however, contains a broad range of proposals for taxation of income from international transactions and is this report's focus. The scope of H.R. 5095 is broad, touching almost every area of U.S. international taxation, from export profits to overseas subsidiary firms, to the foreign tax credit, to foreign parent corporations chartered in tax havens. Accordingly, this report begins by describing the basic structural features of the U.S. international tax system.

Order Code RL31574

Report for Congress

Received through the CRS Web

International Tax Provisions of the American Competitiveness and Corporate Accountability Act (H.R. 5095)

September 20, 2002

David L. Brumbaugh
Specialist in Public Finance
Government and Finance Division

http://wikileaks.org/wiki/CRS-RL31574

International Tax Provisions of the American Competitiveness and Corporate Accountability Act (H.R. 5095)

http://wikileaks.org/wiki/CRS-RL31574

Summary

On July 11, 2002, House Ways and Means Committee Chairman William Thomas introduced H.R. 5095, the American Competitiveness and Corporate Accountability Act. The focus of this report is the bill's proposed changes in U.S. taxation of income from international transactions. The bill also contains provisions designed to restrict corporate tax shelters; the report does not discuss these.

The bill's international proposals are in three general areas. First, the bill would repeal the extraterritorial income (ETI) tax benefit for exporting, thereby attempting to end a long-running dispute between the United States and the European Union (EU) over whether the U.S. tax benefit is an export subsidy prohibited by the World Trade Organization agreements. Second, the bill contains proposals aimed at offshore corporations with subsidiaries in the United States. In part, these proposals are aimed at corporate "inversions" where some U.S.-owned firms have reorganized to include paper parent corporations chartered in "tax haven" countries. In part, these proposals also address "earnings stripping," or the shifting of U.S. profits abroad by means of intra-firm transactions. Third, H.R. 5095 contains proposals altering the tax treatment of U.S. firms with foreign operations and investment. The bill terms these changes international tax "simplification;" the bulk of the provisions would have the effect of reducing U.S. tax on foreign-source income. The chief areas that would be affected are rules related to the foreign tax credit and provisions affecting the "deferral" tax benefit for overseas business operations.

This report does not attempt a comprehensive economic analysis of H.R. 5095. Several likely broad effects, however, can be identified. First, taken alone, repeal of the ETI export benefit would likely not increase the U.S. trade deficit, but would reduce the overall level of U.S. trade – exports and imports alike – by a small amount. Because export subsidies generally reduce the aggregate economic welfare of the subsidizing country, repeal of the ETI provisions would likely increase U.S. economic welfare, while leading to a small contraction of the export sector and a small expansion of import competing sectors. Second, tax-motivated inversions are apparently events that chiefly occur on paper, involving little alteration of the location of economic activity. Their chief economic impact is probably a reduction in U.S. tax revenues. Thus, the chief impact of H.R. 5095's inversion provisions would probably be to reduce the extent to which inversions erode U.S. corporate tax collections. The bill's earnings stripping provisions may likewise reduce erosions in U.S. tax collections but an assessment of whether these provisions would reduce foreign investment in the United States is not attempted here. Third, the bill's foreign source income provisions would likely reduce the tax burden on foreign-source income. As a result, their impact would probably be to increase the level of U.S. investment abroad beyond what would otherwise occur. Preliminary estimates by the Joint Committee on Taxation indicate the bill would increase tax revenue by a net of $6.4 billion over five years and a net of $1.1 billion over 10 years.

This report will be updated as legislative developments occur.

http://wikileaks.org/wiki/CRS-RL31574

Contents

List of Tables

http://wikileaks.org/wiki/CRS-RL31574

International Tax Provisions of the American Competitiveness and Corporate Accountability Act (H.R. 5095)

The American Competitiveness and Corporate Accountability Act (ACCAA; H.R. 5095) was introduced on July 11, 2002, by Chairman William Thomas of the House Committee on Ways and Means. The first title of the bill contains several provisions designed to restrict corporate tax shelters – provisions beyond the scope of this report. The balance of the bill, however, contains a broad range of proposals for taxation of income from international transactions and is the report's focus. The international proposals are in three general areas: taxation of income from foreign business operations and investment; export tax benefits; and the tax treatment of offshore corporations that have U.S. subsidiaries, including foreign "inversions" or "expatriation." Compared to changes enacted in international taxation in recent years, the bill's changes are important and broad in scope. At the same time, however, the proposals are incremental rather than a broad structural revision of the U.S. international tax system.

The likely impacts of the proposals on business tax burdens vary: its foreign-source income provisions would likely reduce the tax burden on the overseas operations of U.S.-owned firms while the export provisions probably will increase the tax burden on U.S. export firms. The inversions provisions may restrict the viability of the restructuring transactions as tax-saving devices and thus reduce U.S. revenue losses from the transactions, although the proposed provisions are temporary. The bill's earnings stripping provisions would probably reduce revenue losses from the shifting of otherwise-taxable profits abroad and may increase the tax burden on foreign business investment in the United States. According to preliminary estimates by the Joint Committee on Taxation, H.R. 5095's proposals – including both its international and tax shelter provisions – would increase U.S. tax revenue on a net basis by $6.4 billion over five years and $1.1 billion over 10 years.[1]

The scope of H.R. 5095 is broad, touching almost every area of U.S. international taxation, from export profits to overseas subsidiary firms, to the foreign tax credit, to foreign parent corporations chartered in tax havens. Accordingly, this report begins by describing the basic structural features of the U.S. international tax system.

---

[1]U.S. Congress, Joint Committee on Taxation, "Estimated Revenue Effects of H.R. 5095," reprinted in BNA *Daily Tax Report*, July 17, 2002, pp. L-1 - L-3. The estimates are reproduced below, on pages 20-21.

Basic Features of the U.S. International Tax System

In the international setting, countries base their tax jurisdiction on either the source of income or the residence of the taxpayer. That is, in determining whether it has jurisdiction to tax income, a tax system can look either to the geographic or territorial source of the income or to the residence of the entity or person earning the income. Under a "territorial" system, a country taxes only income earned within its borders. However, under a "residence system" a country taxes the worldwide income of its resident individuals or firms.

In applying its tax jurisdiction to the overseas income of its own citizens and firms, the United States generally – with some exceptions – operates a residence-based system. It looks to the nationality of the taxpayer, taxing U.S. citizens and residence on their worldwide income and, in the case of businesses, taxing corporations chartered or organized in the United States on their worldwide income. Thus, if a U.S. corporation earns dividends whose source is, say, Ireland or Germany, the U.S. firm will generally be subject to U.S. tax on the dividends – at least in principle. In applying its tax system to foreign investors in the United States, the United States operates a source-based system, taxing the U.S. branches of foreign corporations only on their U.S.-source income.

But there are exceptions to this general structure. First, the United States grants foreign tax credits. While the United States taxes its residents' worldwide income, it concedes that the country of source has the primary right to tax that income and permits its corporate and non-corporate taxpayers to credit foreign income taxes they pay against U.S. taxes they would otherwise owe. In so doing, the United States – in effect – accepts the responsibility for alleviating the double-taxation that would result when the U.S. worldwide tax jurisdiction overlaps the normal practice of host countries in taxing income earned within their borders.

Importantly, however, to protect the U.S. tax base, the U.S. foreign tax credit is limited to offsetting U.S. tax on foreign income; foreign taxes cannot be credited against U.S. tax on U.S. income. The tax credit's limitation and associated rules give rise to some of the most complex parts of the tax code, as described further in the section below on H.R. 5095's foreign tax credit provisions. In general terms, H.R. 5095 would ease restrictions on the foreign tax credit embedded in a number of foreign tax credit rules.

Along with the foreign tax credit, another exception to U.S. worldwide taxation is the so-called "deferral" principle. While the United States taxes foreign income earned directly by branches of U.S. corporations – branches that are not separately incorporated abroad – the United States does not tax foreign-chartered corporations on their foreign-source income. Thus, if a U.S. firm conducts foreign operations through a subsidiary firm chartered abroad, the foreign income is not subject to U.S. tax until the income is remitted to the U.S. parent as dividends or other income (at which point it enters the U.S. tax jurisdiction as income of a U.S.-resident corporation). U.S. tax on the subsidiary's income is thus tax-deferred as long as the income is reinvested abroad.

http://wikileaks.org/wiki/CRS-RL31574

Deferral poses a tax incentive for U.S. firms to invest abroad in countries with relatively low tax rates and reduces U.S. tax revenues, but since 1962 the tax code's Subpart F provisions have denied deferral's benefit to certain types of income – generally income from passive investment and other income whose source is thought to be easy to manipulate in order to reduce taxes. Subpart F and deferral are described in more detail below in the section on H.R. 5095's proposals for U.S.-controlled foreign corporations. In broad terms, H.R. 5095 reduces the scope of Subpart F and expands potential areas where deferral can apply.

U.S. tax treatment of foreign corporations has also been a focus of attention in the recent controversy over corporate "inversions" or "expatriation." Since foreign corporations are not taxed on foreign-source income, a number of U.S. firms with U.S.-incorporated parent segments have reorganized so that the parent segment or holding company is a foreign corporation chartered in low-tax country or "tax haven." The tax savings on foreign-source income is apparently supplemented in many cases by "earnings stripping" – the use of related-company debt – to shift U.S. income from U.S. subsidiaries into the hands of a foreign-chartered parent. H.R. 5095 contains a number of provisions designed to limit inversions and earnings stripping.

http://wikileaks.org/wiki/CRS-RL31574

Under the United States residence-based tax system, U.S. taxes would normally apply to export income in full. If a U.S. corporation were to sell exports directly, U.S. worldwide taxation would ordinarily ensure full U.S. taxation; if a U.S. firm were to sell exports through a related foreign subsidiary outside the U.S. tax jurisdiction, U.S. "transfer pricing" rules – rules governing the allocation of income among related firms – would restrict the extent to which export income could be allocated abroad to a foreign subsidiary outside the U.S. tax jurisdiction. To the extent flexibility in the application of transfer pricing permits the allocation of income to foreign subsidiaries, Subpart F apparently rules out much of the potential for deferral to apply. Notwithstanding these rules, however, several provisions of the U.S. tax code provide tax benefits for U.S. exports. One of these – the extraterritorial income (ETI) benefit – has been the focus of a controversy between the United States and the European Union (EU), with the EU complaining to the World Trade Organization (WTO) that ETI constitutes an illegal export subsidy. Several WTO rulings have supported the EU, and unless the United States brings its tax code into compliance, the WTO may permit the EU to levy tariffs on EU imports of U.S. products. The controversy is described more fully below; H.R. 5095 would repeal the ETI provisions. At the same time, however, the bill would relax the Subpart F rules applicable to sales to related subsidiaries.

We turn now to the specific provisions of H.R. 5095.

Overseas Investment: Foreign Tax Credit Proposals

While the foreign tax credit generally concedes to foreign host countries the primary right to tax foreign income, the limitation of the credit to offsetting U.S. tax on foreign and not U.S. income is designed to protect the part of the U.S. tax base consisting of U.S. income. If not for the limitation, foreign governments could conceivably impose extremely high tax rates on the U.S. investors they host without fear of discouraging inbound investment. With an unlimited credit, investors would be impervious to the high foreign taxes; they could simply credit their foreign taxes against U.S. taxes on their U.S. earnings.

While the foreign tax credit's limitation protects the U.S. tax base, it is also responsible for some of the most complex and difficult-to-administer rules in the tax code. H.R. 5095's foreign tax credit proposals generally simplify and ease restrictions on the tax credit rules in a number of areas related to the limitation. In addition, it increases the extent to which the credit can reduce a firm's alternative minimum tax.

Interest Allocation Rules

In calculating its foreign tax credit limitation, whether a firm can assign an item of income or deductible expense to foreign or domestic sources can have a substantial impact on the company's maximum creditable foreign taxes and thus on its U.S. tax liability, after credits. Among H.R. 5095's foreign tax credit proposals, that which is likely to have the largest impact may well be a proposed change in rules governing the allocation of interest expense between foreign and U.S. sources. To illustrate, the provision is estimated to reduce tax revenue by $23.4 billion over 10 years – approximately half the revenue loss from all the bill's foreign tax credit proposals and about one quarter of the revenue loss of all the bill's revenue-losing items.

Firms with foreign earnings have long argued that current law's rules for interest allocation work improperly and are unfair, and in 1999 Congress included a revision of the rules as part of the more general tax cut it passed with the Taxpayer Refund and Relief Act (H.R. 2488, 106th Congress).[2] However, President Clinton vetoed the Act. H.R. 5095 would essentially implement the changes passed in 1999.

How income and expenses are allocated matters to a firm only if the foreign tax credit limitation is a binding constraint and the firm has excess foreign tax credits. To see why, note that under the foreign tax limitation, maximum creditable foreign taxes are limited to the share of U.S. pre-credit tax falling on foreign source rather than domestic income. It follows that if, for example, an item of revenue is determined to have a foreign rather than U.S. source, the share of U.S. pre-credit tax falling on foreign income is increased and maximum creditable foreign taxes are therefore increased.

The reverse is true with deductions. A deduction allocated to foreign rather than U.S. sources reduces foreign income and U.S. pre-credit tax on foreign income, thereby reducing creditable foreign taxes and increasing after-credit U.S. tax. For interest expense specifically, the important point is this: interest deductions allocated

[2]For a more comprehensive explanation of the interest allocation rules, see: CRS Report RL30321, *The Taxpayer Refund and Relief Act of 1999 and the Foreign Tax Credit's Interest Allocation Rules*, by David L. Brumbaugh and Jane G. Gravelle.

http://wikileaks.org/wiki/CRS-RL31574

to foreign rather than U.S. sources reduce foreign tax credits and increase U.S. taxes. Or, looking at it another way, a firm in an excess credit position has no remaining U.S. tax liability on foreign-source income; it has all been eliminated by foreign tax credits. Thus, a deductible cost allocated to foreign rather than U.S. sources can produce no further tax savings and the deduction is, in effect, lost.

Given the importance of allocating income and expenses, the tax code contains detailed rules for making the allocations, including the rules governing interest expense. Current law provides for the allocation of interest expense by combining the parent firm and its domestic subsidiaries; a portion of the interest is then allocated to foreign source income (and affects the foreign tax credit limit) based on the proportion of the group's assets that are located abroad. Thus, even if all of a domestic firm's borrowing is done in the United States, part of its interest expense may be allocated abroad. This is based on the notion that debt is fungible – that regardless of where borrowing occurs, it funds the totality of a firm's investment.

The controversy over the rules is based on the particular way in which this allocation is applied under current law – a method of allocation sometimes referred to as a "water's edge" allocation. Under this method, the borrowing of foreign subsidiaries is not explicitly included in the allocation. Specifically, debt-financed assets of subsidiaries are not included in the calculation; subsidiary assets are included only to the extent of parent ownership of subsidiary stock. In isolation, this omission has the effect of reducing the amount of interest allocated to foreign sources and increases creditable foreign taxes. Second, while some parent interest expense is allocated to foreign sources, no subsidiary interest is allocated to domestic sources. In isolation, this second omission reduces foreign income and creditable foreign taxes. Mathematically, the impact of omitting foreign interest is larger than omitting foreign assets so that, on balance, omitting foreign debt from the formula reduces creditable foreign taxes.

In a manner similar to the vetoed 1999 Act, section 311 of H.R. 5095 would substitute a "worldwide" allocation regime for current law's water's edge rule.[3] Under this method, the interest costs of foreign subsidiaries would be included in the allocation formula and subsidiary assets would be included in the allocation formula on a gross basis rather than a net-of-debt basis. In isolation, the first of these changes would increase firms' foreign tax credits and reduce taxes while the second would have the reverse effect. On balance, switching to H.R. 5095's worldwide allocation regime would increase firms' foreign tax credits and reduce their after-credit U.S. taxes.

---

[3]H.R. 5095 leaves out part of a set of "subgroup election" rules included in the 1999 legislation. Under current law, firms can elect to apply the interest allocation rules separately for those parts of a corporate group that are financial institutions. The 1999 bill would have expanded this election to include finance companies and insurance firms; it also would have permitted a second election to allocate interest separately for any group of subsidiaries, subject to certain anti-abuse rules. H.R. 5095 includes the expansion for financial firms but not the second, broader election. For a more detailed discussion, see *Ibid*., pp. 9-11.

http://wikileaks.org/wiki/CRS-RL31574

Consolidation of Tax Credit Limitations ("Baskets")

One feature of the foreign tax credit's limit that has occupied the attention of policymakers on a number of occasions is the ability of investors to "cross credit" high foreign taxes on one stream of income or high foreign taxes paid to one country against residual U.S. taxes that might be due on other, more lightly taxed foreign income. Cross crediting works like this: if a U.S. firm's only foreign-source income is subject to low foreign taxes, the firm will not have sufficient foreign tax credits to offset all U.S. taxes on the income and will owe some residual U.S. tax. Or, if a corporation's only foreign income is subject to rates that are high compared to the U.S. tax rate, it will be able to eliminate its entire U.S. tax on foreign income but will have excess credits left over. But if a firm has both heavily-taxed and lightly-taxed foreign income, it can "cross credit" the excess credits from the heavily-taxed income against U.S. tax due on the lightly-taxed income.

In effect, cross crediting shields investment in low-tax countries from U.S. tax, leaving the low foreign taxes as the only tax burden the investment faces and posing an incentive to invest abroad in low tax countries while reducing U.S. tax revenue. At the same time, cross-crediting reduces the effective tax burden where foreign taxes are high, thereby reducing what would otherwise be a tax disincentive to invest abroad in high-tax countries. Because of these incentive and revenue effects, legislation has been enacted on a number of occasions that is intended to limit the ability of firms to cross credit by requiring the foreign tax credit limit to be calculated separately for different types or "baskets" of income, in effect segregating different streams of foreign income and prohibiting cross-crediting between different baskets. In some periods in the past, separate limits have applied on a country-by-country basis, thereby prohibiting taxes paid in "high tax" countries from being cross credited against income earned in "low tax" countries. Under current law, however, separate limits apply to several different categories of income rather than to separate countries; much of their structure was implemented by the Tax Reform Act of 1986 (Public Law 99-514).

Under current law, there are nine separate foreign tax credit baskets, as follows:

1. dividends from Domestic International Sales Corporations (DISCs);
2. income attributable to "foreign trade income;"
3. distributions from Foreign Sales Corporations (FSCs);
4. financial services income;
5. shipping income;
6. dividends from each "section 902" corporation;
7. high withholding tax interest;
8. passive income;
9. all other income.

In addition, section 907 of the tax code limits the amount of taxes on foreign oil and gas extraction income that can be credited, albeit under a somewhat different mechanism.

The first three of the baskets in the above list are of limited importance, applying to export income that is typically not subject to high foreign taxes and to

http://wikileaks.org/wiki/CRS-RL31574

income related to export tax benefits – FSCs and DISCs – that have been repealed.[4] The next two baskets are relatively narrow, applying to specific industries: income from financial services and shipping income. (Note, however, that IRS data show that the financial services basket is the second largest in terms of the amount of taxable income it contains.[5]) The geographic source of this income is thought to be relatively flexible, and thus relatively easy to locate in low-tax foreign countries, making cross-crediting with heavily-taxed income particularly useful to the taxpayer.

The next three baskets apply to different types of income from passive investment. One is dividends a taxpayer receives from each foreign subsidiary corporation that is not controlled by U.S. stockholders but in which the dividend's recipient owns at least 10% of the stock. (These are known as "section 902" corporations. As described more fully below, however, this basket is scheduled for elimination in 2003.) Under this basket's rules, a separate limitation must be calculated for dividends from each subsidiary, thus restricting cross-crediting among income from different foreign corporations. The remaining passive income baskets are a basket for passive income in general – for example, interest, rents, and royalties – and interest income that is subject to a high foreign withholding tax.[6] As with the transportation and banking limitations, the separate basket for general passive income was implemented because passive income is thought to be geographically flexible.[7] The high-withholding-tax basket was created because even low foreign withholding taxes on a U.S. lender's gross interest received from abroad could amount to a high effective tax rate on the investor's net interest from a loan, thereby generating large amounts of excess credits.[8]

The last remaining basket is a residual category into which any remaining type of income is placed. It is thus a general, "overall" basket into which income from most active business operations is placed.

Section 313 of H.R. 5095 would consolidate current law's nine baskets into three: a general passive income basket; a basket for financial services income; and a general, "overall" basket. In doing so, the bill eliminates the separate baskets related to export income, the basket for shipping income, the basket for high-withholding-tax interest, and the basket for section 902 corporations. The general effect of the proposal would be to increase cross crediting. What data are available

---

[4]Pointed out by Richard Doernberg in his *International Taxation in a Nutshell*, 5th ed. (St. Paul, MN: West Group, 2001), p. 215. Our explanation of baskets relies heavily on Professor Doernberg's book.

[5]See Kathryn A. Green and Scott Luttrell, "Corporate Foreign Tax Credit, 1977," *Statistics of Income Bulletin*, vol. 21, Winter 2001-2002, p. 143.

[6]A high withholding tax is defined for purposes of the limitation as a withholding tax with a rate of at least 5%.

[7]U.S. Congress, Joint Committee on Taxation, *General Explanation of the Tax Reform Act of 1986*, joint committee print, 100th Cong., 1st sess. (Washington: GPO, 1987), p. 863.

[8]Ibid., p. 864. See also the explanation in Doernberg, *International Taxation in a Nutshell*, p. 220.

http://wikileaks.org/wiki/CRS-RL31574

suggest that the most important consolidations would be eliminating the high-withholding-tax basket (whose contents would most likely be placed in the passive-income basket) and eliminating the basket for section 902 corporations.

"Look Through" Treatment for Dividends from Section 902 Corporations

As noted above, the tax code currently requires a separate foreign tax credit limitation to be calculated for dividends received from each section 902 corporation – noncontrolled corporations where the recipient owns at least 10% of the stock. The purpose of the separate limitations is to prevent cross-crediting between dividends from a 902 corporation and other streams of income; the provision was first enacted with the Tax Reform Act of 1986.

In 1997, Congress concluded that the separate limitations for section 902 dividends were overly complex and discouraged participation by U.S. firms in joint ventures overseas.[9] The Taxpayer Relief Act of 1997 scheduled the limitation for a manner of phaseout by applying "look through" rules for section 902 dividends paid out of earnings generated after 2002. Under the look through rules, the dividend is apportioned among the tax credit baskets in proportion to the types of income comprising the section 902 corporation's earnings and profits. The 1997 Act also changed the treatment of section 902 dividends paid out of earnings and profits generated prior to 2003; effective beginning in 2003, the Act places dividends from all section 902 corporations in a single basket.

As described in the preceding section, H.R. 5095 would remove the separate limitation for section 902 dividends. H.R. 5095 would also apply a look through rule to all section 902 dividends, allocating the dividend among the bill's three baskets in proportion to the amount of passive, financial services, and general active-business income comprising the firm's earnings and profits.

Recharacterization of Overall Domestic Losses

An additional foreign tax credit proposal in H.R. 5095 changes the way the tax code's loss rules and foreign tax credit rules interact. Under current law, if a taxpayer incurs a loss for tax purposes – that is, if it has negative taxable income – the loss (termed a "net operating loss," or NOL, in tax parlance) can be "carried back" up to two years and used to offset taxable income in those years, potentially generating a tax refund.[10] If some or all of the NOL remains after applying it to carryback years, the loss can be saved and carried forward up to 20 years in the future.

---

[9]U.S. Congress, Joint Committee on Taxation, *General Explanation of Tax Legislation Enacted in 1997,* joint committee print, 105th Cong., 1st sess. (Washington: GPO, 1997), p. 302.

[10]In March, 2002, Congress enacted as part of P.L. 107-147 a provision that extended the carryback period to five years in the case of NOLs incurred in 2001 and 2002.

http://wikileaks.org/wiki/CRS-RL31574

In calculating the foreign tax credit limitation, a taxpayer who incurs a loss with respect to domestic operations can use the loss to reduce foreign income. If a firm has some residual U.S. tax liability on foreign income – that is, if it does not have excess credits – the loss can generate tax savings by reducing U.S. tax on foreign-source income. However, H.R. 5095's loss provision is aimed at taxpayers in a different situation: firms that have a domestic loss and excess foreign tax credits. Here, while the loss does reduce foreign-source income, it produces no tax saving in the loss year because there is no U.S. tax liability on foreign-source income. Further, the potential NOL carryforward embodied by the loss – and the resulting future tax savings – is reduced to the extent the loss is deducted from foreign income. Excess foreign tax credits can be carried forward up to five years, and deducting the NOL from foreign income in this case generally increases foreign tax credit carryforwards in a manner that potentially offsets the loss in tax savings from the reduced NOL carryforward. However, if a firm expects to be in an excess credit position indefinitely, this offsetting mechanism does not work and the taxpayer will, in effect, have lost some or all of its NOL carryforward – an important loss if the firm anticipates returning to having positive taxable income in the near future.

H.R. 5095 would give firms with domestic losses the option of recharacterizing a certain amount of U.S.-source income as foreign-source income in a subsequent year. For firms in an excess credit position in the year the recharacterization occurs, the recharacterization would increase the amount of foreign tax credits that can be claimed, thereby compensating for the reduced NOL. The amount of income that can be recharacterized would be equal to the firm's previously-incurred domestic loss, subject to a cap equal to 50% of the firm's U.S.-source taxable income.

H.R. 5095's recharacterization proposal has been proposed previously – first in 1983 and again in 1992 – but was not adopted. In part, this was because of concern over whether firms without excess credits in a loss year, but with excess credits in a subsequent year, could obtain both the benefit of deducting the loss in the loss year and recharacterizing income in the later, excess credit year. Treasury Department testimony in 1992 indicated that "certain objections" to the proposal had been rendered moot, but did not elaborate. Thus, it is not certain whether the double-benefit exists with the current proposal.[11]

Extension of Foreign Tax Credit Carryforward Period

Excess foreign tax credits that accrue in one year can be carried back to the two preceding years and any credits that remain after the carryback can be carried forward up to five years. The carryback and carryforward provisions were instituted as a means of compensating for the possibility that income and deductions may be

---

[11]For a description of the double benefit, see U.S. Congress, Senate, Committee on Finance, *1983-84 Miscellaneous Tax Bills– VII: S. 120, S. 1397, S. 1584, S. 1814, S. 1815, and S. 1826*, hearings, 98th Cong., 1st sess., Sept. 26, 1983 (Washington: GPO, 1984), pp. 79-80. For subsequent testimony, see U.S. Congress, House, Committee on Ways and Means, *Foreign Income Tax Rationalization and Simplification Act of 1992*, hearings, 102nd Cong., 2nd sess., July 21 and 22, 1992 (Washington: GPO, 1992), p. 235.

http://wikileaks.org/wiki/CRS-RL31574

recognized at different times under foreign tax systems than under the U.S. system. H.R. 5095 would extend the carryforward period to 10 years.

Repeal of Foreign Tax Credit Restrictions under the Alternative Minimum Tax

Under current law, taxpayers pay either their regular tax or their alternative minimum tax (AMT), whichever is larger. The two amounts ordinarily differ because taxable income is defined more strictly under the AMT while tax rates under the AMT are lower than under the regular tax. The purpose of the AMT is to ensure that every firm or individual who registers positive economic income pays at least some tax and is not able to use various tax benefits to eliminate their tax completely. The foreign tax credit is generally not considered a tax "benefit," but is instead a mechanism for alleviating double taxation of foreign-source income; the credit is therefore generally allowed to offset a taxpayer's AMT. Nonetheless, as part of a broad revision of the AMT in 1986, Congress concluded that every taxpayer with positive income should make at least a "nominal" contribution to the U.S. tax base, even when it is foreign tax credits that eliminate U.S. taxes.[12] Accordingly, foreign tax credits are permitted to offset only 90% of a taxpayer's AMT.

H.R. 5095 would repeal the 90% limitation.

Overseas Investment: Deferral and Subpart F

As described above, the tax deferral available to income earned through foreign subsidiary corporations is restricted in some cases by the tax code's Subpart F provisions – provisions that were first enacted in 1962 and that were designed to restrict firms' ability to augment the deferral tax benefit by concentrating income in tax havens or other countries with low tax rates. Subpart F denies the deferral benefit to certain types of income whose geographic source is thought to be easily manipulated. The tax code contains several other "anti-deferral" regimes in addition to Subpart F. Most prominent of the other anti-deferral regimes is the passive foreign investment company (PFIC) rules.

The tax code applies Subpart F to those U.S. stockholders who own at least 10% of a "controlled foreign corporation (CFC)," as defined by the tax code. A CFC, in turn, is a foreign corporation that is more 50% owned by those U.S. stockholders owning at least 10% of the corporation's stock. One component of income covered by Subpart F is income the tax code terms "foreign personal holding company income," which is generally income from passive investment (e.g., interest, dividends, and royalties). Subpart F income also includes income from international air or sea transportation, certain oil-related income, certain insurance income, and certain sales and services income from transactions with related firms. H.R. 5095

[12]U.S. Congress, Joint Committee on Taxation, *General Explanation of the Tax Reform Act of 1986*, joint committee print, 100th Cong., 1st sess. (Washington: GPO, 1987), p. 436.

http://wikileaks.org/wiki/CRS-RL31574

would generally reduce the scope of Subpart F, thus expanding the applicability of deferral.

Sales and Services Income Subject to Subpart F

H.R. 5095's most important change to Subpart F is likely its proposal to remove sales and services income from the provision's coverage. As defined under current law these categories of income – termed "foreign base company sales income" and "foreign base company services income"– consist (respectively) of income from sales to a related corporation where the property is both produced and used outside the related corporation's country of incorporation, and income from the provision of services to a related corporation, outside the CFC's country of incorporation. H.R. 5095 would retain Subpart F coverage for sales of U.S. products back to the United States, thus apparently restricting the ability of firms to apply the deferral benefit to what might be U.S.-source income.

Given the elimination of the extraterritorial income (ETI) tax benefit for exporting by other parts of H.R. 5095, the question of whether or not the bill's repeal of foreign base company sales and services income could pose a replacement export benefit is relevant.[13] Suppose, for example, a U.S. exporting corporation sells its exports to a subsidiary foreign corporation chartered in a low-tax country, and the foreign subsidiary, in turn, sells the exports in various foreign markets. To the extent export income is allocated for tax purposes to the foreign subsidiary rather than the U.S. parent, an export tax benefit results. Further, it is not clear whether continuing to apply Subpart F coverage to sales of products back to the United States while exempting exports would run afoul of the WTO agreements.

Absent stringent regulations governing the allocation of income, a firm might be able to achieve such an export benefit by, for example, charging an unrealistically low price for exports sold to its foreign subsidiary; such a technique would make the foreign subsidiary's income unrealistically high and the U.S. parent's income unrealistically low. However, the internationally-accepted norm for allocating income between related entities for tax purposes is a method known as "arm's length pricing" – a method that approximates the division that would occur if the different parts of the firm were, in fact, unrelated. And where "arm's length pricing" rules are followed in allocating income between a U.S. parent and its foreign sales subsidiary, little or no export income can be allocated to a foreign sales subsidiary. IRS regulations issued under section 482 of the Internal Revenue Code generally require arm's length pricing to be used in allocating income.[14] Some observers, however,

[13]The possibility of solving the dispute in this manner was raised as early as 1988. See: Robert E. Hudec, "Reforming GATT Adjudication Procedures: The Lessons of the DISC Case," *Minnesota Law Review*, vol. 72, June 1988, p. 1449. However, the writer ignores the obstacle to this solution posed by application of arm's length pricing.

[14]Doernberg, *International Taxation in a Nutshell*, p. 237.

http://wikileaks.org/wiki/CRS-RL31574

have expressed concern over potential manipulation of transfer prices so as to shift export income abroad.[15]

"Look through" Treatment for Dividends Flowing Between Related Foreign Subsidiaries

As noted above, one broad type of income subject to Subpart F is income from passive investment, which is defined to include dividends. Current law makes an exception, however, for dividends and interest a CFC receives from a related corporation that is incorporated in the same foreign country as the CFC itself, and that conducts business in that country. Subpart F income also does not include rents and royalties received for the use of property in the CFC's own country. H.R. 5095 would add to these exceptions dividend, interest, and other passive income a CFC receives from a related CFC to the extent the payments are not attributable to what would be Subpart F income in the hands of the related corporation. The proposed look through rule contrasts with current law's exceptions in that the country where the excepted income originates would be immaterial, but would not include all dividend or other income received from the related CFC.

Other Provisions for U.S. Investment in Foreign Corporations

As described above, one type of Subpart F income is "foreign personal holding company (FPHC) income," which is generally income from passive investment, generally including dividends, interest, rents, royalties, and annuities. FPHC income also includes gains from the sale of assets that produce the identified types of passive income, gains from the sale of interests in partnerships or trusts, and gains from certain commodities transactions. H.R. 5095 would repeal Subpart F's inclusion of **gain from the sale of partnership interests** and would ease its applicability to gains from **commodities transactions**. It would also provide more generous treatment under Subpart F's oil-income rules to **income from transportation of oil**.

As noted above, Subpart F is not the only anti-deferral regime contained in the U.S. tax code, although it likely is the most broadly applicable. Next to Subpart F, the most widely applicable set of rules limiting deferral are the passive foreign investment company (PFIC) rules, enacted with the Tax Reform Act of 1986. In contrast to Subpart F, the PFIC rules deny the deferral benefit to all income of defined corporations (PFICs) and to all stockholders, not just 10% stockholders. A PFIC is defined differently than a CFC, however. Rather than criteria based on control by U.S. stockholders, a PFIC is a foreign corporation that is intensively engaged in passive investment, according to several tests set forth in the PFIC rules.

Beyond the Subpart F and PFIC rules, deferral of tax on foreign income can potentially be restricted under four additional sets of rules: the **foreign personal holding company provisions; the foreign investment company rules; the personal holding company provisions**; and the accumulated earnings tax rules. (The last two of these can apply to domestic as well as foreign corporations.) The

[15]Samuel C. Thompson, Jr. "A Critical Perspective on the Thomas Bill," *Tax Notes*, Jul. 22, 2002, pp. 581-584.

http://wikileaks.org/wiki/CRS-RL31574

scope and applicability of the regimes differ and can overlap in some cases. The tax code contains rules coordinating the various regimes.

H.R. 5095 would repeal the foreign personal holding company rules and the foreign investment company rules. It would exclude foreign-chartered corporations from coverage under the personal holding company provisions.

Provisions Directed at "Earnings Stripping" and Corporate "Inversions" or "Expatriation"

Recent news reports and articles in professional tax journals have drawn the attention of policymakers and the public to a phenomenon sometimes called corporate "inversions" or "expatriation" – instances where firms that consist of multiple corporations reorganize their structure so that the "parent" element of the group is a foreign corporation rather than a corporation chartered in the United States. Firms engaged in the inversions cite a number of reasons for undertaking them, including creating greater "operational flexibility," improved cash management, and an enhanced ability to access international capital markets.[16] Prominent, if not primary, however, is the role of taxes: firms that undertake inversion have indicated they expect significant tax savings from the reorganizations.

A prototypical inversion begins with a firm with operations in both the United States and abroad, but whose parent corporation – the component of the firm whose stock is traded on the stock exchange – is chartered in the United States. Thus, the firm may use the deferral tax benefit for its foreign operations, but its foreign income is ultimately subject to U.S. tax when it is repatriated to the United States. The firm in question inverts by creating a foreign corporation chartered in a low tax country – Bermuda and the Cayman Islands have been cited as popular destinations. The firm reorganizes so the new foreign corporation becomes the parent of the U.S. corporation that was formerly the parent firm; the former U.S. parent transfers its foreign subsidiary corporations to the new foreign parent. The stockholders of the erstwhile U.S. parent firm automatically become stockholders of the new foreign parent.

Inversions need not involve the shift of economic activity from the United States abroad, and those that have been prominently featured in the recent controversy have apparently been accomplished entirely on paper. The transaction does, however, produce tax savings from two general sources. First, as described above, although the United States does not tax the foreign-source income of foreign subsidiaries immediately, it does tax their income when it is ultimately remitted to the United

[16]These reasons were cited by Stanley Works in a Feb. 8, 2002 press release. The release is available at the firm's website at [http://www.stanleyworks.com/index.htm]. See also the Nov. 2, 2001 proxy statement by Ingersoll-Rand, which cited "a variety of potential business, financial and strategic benefits." The statement is available on the IR website at: [http://www.ingersoll-rand.com/proxy.pdf]. Note that on Aug. 1, Stanley Works announced that it was cancelling its planned reorganization.

http://wikileaks.org/wiki/CRS-RL31574

States. An inversion eliminates this deferred tax liability by placing the ownership of foreign subsidiaries in the hands of the new foreign parent.[17]

A second source of tax saving from an inversion – known as "earnings stripping" – actually applies to U.S. rather than foreign-source income. The practice of earnings stripping involves a U.S. subsidiary corporation essentially shifting U.S.-source income out of the U.S. tax jurisdiction, from the hands of a taxable U.S. corporation into the hands of a foreign corporation. In general, the U.S. subsidiary of a foreign corporation makes tax-deductible payments (e.g., interest or royalties) to its foreign parent firm in compensation for intrafirm loans or the use of patents or copyrights. The tax deduction reduces the taxable income of the U.S. subsidiary, while increasing the income of the foreign subsidiary. Given that foreign corporations are subject only to U.S. corporate income tax on the active conduct of a U.S. trade or business, the interest or royalty income is removed from the U.S. tax base.[18] Note that earnings stripping is not unique to inverted U.S.-owned firms, but can be practiced by foreign-owned firms that invest in the United States through U.S.-chartered subsidiaries. Indeed, in 1989 provisions designed to curtail earnings stripping were enacted with section 163(j) of the Internal Revenue Code.

H.R. 5095 contains provisions that would curtail each of these sources of tax savings. First, it would revamp existing restrictions on earnings stripping contained in section 163(j). Under current law, deductions are denied for interest paid to related entities if the payor's debt-to-equity ratio exceeds 1.5 to 1; the deduction is generally denied for interest exceeding 50% of its taxable income, after certain adjustments. Denied deductions are permitted to be carried forward indefinitely, and used to reduce taxable income in the future. H.R. 5095 would redesign the restrictions by removing the debt-to-equity test and reducing the percentage threshold to 35% from 50%. The bill would also limit the carryforward of interest to five years.

In addition to these changes, H.R. 5095 would disallow a portion of interest deductions if a domestic subsidiary's indebtedness is out of proportion to the entire corporate group's indebtedness, and the indebtedness consists of debt to related entities. More specifically, the deductibility of interest on related party debt would be disallowed to the extent the subsidiary's total debt (to both related and unrelated entities) exceeds a share of the entire group's external debt equal to the subsidiary's share of the group's assets.

http://wikileaks.org/wiki/CRS-RL31574

---

[17]At the same time, however, an inversion may trigger U.S. capital gains tax for U.S. individual stockholders of inverting firms. Some have suggested this provides a clue as to the reason for the recent apparent upsurge in inversions – the declines in the stock market have made the individual-level capital gains tax consequences of inversions less onerous. For further information, see CRS Report RL31444, *Firms That Incorporate Abroad for Tax Purposes: Corporate "Inversions" and "Expatriation,"* by David L. Brumbaugh.

[18]Note that aside from the corporate income tax, the United States in some cases applies a withholding tax on interest or royalty payments to non-residents. However, the withholding tax is frequently reduced or eliminated by treaty provisions.

H.R. 5095 addresses inversions' savings on foreign-source income with a temporary measure that would treat the new foreign parent firms created in an inversion transaction as U.S. firms. The foreign parents' foreign-source income would thus be subject to U.S. taxation upon its receipt. The provision would apply to transactions where the shareholders of the former U.S. parent corporation own 80% or more of the new foreign-chartered parent, and the foreign parent does not have substantial business activity in its country of incorporation. The provision would apply for inversions occurring during the three-year period spanning March 20, 2002 to March 20, 2005.[19]

An additional inversion provision under the bill would apply to transfers of foreign stock by a U.S. corporation (e.g., a former parent corporation) to a new foreign parent firm. Under current law, such transfers are in principle subject to U.S. tax, but U.S. tax can be offset by foreign tax credits or net operating losses. H.R. 5095 would prohibit such "toll taxes" from being offset by tax credits and other tax attributes. This provision would apply to transactions where 60% or more of the foreign parent company is owned by stockholders of the former U.S. parent. The provision would be permanent rather than limited to three years.

In contrast to the tax savings inversions can generate at the corporate level, individual stockholders of an inverting firm are generally required to recognize any gain embedded in their stock at the time of inversion. In contrast, current law provides that persons holding stock options are not subject to U.S. tax until the option is exercised. Accordingly, persons holding stock options in inverting firms – for example, corporate officers – could avoid the capital gains tax that would ordinarily apply when an inversion occurs. H.R. 5095 would impose a 20% excise tax on certain holders of an inverting firm's stock options, including officers, directors, and persons owning 10% or more of the firm's stock. The tax would be imposed on gain determined by reference to an option-pricing model specified by the Treasury Department.

Repeal of the Extraterritorial Income Tax Benefit for Exports

Under the U.S. residence-based tax system, the United States would ordinarily tax income its exporters earn from sales of U.S. goods abroad. However, prior to 2001, the U.S. tax code's Foreign Sales Corporation (FSC) rules provided an explicit tax benefit for exporting.[20] The FSC provisions were the statutory descendant of the

[19]This provision is similar to anti-inversion provisions of several other bills introduced in the 107th Congress, although those proposals would generally not be temporary. For a discussion of those bills, see: CRS Report RL31444, *Firms that Incorporate Abroad for Tax Purposes: Corporate "Inversions" and "Expatriation"*, by David L. Brumbaugh.

[20]An alternative, implicit tax benefit for exporting is provided by the so-called "export source rule," under whose terms an exporter can allocate as much as 50% of export income to foreign sources for purposes of calculating its foreign tax credit limitation. This has the effect of providing a 50% tax exemption for firms in an excess credit position. The EU has

(continued...)

http://wikileaks.org/wiki/CRS-RL31574

an earlier tax benefit – the Domestic International Sales Corporation (DISC) provisions, first enacted in 1971. However, European countries charged that DISC was an export subsidy, and so violated the General Agreement on Tariffs and Trade (GATT). Although a GATT panel supported the European charge, the United States never conceded that DISC violated GATT. The FSC provisions were enacted in 1984 in an attempt to defuse the controversy.

In 1997, the countries of the European Union (EU) complained to the World Trade Organization (WTO; successor to GATT) that FSC also was an export subsidy and contravened the WTO. A WTO panel ruling upheld the EU complaint, and to avoid WTO-sanctioned retaliatory tariffs, the United States in November 2000 replaced FSC with the ETI provisions, which deliver a tax benefit of similar size but that was redesigned in an attempt to achieve WTO-compliance. The United States maintained that the ETI provisions were WTO-compliant, but the EU disagreed and asked the WTO to rule against them and approve $4 billion in tariffs. A WTO panel ruled against the ETI provisions in August, 2001, and in January, 2002, a WTO appellate body denied an appeal by the United States. On August 30, 2002, a WTO arbitration panel issued a report approving the level of tariffs requested by the EU.

Some EU officials have suggested that the EU is not anxious to impose sanctions and will delay their implementation as long as it believes the United States is making progress in becoming WTO-compliant. Unlike the previous legislative responses to GATT and WTO rulings, H.R. 5095 does not attempt to construct a WTO-compliant export tax benefit. Rather, it would simply repeal the provision.[21]

Other Provisions

As noted at the outset of the report, H.R. 5095 contains a set of provisions designed to restrict the use of tax shelters by corporations; these provisions are not discussed in this report. In addition, the bill contains several other proposals not related to taxation of income from international transactions.

One of these provisions is indexation and expansion of the "expensing" allowance contained in section 179 of the tax code. Under current law, firms are permitted to deduct immediately (expense) rather than deduct gradually (depreciate) up to $24,000 of equipment investment each year. The allowance is scheduled to increased to $25,000 in 2003 and thereafter. The amount that can be expensed is reduced and gradually eliminated for a firm's investment above $200,000. The effect of the expensing allowance is to confer a tax benefit in the form of a tax deferral because the expensed investment is deducted more rapidly than the asset in question actually declines in value.

---

[20](...continued)
not lodged a complaint against the export source rules.

[21]For further information on the ETI/FSC/WTO controversy, see CRS Report RS20746, *Export Tax Benefits and the WTO: Foreign Sales Corporations and the Extraterritorial Replacement Provisions*, by David L. Brumbaugh.

http://wikileaks.org/wiki/CRS-RL31574

H.R. 5095 would index for inflation both the basic allowance and the $200,000 threshold above which the allowance is phased out. Indexing would begin in 2005. In addition, the bill would increase the base allowance to $40,000 and the phase-out threshold to $325,000 beginning in 2013.

H.R. 5095 also contains a set of relatively narrow revenue-raising items apart from its tax shelter, ETI, and inversion proposals. The largest item is extension of a set of user fees applied by the U.S. Customs Service that are scheduled to expire at the end of FY2003.

Economic Effects

Impact on Investment and Economic Welfare

The range of provisions contained in H.R. 5095 is broad, and a comprehensive analysis of its likely economic effects is not undertaken here. Nonetheless, several general preliminary assessments are possible. First, the bill's proposals relating to the foreign tax credit, controlled foreign corporations, and repeal of the ETI provisions will each probably increase the share of U.S.-owned capital that is employed abroad rather than in the United States beyond what would otherwise occur. Second, in isolation, repeal of the ETI provisions is likely to reduce the level of U.S. trade, reducing both exports and imports. At the same time, however, the increased flow of U.S. capital abroad that would occur in the near term is likely to reduce the U.S. trade deficit in the near term below what would otherwise occur. The bill's net impact on U.S. economic welfare is uncertain, with repeal of the ETI benefit probably increasing U.S. welfare (in isolation) and the foreign tax credit and CFC provisions reducing it. According to "very preliminary" estimates by the Joint Committee on Taxation, the bill would increase revenues by a net $6.4 billion over five years and by $1.1 billion over 10 years.

Business taxes apply to corporate profits – the return from capital investment. Accordingly, the most direct impact of changes in international business taxes is on the level, location, and type of investment firms undertake, and it is here H.R. 5095 would likely have its most immediate impact. As we have seen, the bill proposes changes in two broad areas affecting the income from overseas operations – changes to the foreign tax credit and related source-of-income rules and changes for the deferral principle and Subpart F. In applying to income from overseas operations, the proposals affect the aftertax rate of return on overseas investment; the changes would generally reduce the tax burden on investment abroad and thus increase its attractiveness for U.S. firms. Accordingly, one broad impact of the bill's foreign tax credit and CFC proposals would be to increase the share of U.S.-owned capital consisting of foreign rather than domestic U.S. investment compared to what would otherwise occur.

In contrast, two other broad areas of the bill – its earnings stripping and ETI exporting provisions – would both likely affect the rate of return on investment in the United States. Export production, by definition, involves investment and production in the United States and sales abroad. Repeal of the ETI provisions would therefore

http://wikileaks.org/wiki/CRS-RL31574

probably reduce the aftertax rate of return on investment in the United States export sector and in isolation may increase the flow of U.S. investment abroad by a small amount. At the same time, a portion of investment released from the U.S. export sector would likely stay in the United States, flowing to the import-competing sector and other parts of the economy. For their part, the earnings stripping rules would likely increase the tax burden on foreign investment in the United States by making it harder to shift U.S.-source income abroad for tax purposes. Accordingly, the earnings-stripping provisions would probably reduce the stock of foreign investment to the United States below what would otherwise occur.

Each of these effects works in the same direction, working to increase the share of U.S.-owned capital employed abroad. The lone exception of the bill's proposals appears to be the increase in the expensing allowance for domestic U.S. investment. This provision, in isolation, would probably reduce the level of investment abroad compared to what would otherwise occur. Nonetheless, because the great bulk of the bill's proposals would increase the flow of U.S. investment abroad, the bill's net impact would probably be in that direction.

The bill's likely impact on U.S. exports is harder to discern. In isolation, repeal of the ETI provisions would probably reduce the level of U.S. exports, although exchange rate adjustments that would reduce the price of the U.S. dollar would probably also reduce U.S. imports. In isolation, repeal of the ETI provisions would probably not alter the U.S. balance of trade. But the provisions of the bill that would alter the level of U.S. capital employed abroad – the foreign tax credit and CFC provisions – would likely alter the balance of trade at least in the near term, triggering exchange rate adjustments that would also reduce the price of U.S. currency in world markets. In isolation, U.S. exports would increase and imports would fall, reducing the U.S. trade deficit. It is likely that the net impact of the bill would be to reduce U.S. imports, but whether the bill would increase exports, on balance, is uncertain. These effects may actually reverse in the long run, as capital stocks abroad adjust to the new levels induced by the bill's foreign investment provisions.

Economic theory suggests, however, that a country's ultimate economic welfare – in this case, that of the United States – does not depend, for example, on exporting as much as it possibly can or even on maximizing the competitiveness of its firms' operations abroad. Rather, it depends heavily on whether investment locations are distorted in inefficient ways or on whether the benefit of subsidies accrues to U.S. individuals or firms or flows out of the United States. In the case of an export subsidy such as the ETI provisions, economic theory suggests that its repeal would, in isolation, increase the economic welfare of the United States on both counts. An export subsidy distorts the allocation of investment, drawing an inefficient amount of capital to the export sector and encouraging the subsidizing country (here, the United States) to export more than is economically efficient. At the same time, a part of the export benefit flows to foreign consumers, as U.S. producers pass on part of their tax reduction in the form of lower prices for U.S. goods.

The net impact of the remaining parts of the bill on U.S. economic welfare are harder to discern, and a definite conclusion is not possible at this point. For example, the deferral tax benefit poses an incentive for U.S. firms to invest in low-tax countries more than they otherwise would, and traditional economic theory

http://wikileaks.org/wiki/CRS-RL31574

suggests that such a distortion of investment reduces U.S. economic welfare. Accordingly, the parts of the bill that relax Subpart F and expand deferral – for example, the provisions relating to section 902 firms and the repeal of foreign base company sales income – probably, in isolation, reduce U.S. economic welfare.

In contrast, the bill's interest allocation rules may reduce distortions in investment. As noted above, the rules are designed to correct an imperfection in the design of existing rules that affect the operation of the foreign tax credit limitation, and, in any case, one general impact of the foreign tax credit limitation is to distort investment by posing a tax disincentive to invest abroad. Accordingly, the revised interest allocation rules, by providing more generous foreign tax credit limitation rules, may ease the limitation's distortion and increase economic welfare.

The impact of other foreign tax credit proposals is more ambiguous. The practice of "cross-crediting" foreign tax credits between different streams of foreign income probably poses an incentive to invest in low-tax countries by shielding such investment from U.S. tax. Expansion of cross-crediting would likely result from H.R. 5095's consolidation of the foreign tax credit's separate baskets. On the other hand, however, cross-crediting probably also reduces a disincentive to invest in high-tax countries, thereby reducing a distortion posed by the U.S. foreign tax credit.

But even if both the interest allocation rules and reduction of foreign tax credit baskets were to reduce investment distortions on balance, we could not automatically conclude that the provisions enhance U.S. economic welfare. The reason is tax revenue: to the extent the provisions reduce U.S. tax revenue collected from foreign sources, the provisions may reduce U.S. welfare, and whether that reduction would be sufficient to offset efficiency gains from allocation of investment is not clear.

Impact on U.S. Tax Revenue

As noted above, the Joint Committee on Taxation's preliminary estimates are that H.R. 5095 would, on balance, increase tax revenue over $6.4 billion over its first five years and by $1.1 billion over its first 10 years. These figures are modest compared to other tax bills enacted in recent years. For example, the Economic Growth and Tax Relief Reconciliation Act of 2001 (Public Law 107-16) was estimated to reduce tax revenue by $552.5 billion over five years and by $1,348.5 billion over 10 years. The estimates we cite for H.R. 5095, however, are net amounts equal to the revenue gain from the bill's revenue-raising items minus the revenue loss from its revenue-losing provisions, and the net amounts mask larger swings in revenue that are estimated to occur. Taken alone, the revenue-raising items would increase revenue by an estimated $43.1 billion over five years and $94.7 billion over 10 years; the revenue -losing items would reduce revenue by an estimated $36.6 billion over five years and by $93.6 billion over 10 years. These revenue changes are still small, however, compared to those projected to result from the 2001 tax cut.

Table 1 shows the Joint Committee's estimates for the bill.

http://wikileaks.org/wiki/CRS-RL31574

Table 1. Estimated Revenue Effects of H.R. 5095
(Prepared by the Joint Committee on Taxation)
(Millions of Dollars)

	Fiscal Years 2002-2007	Fiscal Years 2002-2012
Tax Shelter Provisions	**3,766**	**8,510**
Economic substance doctrine	2,912	6,404
Reportable transactions	551	1,270
Partnership loss transfers	196	547
Substantial understatement penalty	38	188
Certain conduct related to tax shelters and reportable transactions	0	0
Civil penalty on failure to report interest in foreign accounts	1	3
Frivolous tax submissions	15	30
Regulation of individuals practicing before the Treasury	0	0
Stripped interest	40	40
Minimum holding period on foreign tax credit	13	28
Consolidated return regulation	0	0
Tax Avoidance Through Earnings Stripping and Expatriation	**2,597**	**6,305**
Earnings stripping	2,115	5,568
Expatriated entities (inversions)	405	595
Compensation of insiders in expatriated corporations	65	115
Reporting of taxable mergers and acquisitions	12	27
U.S. Business Operations Abroad	**-35,069**	**-88,516**
Repeal of CFC rules on foreign base company sales and service income	-13,727	-37,381
Look through treatment of payments between related CFCs	-854	-2,216
Look through treatment for sales of partnership interests	-392	-948
Repeal of foreign personal holding company rules and foreign investment company rules	-269	-785
Treatment of pipeline transportation income	-26	-126
Foreign personal holding company income related to commodities	-42	-95

http://wikileaks.org/wiki/CRS-RL31574

	Fiscal Years 2002-2007	Fiscal Years 2002-2012
Interest expense allocation rules	-9,882	-23,417
Recharacterization of overall domestic loss	-2,383	-6,041
Consolidation of foreign tax credit baskets	-2,785	-6,151
10-year foreign tax credit carryforward	-2,087	-6,725
Repeal of foreign tax credit limit under the minimum tax	-1,873	-3,860
Look through rules for section 902 corporations	-736	-743
Stock ownership rules in apply section 902 and 960 credits	-13	-28
Repeal of export tax benefits	**22,124**	**51,401**
Repeal of ETI tax benefit for exporters	21,957	51,233
Repeal of FSC transitional rules	167	168
Other Provisions	**10,040**	**16,450**
Application of uniform capitalization rules to foreign persons	-488	-548
Assets acquired by dealers	-47	-113
Dividends of regulated investment companies	-445	-988
Average exchange rate rule	0	0
Withholding tax on dividends	-14	-29
Increase in section 179 expensing	-568	-3,422
Extension of IRS user fees	138	341
Extension of customs user fees	5,767	14,883
Nonqualified deferred compensation plans	4,226	5,214
Transfers of excess defined benefits pension plan assets	59	287
Estimated taxes for deemed asset sales	120	145
Interest on tax overpayments	1,108	527
Interest on potential underpayments	130	104
Installment agreements	61	63
Excise tax on bows and arrows	-7	-14
Interaction among provisions	2,968	6,906

Source: U.S. Congress, Joint Committee on Taxation, reprinted in BNA *Daily Tax Report*, July 17, 2002, pp. L1-L4.

http://wikileaks.org/wiki/CRS-RL31574

http://wikileaks.org/wiki/CRS-RL31574

Affected Industries

A general idea of the industries that would be primarily affected by H.R. 5095 can be gained by perusing Internal Revenue Service Statistics of Income data on Foreign Sales Corporations, foreign tax credits, and controlled foreign corporations.

Tables 2 and 3 present FSC data, by type of product, and provide a glimpse of the industries that would likely be most affected by repeal of FSC's successor, the ETI provisions. The tables show that manufactured products, by far, were the leading exports of FSC-utilizing firms. Further, use of FSC was concentrated in just a few manufacturing industries: together, nonelectrical machinery, motor vehicles and aircraft, electrical machinery, and chemicals and drugs accounted for 63% – nearly two-thirds – of FSC receipts and for 56% of exempt income of FSCs.

Table 2. Foreign Sales Corporations, 1996: Gross Receipts, by Major Product

(money amounts in thousands)

	Gross Receipts	Percent of Total Gross Receipts
All Products	**$285,902,491**	**100.0%**
Nonmanufactured Products: Agricultural	**$17,545,571**	**6.1%**
Grains and Soybeans	9,138,533.00	3.2%
Livestock	3,742,374.00	1.3%
Crops, except cotton, grains and soybeans	2,935,908.00	1.0%
Cotton	1,100,600.00	0.4%
Fishery products	583,222.00	0.2%
Agricultural services	44,934.00	0.0%
Nonmanufactured Products: Nonagricultural	**$16,965,476**	**5.9%**
Computer software	8,985,985.00	3.1%
Motion picture distribution	4,312,768.00	1.5%
Engineering and Architectural Services	1,558,867.00	0.5%
Metal mining, except iron	917,219.00	0.3%
Coal mining	877,641.00	0.3%
Leasing services, other than aircraft	312,996.00	0.1%
Miscellaneous Nonmanufactured Products	2,740,361.00	1.0%
Manufactured Products	**$246,480,712**	**86.2%**
Nonelectrical machinery	52,290,199.00	18.3%
Motor vehicles, aircraft, and other transp. equipment	51,932,407.00	18.2%
Electrical machinery	43,665,146.00	15.3%
Chemicals, drugs, and allied products	31,952,356.00	11.2%
Professional instruments	13,205,941.00	4.6%

	Gross Receipts	Percent of Total Gross Receipts
Tobacco products	6,919,745.00	2.4%
Paper and allied products	6,574,620.00	2.3%
Fabricated metal products	5,082,249.00	1.8%
Primary metal products	3,901,103.00	1.4%
Miscellaneous manufactured products	2,773,969.00	1.0%
Rubber and miscellaneous plastics	2,192,314.00	0.8%
Lumber and wood products	2,119,700.00	0.7%
Textile mill products	1,271,260.00	0.4%
Stone, clay, glass, and concrete	930,767.00	0.3%
Apparel and other finshed goods	907,968.00	0.3%
Leather and leather products	884,299.00	0.3%
Printing, publishing, and allied products	770,966.00	0.3%
Furniture and fixtures	479,266.00	0.2%
Petroleum refinery products	392,570.00	0.1%
Food and kindred products	17,505.00	0.0%

Source: CARS calculations based on data in U.S. Internal Revenue Service *Statistics of Income Bulletin,* Spring, 2000, pp. 99-102.

http://wikileaks.org/wiki/CRS-RL31574

Table 3. Foreign Sales Corporations, 1996: Net Exempt Income, by Major Product

(money amounts in thousands)

	Net Exempt Income	% of Total Net Exempt Income
All Products	**$8,496,280**	**100.0%**
Nonmanufactured Products: Agricultural	**$220,350**	**2.6%**
Grains and soybeans	110,594.00	1.3%
Crops, except cotton, grains, and soybeans	40,327.00	0.5%
Livestock	31,965.00	0.4%
Fishery products and services	19,311.00	0.2%
Cotton	12,450.00	0.1%
Agricultural services	5,703.00	0.1%
Nonmanufactured Products: Nonagricultural	**763,309.00**	**9.0%**
Computer software	482,913.00	5.7%
Motion picture distribution	167,425.00	2.0%
Engineering and architectural services	48,680.00	0.6%
Metal mining, except iron	35,502.00	0.4%
Leasing services, other than aircraft	16,788.00	0.2%
Coal mining	12,001.00	0.1%
Miscellaneous nonmanufactured products	94,380.00	1.1%
Manufactured products	**$7,367,733**	**86.7%**
Electrical machinery	1,693,099.00	19.9%
Machinery, other than electrical	1,377,157.00	16.2%
Chemicals, drugs, and allied products	1,354,662.00	15.9%
Professional instruments	472,533.00	5.6%
Transportation equipment	319,477.00	3.8%
Tobacco Products	285,205.00	3.4%
Food and kindred products	284,647.00	3.4%
Paper and allied products	138,272.00	1.6%
Fabricated metal products	111,174.00	1.3%
Miscellaneous nonmanufactured products	98,775.00	1.2%
Primary metal products	80,828.00	1.0%
Lumber and wood products	55,403.00	0.7%
Rubber and miscellaneous plastics	45,313.00	0.5%
Printing and publishing	36,618.00	0.4%
Textile mill products	35,826.00	0.4%

http://wikileaks.org/wiki/CRS-RL31574

	Net Exempt Income	% of Total Net Exempt Income
Stone, clay, glass, and concrete	27,527.00	0.3%
Apparel and other finished products	18,389.00	0.2%
Leather and leather products	15,405.00	0.2%
Furniture and fixtures	12,956.00	0.2%
Petroleum refining	7,647.00	0.1%

Source: CARS calculations based on data in U.S. Internal Revenue Service *Statistics of Income Bulletin,* Spring, 2000, pp. 99-102.

Table 4, below, presents data on foreign tax credits. In assessing the principal industries that would be affected by the foreign tax credit provisions of the bill, we note first that the bill's main foreign tax credit proposals – its provisions for interest allocation rules, recharacterization of domestic loss, consolidation of separate baskets, and extended carryforward period – would only directly affect firms having excess foreign tax credits. Unfortunately, excess credit data on an industry-by-industry basis have not been published, and we are therefore left with indirect indicators of foreign tax credit position for the various industries. Table 4 offers one such indirect measure, contained in the right-most column of the table: the percentage of all un-credited foreign taxes accounted for by each industry, which can be viewed as an approximation of the percentage of total excess credits in each industry. The table shows that petroleum manufacturing by far accounts for the largest share of "uncredited" foreign taxes, at 30.4%.[22] Primary metal products is a distant second, at 7.9%, motor vehicles is third at 6.1%, banking is fourth at 4.3%, and wholesale trade is fifth, at 3.8%.

Table 5 presents data on Subpart F income. The right-hand column lists Subpart F income by industry, as a percentage of total Subpart F income, and thus gives an idea of which industries may be most affected by H.R. 5095's relaxation of Subpart F rules. According to the table, Subpart F income is concentrated in the finance, insurance, and real estate industry (FIREA) – a phenomenon that likely reflects the importance of passive income in the Subpart F rules. FIREA accounts for 51.7% of all Subpart F income. Within FIREA, holding companies have the largest portion of Subpart F income, followed by credit agencies, banks, and insurance firms. Manufacturing accounts for only 28.39% of Subpart F income, with drugs and electrical equipment manufacturers the leaders.

[22]This high percentage may result from the exclusion of foreign taxes on oil extraction, because oil firms tend to be vertically integrated and taxes on oil extraction tend to be high.

http://wikileaks.org/wiki/CRS-RL31574

Table 4. 1997 Foreign Tax Credits Claimed, by Industry

(money amounts in thousands of dollars)

	Foreign Taxes Available for Credit	Foreign Tax Credit Claimed	Available Foreign Taxes less Credits Claimed	Percentage of Aggregate Foreign Taxes Not Credited
All Industries	$49,979,466	$42,222,743	$7,756,723	100.0%
Agriculture, forestry, and fishing	38,313.00	34,696.00	3,617.00	0.0%
Mining	1,416,118.00	906,954.00	509,164.00	6.6%
Metal mining	417,581.00	166,282.00	251,299.00	3.2%
Oil and gas extraction	854,837.00	637,691.00	217,146.00	2.8%
Coal mining	134,825.00	94,155.00	40,670.00	0.5%
Nonmetallic minerals, except fuels	8,875.00	8,826.00	49.00	0.0%
Construction	63,431.00	44,412.00	19,019.00	0.2%
Manufacturing	35,792,177.00	30,299,210.00	5,492,967.00	70.8%
Petroleum	9,102,941.00	6,748,403.00	2,354,538.00	30.4%
Drugs	2,815,266.00	2,202,041.00	613,225.00	7.9%
Electrical and electronic equipment	3,437,298.00	2,962,524.00	474,774.00	6.1%
Primary metal products	701,061.00	421,868.00	279,193.00	3.6%
Motor vehicles and equipment	2,624,433.00	2,380,504.00	243,929.00	3.1%
Food and kindred products	3,042,404.00	2,801,304.00	241,100.00	3.1%
Office, computing, and accounting	3,376,725.00	3,150,955.00	225,770.00	2.9%
Industrial plastics	1,861,492.00	1,647,569.00	213,923.00	2.8%
Other chemicals	1,471,640.00	1,321,594.00	150,046.00	1.9%
Fabricated metal products	844,557.00	694,974.00	149,583.00	1.9%
Other machinery, except electrical	985,714.00	854,506.00	131,208.00	1.7%
Tobacco manufactures	1,379,627.00	1,302,880.00	76,747.00	1.0%
Instruments	1,344,804.00	1,292,349.00	52,455.00	0.7%
Paper and allied products	716,140.00	664,059.00	52,081.00	0.7%
Stone, clay, and glass	144,642.00	101,193.00	43,449.00	0.6%
Printing and publishing	331,423.00	288,130.00	43,293.00	0.6%
Miscellaneous manufacturing	217,384.00	177,199.00	40,185.00	0.5%
Rubber and misc. plastics	440,363.00	402,316.00	38,047.00	0.5%
Apparel and other textile products	291,790.00	266,279.00	25,511.00	0.3%
Furniture and fixtures	41,940.00	22,761.00	19,179.00	0.2%

http://wikileaks.org/wiki/CRS-RL31574

	Foreign Taxes Available for Credit	Foreign Tax Credit Claimed	Available Foreign Taxes less Credits Claimed	Percentage of Aggregate Foreign Taxes Not Credited
Lumber and wood products	52,370.00	40,342.00	12,028.00	0.2%
Transportation equipment, except motor vehicles	527,783.00	517,204.00	10,579.00	0.1%
Textile mill products	28,485.00	26,532.00	1,953.00	0.0%
Leather and leather products	11,896.00	11,724.00	172.00	0.0%
Transportation and Public Utilities	969,683.00	802,644.00	167,039.00	2.2%
Communication	539,130.00	451,925.00	87,205.00	1.1%
Electric, gas, and sanitary services	216,693.00	163,078.00	53,615.00	0.7%
Transportation	213,860.00	187,641.00	26,219.00	0.3%
Wholesale trade	980,300.00	686,471.00	293,829.00	3.8%
Retail trade	913,847.00	696,776.00	217,071.00	2.8%
Finance, insurance, and real estate	7,370,111.00	6,654,591.00	715,520.00	9.2%
Banking	3,672,822.00	3,337,311.00	335,511.00	4.3%
Insurance	1,703,013.00	1,552,984.00	150,029.00	1.9%
Holding companies	620,007.00	481,423.00	138,584.00	1.8%
Credit agencies	505,543.00	457,527.00	48,016.00	0.6%
Security, commodity brokers, and services	801,877.00	765,424.00	36,453.00	0.5%
Real estate	16,188.00	9,759.00	6,429.00	0.1%
Insurance agents	50,660.00	50,162.00	498.00	0.0%
Services	2,435,487.00	2,096,990.00	338,497.00	4.4%

Source: U.S. Internal Revenue Service, *Statistics of Income Bulletin*, Winter 2001-2002, pp. 121-135; CRS calculations.

http://wikileaks.org/wiki/CRS-RL31574

http://wikileaks.org/wiki/CRS-RL31574

Table 5. 1996 Subpart F Income of Controlled Foreign Corporations, by Industry

(dollar amounts in thousands)

	Subpart F Income	Percent of Total Subpart F Income
All Industries	**22,943,983.00**	**100.00%**
Agriculture, forestry, and fishing	**18,099.00**	**0.08%**
Mining	**357,072.00**	**1.56%**
Oil and gas extraction	323,957.00	1.41%
Nonmetallic minerals, except fuels	25,051.00	0.11%
Metal Mining	8,065.00	0.04%
Construction	119,762.00	0.52%
Special trade contractors	109,199.00	0.48%
Heavy construction contractors	10,551.00	0.05%
General bldg. contractors and operative builders	12.00	0.00%
Manufacturing	**6,512,757.00**	**28.39%**
Drugs	1,386,119.00	6.04%
Electrical and electronic equipment	872,370.00	3.80%
Industrial, plastics, and synthetic materials	562,158.00	2.45%
Office, computing, and accounting machinery	534,811.00	2.33%
Petroleum and coal products	521,951.00	2.27%
Motor vehicles and equipment	486,697.00	2.12%
Food and kindred products	452,812.00	1.97%
Tobacco manufacturers	436,613.00	1.90%
Other chemicals	279,546.00	1.22%
Instruments and related products	269,941.00	1.18%
Miscellaneous manufacturing products	208,228.00	0.91%
Primary metals industries	141,864.00	0.62%
Other machinery, except electrical	126,859.00	0.55%
Fabricated metal products	110,018.00	0.48%
Paper and allied products	46,856.00	0.20%
Rubber and misc. plastic products	29,719.00	0.13%

	Subpart F Income	**Percent of Total Subpart F Income**
Transportation equipment, except motor vehicles	11,631.00	0.05%
Textile mill products	10,394.00	0.05%
Printing and publishing	9,394.00	0.04%
Stone, clay, and glass products	5,661.00	0.02%
Furniture and fixtures	4,662.00	0.02%
Apparel and other textile products	2,607.00	0.01%
Lumber and wood products	1,846.00	0.01%
Transportation and public utilities	**388,157.00**	**1.69%**
Water transportation	130,536.00	0.57%
Other transportation	119,321.00	0.52%
Communication	70,381.00	0.31%
Electric, gas, and sanitary services	67,919.00	0.30%
Wholesale trade	**2,148,213.00**	**9.36%**
Retail trade	**241,478.00**	**1.05%**
Finance, insurance, and real estate	**11,862,803.00**	**51.70%**
Holding and other investment companies	4,859,873.00	21.18%
Credit agencies, other than banks	2,911,319.00	12.69%
Banking	1,653,523.00	7.21%
Insurance	1,597,589.00	6.96%
Security, commodity brokers, and services	677,939.00	2.95%
Real estate	119,665.00	0.52%
Insurance agents, brokers, and services	42,896.00	0.19%
Services	**1,295,642.00**	**5.65%**
Business services	791,333.00	3.45%
Other services	421,221.00	1.84%
Hotels and other lodging places	39,983.00	0.17%
Amusement and rec. services	15,559.00	0.07%

Source: U.S. Internal Revenue Service, *Statistics of Income Bulletin*, Spring, 2001, pp. 146-7; CRS calculations.

http://wikileaks.org/wiki/CRS-RL31574