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This paper, due to space considerations, will focus on Professor Peroni's discussion concerning the imposition of tax on the foreign income derived by resident taxpayers through foreign entities.

Initially, the basic question is whether income from capital is to be taxed at all. Professor Peroni assumes that it will, and I do not disagree. But there are others, such as Malcolm Gammie, who believe that it is administratively infeasible to impose a tax on internationally mobile capital, or on the income derived therefrom, and conclude from this that capital and capital income should not be taxed at all.[1]

This position has always struck me as unacceptable as a matter of social and political policy. In the era of a widening gulf between rich and poor, I cannot imagine that wage earners (and real estate owners) should entirely bear the cost of government, while entrepreneurs such as Bill Gates, for example, contribute nothing. Nevertheless, this argument suggests two relevant points. The first, of course, is that much simplicity could in fact be achieved by simply exempting capital income from tax. The second point, more relevant here, is that effective enforcement of a residence-based tax on international income is highly problematic.

Foreign income is often derived through complex legal structures. Moreover, as Dan Frisch aptly pointed out several years ago,[2] the mix of international flows includes a growing component of portfolio investment. Anyone who has contemplated how to enforce compliance with "treaty-shopping" limitations on reduction of withholding taxes on portfolio dividends,[3] or has struggled to advise a client with respect to a second- or third-tier corporation which is or may be a Passive Foreign Investment Company,[4] can attest to the difficulties involved. The advent of cyberspace can only make the situation dramatically worse.

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1. *See, e.g.*, Gammie, *The Global Future of Income Tax, Int'l Bull., Fiscal Doc.* (Nov./Dec. 1996).

2. *See* Daniel J. Frisch, *The Economics of International Tax Policy: Some Old and New Approaches*, 47 TAX NOTES 581, 587 (1990).

3. *See* David R. Tillinghast, *Tax Treaty Issues*, 50 U. MIAMI L. REV. 455, 465-67 (1996).

4. *See* I.R.C. § 1297(a)(2), (b)(5) (1982).

Absent a quantum leap in the level of available administrative resources and inter-governmental cooperation, we must face the fact that, at a time when tax morality is hardly at its zenith, the enforcement of far-reaching "look-through" rules, designed to prevent resident taxpayers from sheltering otherwise taxable income in offshore entities, can be spotty at best. The rules will apply only to those who voluntarily comply with them and those who are discovered in exceptional circumstances.

The issue is whether such a situation is preferable to one in which the very attempt to tax international income flows is abandoned as hopeless. Like Professor Peroni, I am persuaded that it is; however, this is a central issue which precedes virtually all discussion about taxing international income flows.

Professor Peroni correctly emphasizes that the concept of capital import neutrality must be understood in a broad range of cases to imply exemption or near exemption from tax, simply because participants in international markets have such a broad range of choices in sourcing income and many countries seem more than happy to accommodate them. A rapidly expanding sector of international commerce involves the provision of information services, which have no inherent source. (I was intrigued to learn, for example, that Guyana has become the major source of available on-line pornography.)[5] Beyond this, moreover, the explosion in communications technology makes it feasible in many cases to have services physically performed wherever this seems advantageous. And even in the case of "hard goods" and manufacturing, the range of locational choice continually increases.

The danger of a "race to the bottom," as Professor McClure so aptly put it,[6] by countries anxious to attract investment through tax concessions, is very real. One need look no further than to a relatively respectable country, the Netherlands, for confirmation. Already offering an attractive tax regime for holding companies, the Dutch have recently introduced a highly concessional scheme for group finance companies[7] whose sole purpose is to attract multinational investment and income flows to that country.

If one rejects the concept of capital import neutrality, one comes quickly to Professor Peroni's argument for ending the deferral of U.S. tax on the income which U.S. taxpayers derive through foreign entities.

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5. *See Cybersex: An Adult Affair*, THE ECONOMIST, Jan. 4, 1997, at 65.

6. Visions of Tax Systems in the Twenty-First Century, Address at the 50th Annual Congress of the International Fiscal Association (Sept. 3, 1996) (forthcoming 1997).

7. *See* Maarten van der Weyden, Dick Hofland & Kees van Raad, *Netherlands Tackles Tax-Base Erosion and Proposes Measures to Improve Investment Climate*, 12 TAX NOTES INT'L 447 (1996).

This requires dealing with direct investment on the one hand, and with portfolio investment on the other, as these present quite different sorts of issues. In general, I found Professor Peroni's proposals for a Controlled Foreign Corporation ("CFC") regime to be sensible (if not politically attainable). In particular, I would agree with his extending "look-through" foreign tax credits to non-corporate shareholders in a CFC.

An issue which requires more attention, however, is how to treat a U.S. person who is a substantial (direct) investor in a foreign corporation which is controlled by a limited number of shareholders, but is not U.S.-controlled. The prototype case is the frequently encountered one in which a U.S. corporation enters into a joint venture with one or more foreign corporations. Suppose that the U.S. corporation owns 50%, 25% or 10% of a foreign joint venture company's stock, and that the remainder is owned by two foreign corporations having no U.S. ownership. If the foreign entity were a partnership, the U.S. corporation (or, in the real world, its participating subsidiary) would be taxed currently under Professor Peroni's proposal. It seems that the result should be the same if it is a corporation for U.S. tax purposes.

Stephen Shay would impose a current tax in this case (although he does not fully define the circumstances in which his rule would apply).[8] Professor Peroni would deal with this issue by denying indirect foreign tax credits to a U.S. corporation holding such a participation unless the corporation elected to include its share of the foreign corporation's income currently. The problem is that in the case of tax haven operations, the loss of credits will be insignificant.

Since joint ventures, "strategic alliances," and the like, have become an increasingly important part of the international scene, this issue should be addressed. A decision must be made, of course, as to where to draw the line between direct investment and portfolio investment. One idea would be to apply the controlled foreign corporation definition[9] regardless of whether the controlling persons are U.S. persons. This would impose the tax only on a 10% or greater holder, and the existence of concentrated control of the foreign corporation would give at least some assurance that the U.S. participant(s) would be able to command distributions, if necessary, to fund their U.S. tax burdens.

Further, I was not entirely satisfied with Professor Peroni's proposals for dealing with portfolio investment. I would agree that the way to address this issue is to modify the Passive Foreign Investment Company

8. *See* Stephen E. Shay, *Revisiting U.S. Anti-Deferral Rules*, 74 TAXES 1042, 1061 (1996).

9. I.R.C. § 957(a) (1982) (defining a controlled foreign corporation as one in which a U.S. person or persons, each owning at least 10% of the voting shares, together own more than 50% of the total voting power or value).

("PFIC") provisions of existing law, but I would modify them in a different way. To begin with, I think that we need to focus on the definitional structure. A common, if banal, aphorism among practitioners is that every foreign corporation is a PFIC. If not literally true, this adage does reflect the fact that the PFIC rules are overreaching in the sense that they apply (or may apply) to a very large number of foreign corporations that are nothing like the offshore investment companies at which Congress originally took aim. To take only the simplest example, the "once-a-PFIC-always-a-PFIC" rule[10] makes the PFIC regime applicable to many foreign corporations which engage in an active business by any reasonable standard, and has the effect of deterring U.S. portfolio investment in foreign "start-up" situations. (For a variety of reasons, the existing "start-up" exception is not adequate.)[11] There are other areas (such as multi-corporate real estate enterprises) in which the statute or the regulations seem too restrictive.

Beyond this badly needed clean-up, the major issue is how to tax a U.S. shareholder in a PFIC. I am dubious about Professor Peroni's proposal to require current inclusion of a "deemed rate of return" in cases where the U.S. shareholders have insufficient information to compute an actual pro rata share of the PFIC's income. There is no doubt that this addresses a critical problem. My experience (and I believe that other practitioners share it) is that a U.S. shareholder in a PFIC will elect current inclusion wherever possible, because the "deferral with interest charge" inclusion rules are considered a greater evil, and the inability to persuade the foreign corporation to supply the necessary information statement[12] is, in practice, the principal obstacle to current inclusion. But taxing the U.S. shareholder on imputed income raises some rather fundamental issues.

The existing PFIC rules were premised on the idea that compelling (as opposed to permitting) a U.S. taxpayer to pay tax on corporate income that is not distributed—and which the taxpayer cannot cause to be distributed by participating in a controlling shareholder group—raises questions of fairness and possibly even legality.[13] I have not examined

10. I.R.C. § 1297(b)(1) (1982). The impact of this rule can be avoided if the shareholder makes a qualified electing fund election under I.R.C. § 1293, but in many cases this is not feasible.

11. Under I.R.C. § 1297(b)(2), a corporation which would otherwise be a PFIC in the first year it has gross income will not be so treated if it is not a PFIC in the two succeeding years. In many "greenfield" foreign projects, there is an initial construction period in which the only income the foreign corporation receives is interest on temporarily invested balances, so that 100% of its gross income consists of passive income. This period frequently lasts more than one year. *See* I.R.C § 1297(b)(2) (1982).

12. *See* I.R.S. Notice 88-125, 1988-2 C.B. 535 (1988).

13. *See* AMERICAN LAW INSTITUTE, INTERNATIONAL ASPECTS OF UNITED STATES INCOME

these issues recently and so I cannot speak to them. It is incumbent, however, on those who propose current inclusion based upon an imputed return to demonstrate that this appropriately comports with the concept of an income tax.

Putting the question in less legalistic terms, the issue is whether the simplicity gains achieved by imposing a current tax based upon a prescribed interest rate are more meaningful than the inevitable unfairness which will result. Surely, any prescribed rate of return will wildly under-estimate the income of some, while wildly over-estimating the income of others. To take an extreme example, imputing a rate of return equal to three percentage points over the federal refund interest rate would be confiscatory for a U.S. person who invested in a foreign money market fund.

A question which Professor Peroni does not address is how he would treat the disposition of shares by U.S. persons subject to the imputed income regime. If a differential capital gains rate applied, a benefit would accrue to the U.S. taxpayer whose share of the PFIC's income has been under-reported. This could be accepted as an inevitable glitch in the system. But what about the U.S. person whose share of the PFIC's income has been overstated? Absent a special rule, that person would suffer a capital loss, which could often be unusable. This would systematically disadvantage portfolio investment abroad.

Requiring current inclusion based upon an imputed income does not strike me as being necessarily the best way to deal with the problem of PFIC inclusions. For example, much can be said for the "mark-to-market" rule.[14] It is true that the rule may complicate the statute, because it will not apply in every case. It also requires the U.S. taxpayer to forego capital gains benefits. But at the same time, it works rather simply and equitably for a broad range of taxpayers that acquire shares in quoted companies (and who may be thought, therefore, to be the least devious of the investors with whom the PFIC rules must deal).

No doubt the residual PFIC inclusion rule, which defers the imposition of tax but imposes an interest charge,[15] is a highly complex and imperfect taxing mechanism. There are a number of ways in which it could be improved. For example, the assumption built into the rule that any gain on disposition of PFIC shares accrued ratably over the holder's holding period is harsh and irrational. What would be of great interest would be a study of how a reformulated deferral rule would compare

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TAXATION—PROPOSALS ON UNITED STATES TAXATION OF FOREIGN PERSONS AND OF THE FOREIGN INCOME OF UNTIED STATES PERSONS 188-92 (1987).

14. *See* Prop. Treas. Reg. § 1.1291-8, Fed. Reg. (1996).

15. I.R.C. § 1291 (1982).

with a fleshed-out "deemed rate of return" rule. In my book, the formulation of the PFIC regime could then include: (1) an elective current inclusion rule based on the existing qualified electing fund election; (2) an elective "mark-to-market" rule; and (3) one of the above alternatives as the residual taxing rule. This three-tier structure would mirror the technical amendment which has already been floated—except that the third-tier rule might change.