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Richard S. Lehman

THE TAX REFORM ACT OF 1975 AND THE FOREIGN TAX AREA

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On December 4, 1975 the House of Representatives passed H.R. 10612, the Tax Reform Act of 1975 (the Act). It is presently before the United States Senate and it is likely that final action will be taken during the year 1976. The Act contains a substantial number of revisions to the present method by which the United States taxes both United States persons earning income from without the United States, as well as nonresident alien individuals and foreign corporations earning income within the United States (foreign tax).

The purpose of this article is to consider most, but not all the proposed changes in the foreign tax area. This will enable persons affected to be heard prior to enactment if they wish to be involved in the legislative process, and to make the necessary plans to accommodate to the Act should it become law. Each proposed change will be considered by first summarizing the existing law and its underlying policy. Next the proposed change and the Congressional policy for such change will be discussed. Future editions of *Lawyer of the Americas* will report the fate of the Tax Reform Act of 1975.

INCOME EARNED ABROAD BY UNITED STATES CITIZENS

Presently a United States citizen who establishes either (1) that he has been a bonafide resident of a foreign country or countries for an uninterrupted period which includes an entire taxable year; or (2) that he has been physically present in such country or countries for at least five hundred and ten full days during a consecutive eighteen-month period can exclude a certain amount of income consisting of remuneration for personal services from his gross income for Federal income tax purposes.[1] The amount to be excluded cannot exceed $20,000. However, for bonafide

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residents of a foreign country a higher ceiling of $25,000 is provided for the fourth and subsequent years if they have been bonafide residents for an uninterrupted period of three years.[2]

This income tax exclusion is of interest to both United States citizens and their employers since it has a direct bearing on the cost of labor to United States-owned business working abroad. The exclusion was originally intended to encourage Americans with skill and technical knowledge to go abroad and to allow United States-owned businesses working abroad and using United States personnel to compete on an equal footing with companies of other nations whose nationals were not subject to taxation by their own countries.[3]

The Act proposes to phase out over a four-year period the exclusion for income earned abroad by United States citizens. Beginning in the year 1976, the $20,000 and $25,000 exclusion will be reduced 25% each year and for taxable years beginning in 1979, the exclusion will be completely repealed.[4]

The following is the House Ways and Means Committee policy discussion on the repeal of the exclusion:

> The exclusion of $20,000 (or $25,000) of income earned abroad provides a tax advantage to those U.S. citizens who live and work abroad compared with those who live and work in the United States. Moreover, in many cases the foreign governments in the country where U.S. citizens are employed do not impose income taxes on the U.S. citizens, particularly if the compensation is paid to a private employee outside of that foreign country (e.g. if the salary is sent to a bank outside of that country).
>
> Moreover, in those cases where a foreign tax is paid by the U.S. citizen, that tax is creditable directly against any U.S. tax that might otherwise exist on income above the $20,000 or $25,000 excludable limits. This combination of an exclusion of $20,000 or $25,000 of income (including the excluded income) gives taxpayers who do pay tax to foreign governments in effect a double benefit, in that they can offset the foreign taxes paid on the excluded income against any U.S. tax which may be due on additional income. The result is that in effect up to $40,000 or more of earned income can be exempted from U.S. tax if the U.S. employee pays any significant income tax to the foreign government.

> Your committee has concluded that a tax advantage for U.S. citizens living and working abroad for private companies over U.S. citizens living and working in the United States is no longer appropriate. Although it is true that in many cases the cost of living and additional travel and other expenses make total living costs for a U.S. citizen working abroad higher than that of many U.S. citizens working in the United States, it is also true that the cost of living varies greatly from area to area within the United States, and that the cost of living in some areas of the United States is significantly higher than in many areas abroad. Given these wide variations both within and without the United States, your committee believes that the tax laws in practice cannot be fairly adjusted for these costs.[5]

WESTERN HEMISPHERE TRADE CORPORATIONS

Under existing law a special provision provides for a reduced corporate tax rate for a United States domestic corporation which is engaged in a trade or business almost exclusively in the Western Hemisphere. This provision applies to what is known as Western Hemisphere Trade Corporation.[6]

A Western Hemisphere Trade Corporation is a United States corporation which (1) conducts all of its business (except for incidental purchases) in the Western Hemisphere; (that is, North, Central or South America, or in the West Indies)[7] (2) derives at least 95% of its income from sources outside the United States; and (3) derives at least 90% of its gross income from the active conduct of a trade or business. In determining whether 95% of the gross income is derived from sources outside the United States, one looks at the place of sale when United States goods are sold abroad.[8]

The tax benefit extended to Western Hemisphere Trade Corporations is one of reduced Federal corporate income tax.[9] The tax concession is achieved by the use of a special deduction in computing taxable income. The deduction is a fraction of taxable income which can result in a corporate tax rate reduction as high as fourteen percent.

The announced legislative purpose of this tax concession was to encourage domestic corporations to engage in foreign commerce. European countries had granted tax concessions to their own nationals engaged in business in the Western Hemisphere and it was believed that in order to allow American business to compete equally, United States tax concessions were a necessity.[10]

The proposed change will phase out over a five-year period the tax benefits accorded Western Hemisphere Trade Corporations. Beginning in the year 1976, the maximum 14% tax benefit will be reduced 3% each year until the benefit is completely repealed for taxable years beginning after 1979.[11]

The reason for the proposed change was expressed by the House Ways and Means Committee as follows:

> The WHTC provisions were originally enacted in 1942 during a period of high U.S. wartime taxes and generally low taxes in other Western Hemisphere countries. The provision was aimed at insuring that domestic corporations did not operate at a disadvantage in competing with foreign corporations within the Western Hemisphere. While not explicitly stated, it appears that the goal was to retain U.S. ownership of foreign investments, which if placed in a foreign corporation, might end up being owned by foreign interests.
>
> Your committee believes general tax equity requires that income derived from all foreign sources be taxed at the same rate. To the extent that incentives are needed for the export of U.S. manufactured goods the committee believes that the Domestic International Sale Corporation (DISC) provisions of present law are a more appropriate incentive. Further, because the taxes imposed by other Western Hemisphere countries have been substantially increased since the original enactment of the provision, many companies which qualify as WHTCs receive little or no benefit from the deduction. Thus, in many instances the WHTC deduction, merely adds to the complexity of preparing an income tax return without providing significant tax benefits.
>
> The preferential rate granted to WHTCs has also encouraged U.S. manufacturers to set the prices on sales of goods to related WHTCs so as to maximize the income derived by the WHTC, since this income is taxed at the lower WHTC rate. These pricing practices have been the source of many controversies between taxpayers and the Internal Revenue Service. Finally, the broad interpretation given to the WHTC provisions by the

Internal Revenue Service has enabled corporations to obtain the benefits of the WHTC provisions for goods manufactured outside the Western Hemisphere by causing the title to the goods which are sold to the WHTC to be passed within the Western Hemisphere. In such a situation your committee believes it is inappropriate to give special tax relief. For the above reasons your committee believes that the special tax relief given to WHTC should be repealed.[12]

DOMESTIC INTERNATIONAL SALES CORPORATIONS

In 1971 legislation recommended by the Treasury was enacted with the expressed intent of conferring tax *deferral* benefits on the export industry when exporting United States products. The general effect of this legislation which established the Domestic International Sales Corporation or DISC was to tax immediately to the shareholders of a DISC, only 50% of the income earned by a DISC so long as the remaining income was continued to be used by the DISC and not distributed.

This is a very complex piece of legislation. In brief, a DISC is a domestic corporation whose income is derived primarily from export sale and lease transactions, or certain other export-related activities or investments and whose properties consist predominantly of "qualified" export-related assets. The principal function of a DISC is to handle export sales and leasing activities. *A DISC itself is not subject to Federal Income Tax if it elects to be treated as a DISC;* instead, *approximately one-half of the DISC's earnings are taxed currently to its shareholders as constructive dividends even though not distributed, and the rest of its earnings are not taxable to the shareholders until actually distributed,* or until a shareholder disposes of his DISC stock in a taxable transaction, or the corporation ceases to qualify as a DISC. The effect of all this is that taxation is deferred for approximately one-half the export earnings of a DISC, the other half being subject to current taxation, as constructive dividends, at the shareholder level.

Essentially, DISC qualification is extended to a (1) domestic corporation; (2) if at least 95% of its gross receipts consist of qualified export receipts; (3) at least 95% of its assets consist of qualified export assets (4) which elects treatment as a DISC.[13]

The basic definitional elements of a DISC are "qualified export receipts" and "qualified export assets." In brief, qualified export receipts are defined as receipts arising from the sale of qualified "export property" (generally inventory produced in the United States, by someone other than the DISC, for export abroad), receipts from the leasing of export property which is used outside the United States, gains from the sale of qualified "export assets" other than export property (generally the nonmanufacturing operating assets of the DISC), and receipts from various other export related services and investments.[14]

Qualified export assets are defined as "export property," e.g., inventory or rental property produced in the United States, by someone other than the DISC, and held for sale or rental use outside the United States, operating assets of the export business (other than "manufacturing assets"), receivables from export transactions, working capital funds, and various other export-related investments.[15]

Thus, the principal function of a DISC, under these definitions, is the selling or leasing of export property which has been created by someone else in the United States for ultimate use outside the United States. In other words, a DISC is not allowed to manufacture or in any way bring into being the property designed for export.

The DISC legislation was extremely successful. In fact, its success may result in its undoing, for as the Committee report reflects, the main reason for the proposed changes to the DISC legislation is the cost of the tax deferral benefits to the Treasury.

Basically, there are two main proposed changes applicable to the DISC. One is that DISC benefits will no longer apply to products and commodities which do not need export incentives because they are in demand both at home and abroad.[16]

The more important modification is one which substantially restricts the deferral benefits of the DISC legislation. However, it does not apply to DISC's whose taxable income is $100,000 or less. The effect of the reform is to extend the fifty percent tax deferral benefits on DISC taxable income only to that proportionate part of the DISC taxable income which reflects *increased* earnings due to increased exports over a certain base measuring period. In other words, if the DISC does not continually improve export sales on a yearly basis, it will be able to make little use of DISC benefits. Until the year 1981, the base measuring period will be the years 1972, 1973 and 1974.[17]

Beginning in 1981 the base period becomes a moving three-year period. For the near term, the practical effect will be that newly formed

DISCs which have no DISC sales during the 1972-1974 period will enjoy complete DISC benefits while those DISCs which were active in the years 1972-1974 will only enjoy DISC benefits based on a formula which reflects increased exports for those years. The best approach to simplify the reforms applicable to the DISC and to explain the formula which must be used to reflect reduced DISC benefits resulting from the reform is by way of example. The following example is used only for purposes of illustrating the proposed changes.

Assume *DISC A* was in existence during the years 1972, 1973 and 1974 and had export gross receipts of $100X each year. Assume in the year 1976 its export gross receipts was only $75X and it had a taxable income of $20X. Under existing law, of the taxable income of $20X, only $10X would be deemed distributed and taxable to the DISC shareholders. If the proposed reforms are enacted into law, all $20X will be subject to immediate taxation by the DISC shareholders. The new law provides for a deemed taxable distribution for the entire non-incremental portion of the taxable year's export gross receipts. The amount of taxable income which would be subject to the 50% DISC deferral is *0* and is calculated as follows:

That amount of the DISC current year taxable income *included* in shareholder income is:

(1) $$\text{DISC Current Taxable Income} \times \frac{\text{75\% of the Average Export Gross Receipts for the Base Period (years 1972-1974)}}{\text{DISC Current Year Export Gross Receipts}}$$

OR

(2) $$20 \times \frac{75\% \text{ of } 100}{75}$$

(3) $$20 \times \frac{75}{75} = 20$$

The Committee explained its reform as follows:

> Your committee has examined the DISC provisions at great length and has concluded that the legislation has had a beneficial impact on U.S. exports. Since 1971, when DISC was enacted, exports have increased from $43 billion to nearly $109

billion at an annual rate for the first quarter of 1975. It is clear that much of this increase has resulted from the devaluation of the dollar which has taken place since that period. Nonetheless, your committee concluded that a significant portion of the increase in exports which has taken place resulted from the DISC legislation. This increase in exports, the committee concluded, provides jobs for U.S. workers and helps the U.S. balance of payments.

However, your committee also recognized that the revenue cost of the DISC program has been substantial. In 1975, the program is expected to cost nearly $1.3 billion and in 1976 the amount is estimated to be $1.4 billion. Furthermore, the committe believes that the DISC legislation is made less efficient because the benefits apply to all exports of a company, regardless of whether or not a company's products would be sold in similar amounts without export incentives and regardless of whether or not the company is increasing or decreasing its exports.

Given these considerations your committee concluded that the DISC program could become more efficient and less costly while still providing the same incentive for increased exports and jobs by granting DISC benefits only to the extent that a company increases its exports over a base period amount and by excluding from DISC benefits certain products and commodities for which the committee believes that no incentive is needed for export sales.[18]

TAXATION OF UNITED STATES SHAREHOLDERS OF FOREIGN CORPORATIONS

Before considering the proposed modifications to the taxation of United States shareholders of foreign corporations it is deemed advisable to provide brief background on the taxation of foreign income of foreign corporations and their shareholders by the U.S. Government.

Since the inception of the United States corporate income tax, with only limited exceptions, earnings derived by foreign corporations from sources without the United States have not been subject to current United States income tax.[19] Thus, a foreign corporation may be owned by United

States citizens or residents and if it is not engaged in a trade or business within the United States and does not have United States source income it will not be subject to Federal income tax. The basic policy reason for this stems from Congress' concern whether a foreign corporation with U.S. shareholders could be subjected to the full force of United States taxation of its foreign income without violating certain tenets of international law.[20]

However, the earnings of these American-owned foreign corporations do become taxable to the United States shareholders when the corporate earnings are distributed as dividends or when the interest in the foreign corporation is sold or exchanged.[21]

This concept of not taxing such earnings until actual distribution or disposition of the interest in the foreign corporation results in a certain tax benefit known as "tax deferral." Tax deferral, which enables the beneficiary to avoid *current* United States taxation has been referred to as "an unwarranted tax advantage to U.S. owned foreign corporations or an appropriate tax policy depending upon one's point of view."[22]

Be that as it may, it does presently exist. However, prior to 1962 the above described statutory scheme had led to certain abuses. This resulted in legislation that at times completely negated the idea of deferral of certain types of foreign source income earned by foreign corporations controlled by United States shareholders. That corrective legislation established a pattern of taxation for the "Controlled Foreign Corporations." The Tax Reform Act of 1975 has certain major changes to the legislation dealing with these corporations. Therefore, the controlled foreign corporation tax concept will be briefly considered before reviewing the proposed modifications.

Essentially, the United States Federal income taxation of controlled foreign corporations was aimed at foreign corporations established in "tax haven" countries with no real business purpose other than the accrual of tax free profits.[23] The method for preventing such tax abuse was to tax certain United States shareholders immediately on certain types of income earned by the foreign corporation controlled by U.S. persons. In addition to denying deferral on certain categories of income earned by controlled foreign corporations, some repatriations of tax deferred earnings realized by a United States person upon the sale or exchange of stock in a controlled foreign corporation are taxed at ordinary income rates rather than at the capital gains rates which would apply to similar stock dispositions.[24]

The immediate taxation of foreign corporations' foreign earnings to the United States shareholders depends upon a number of factors such as 1) the element of control of the corporation asserted by United States shareholders; 2) the type of income earned by the foreign corporation and 3) the use to which the earned income is put.[25]

The pertinent law applicable to the above three elements as related to the proposed modifications will be considered next. First, a brief definition of the type of United States shareholder control of a foreign corporation which may subject the shareholders to immediate taxation, if there is such control. The rule of immediate taxation generally applies to United States persons owning ten percent or more of the voting power of a foreign corporation if more than 50% of the voting power of that foreign corporation is owned by United States persons owning 10% interests.[26]

Next, what type of income is subject to this immediate taxation when earned by a controlled foreign corporation? Only one type of income mentioned herein is pertinent for purposes of studying the proposed changes in the law. Basically, the type of income subject to immediate taxation is (1) income which results from certain passive investment that is not made in the course of any trade or business, (2) income referred to here as "foreign base company income", and (3) income that results from a controlled foreign corporation's investments in the United States.[27] Essentially, base company income is income which is earned by a foreign corporation in a low tax jurisdiction when that corporation has been organized not to actually add to the business transaction for any business purpose but instead to accrue for tax reasons an element of the profit resulting from the transaction. Base company income may be any of the following: sales income from property purchased from, or sold to, a related person if the property is manufactured and sold for use, consumption, or disposition outside the country of the corporation's incorporation, service income from services also performed outside the country of the corporation's incorporation, and or on behalf of any related persons, and shipping income (unless reinvested in shipping assets.)

The type of income we are most concerned with is income subject to immediate taxation by the shareholder that results when a foreign corporation increases its earnings invested in United States property.[28] This may be an investment in tangible property, stock of a domestic corporation or bonds of a United States obligor and intangibles. The theory behind this immediate taxation due to increased U.S. investment is that once funds of a controlled foreign corporation are reinvested in the United States, they have in effect been "repatriated" to the U.S. shareholder and should be subject to taxation as if a dividend has been paid. It is here that a major change is proposed. The effect of the tax law in this area to date has been to discourage investment of controlled foreign corporate funds in the United States. In a time of intense capital needs, Congress has decided to eliminate this barrier to investment and not subject such investments to immediate shareholder taxation. However, the law will not change if the foreign corporate funds are intended to be reinvested in property of a related United States person, for then indeed there is something approaching an actual dividend. The committee explanation for this proposed change is as follows:

> As indicated above, present law treats an investment in U.S. property by a controlled foreign corporation as a taxable distribution to its U.S. shareholders. The reason why this provision was adopted was the belief that the use of untaxed earnings of a controlled foreign corporation to invest in U.S. property was "substantially the equivalent of a dividend" being paid to the U.S. shareholders. Therefore, it was concluded that this should be the occasion for the imposition of a tax on those earnings to the U.S. shareholders of the controlled foreign corporation making the U.S. investment. Present law is very broad as to the types of property which are to be classified as U.S. investments for purposes of this rule. For example, the acquisition by the foreign corporation of any tangible property located in the United States, or stock or obligations of a domestic corporation or a U.S. person (even though unrelated to the investor) is considered an investment in U.S. property for purposes of imposing a tax on the untaxed earnings to the investor's U.S. shareholders.
>
> Your committee believes that the present scope of the provision is too broad. In its present form it may, in fact, have a detrimental effect upon our balance of payments by encouraging foreign corporations to invest their profits abroad. For example, a foreign corporation looking for a temporary investment for its working capital, is by this provision, induced to purchase foreign rather than U.S. obligations. In your committee's view, a provision which acts to encourage rather than

> prevent the accumulation of funds offshore should be altered to minimize any harmful balance of payments impact while not permitting the U.S. shareholders to use the earnings of controlled foreign corporations without payment of tax.
>
> In your committee's view, since the investment by a foreign corporation in the stock or debt obligations of a related U.S. person or its domestic affiliates makes funds available for use by the U.S. shareholders, it constitutes an effective repatriation of earnings which should be taxed. The classification of other types of investments as the equivalent of dividends is, in your committee's view, detrimental to the promotion of investments in the United States. Accordingly, your committee's bill provides that an investment in U.S. property results only if the foreign corporation invests in the stock or obligations of a related U.S. person or in tangible property which is leased to, or used by, a related U.S. person.[29]

Another change proposed in the area of controlled foreign corporations deals with the taxation of proceeds from the sale of stock of such corporations.

Under present law, the United States has used the controlled foreign corporation taxing provisions to achieve a basic policy of aiding lesser developed countries. This is accomplished by allowing, under certain circumstances, the repatriation at capital gains rates of earnings and profits accumulated by a foreign corporation which is organized in a less developed country.[30] This is done by allowing the sale or exchange of stock in a less developed country foreign corporation to be taxed at capital gains rates as opposed to a dissimilar treatment extended to sales of stock in a foreign corporation that is not a less developed country controlled foreign corporation. Proceeds from sales of stock of developed country corporations are treated as ordinary income dividends to the extent of a proportionate share of the developed country corporation's earnings and profits.

The House Ways and Means Committee believes this special treatment should end. Its reason for ending this dissimilar treatment follows:

> . . . present law contains an exception to the rules providing for dividend treatment on the sale of stock of a subsidiary which is classified as a less-developed country corporation. The ex-

tent to which this exception has provided an incentive to invest in less-developed countries is questionable. The size of the tax benefit to the U.S. investor depends on a variety of factors, such as the foreign tax rate in the country where the investment is made and in other countries, and the capital gains tax rate in the United States. Further, the relationship of the tax benefits to the investor to the benefits obtained by the developing country is erratic since the size of the tax benefit may bear no relationship to the amount of development capital invested. While these factors may occasionally combine to encourage investment in a certain less-developed country, your committee believes that it would be preferable to provide whatever assistance is appropriate to less-developed countries in a direct manner where the economic costs can be accurately measured.[31]

THE FOREIGN TAX CREDIT

A number of reforms apply in the area of law pertaining to credits for foreign taxes paid by United States taxpayers to foreign countries. Taxpayers subject to United States taxation on foreign source income are allowed a foreign tax credit for the amount of foreign taxes paid on income from sources outside of the United States. The credit is provided only for the amount of income, war profits or excess profits taxes paid or accrued during the taxable year to any foreign country or to a possession of the United States.

The concept of the foreign tax credit reflects the principle that the country in which income is earned or in which a business activity is conducted has the right to tax the income arising from activities in that country, even though the activities are conducted by corporations or individuals foreign to that host country. Under this principle, the home country of the individual or corporation has a residual right to tax income arising from its foreign activities; however, there is an obligation to insure that double taxation does not result.[32] The United States honors this principle by providing for the foreign tax credit. The intent is not only the avoidance of double taxation but in addition to allow United States owned foreign operations equal competitive footing with its foreign counterparts. This allows a dollar-for-dollar credit against United States tax liability for income taxes paid by United States taxpayers to a foreign country.

The foreign tax credit is allowed not only for taxes paid on income derived from operations in a specific country or possession of the United States, but it is also allowed for dividends received from foreign corporations operating in foreign countries and paying foreign taxes. This credit for taxes paid on income distributed as dividends is provided for dividends paid by foreign corporations to a United States corporation which owns at least 10% of the voting stock of the foreign corporation.[33]

The computation of the amount of the foreign taxes allowed as a credit in the case of a dividend distribution differs depending upon whether or not the payor of the dividend is a less-developed country corporation.[34] This differing credit treatment results in less-developed country corporations receiving more than a dollar-for-dollar credit on taxes paid to foreign countries on dividend payments made to United States shareholders.

The Committee reports concerning corrective legislation in this area read as follows:

> Under present law, the amount of dividend from a less-developed country corporation included in income by the recipient domestic corporation is not increased (i.e. grossed up) by the amount of taxes which the domestic corporation receiving the dividend is deemed to have paid to the foreign government. Instead the amount of taxes is reduced by the ratio of the foreign taxes paid by the less developed country corporation to its pretax profits.
>
> The failure to gross-up the dividend by the amount of the foreign taxes that are deemed paid results, in effect, in a double allowance for foreign taxes. *The problem arises from the fact that the amount paid in foreign taxes not only is allowed as a credit in computing the U.S. tax of the corporation receiving the dividend, but also is allowed as a deduction.* (Since the dividends can only be paid out of income remaining after payment of the foreign tax.) The result is that the combined foreign and U.S. tax paid by the domestic corporation is less than forty-eight percent of the taxpayers' income in cases where the foreign tax rate of the less-developed country corporation is lower than the forty-eight percent U.S. corporate tax rate (but not below zero). In cases where the foreign tax rate exceeds

> forty-eight percent, the dividend does not bring with it all the foreign taxes that were paid and thus the size of foreign tax credit carryover is reduced.
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> . . . Your committee believes that in the interests of uniform tax treatment between developed and less-developed country corporations and among all less-developed country corporations, this double allowance should be removed. Further, providing for identical treatment between all foreign corporations will simplify the foreign tax credit computation.[35]

A second major change in the foreign tax credit area deals with the method that may be used to claim foreign tax credits when a United States taxpayer is paying foreign taxes in more than one foreign jurisdiction. Presently, two alternative limitations on the amount of foreign tax credits which can be claimed are provided by present law. Under the overall limitation, the amount of foreign tax credits which a taxpayer can apply against his United States tax liability on his world-wide income is limited to his United States tax liability multiplied by a fraction the numerator of which is taxable income from sources outside the United States (after taking all relevant deductions) and the denominator of which is his worldwide taxable income. Under this limitation, the taxpayer thus aggregates his income and taxes from all foreign countries; a taxpayer may credit taxes from any foreign country as long as the total amount of foreign taxes applied as a credit in each year does not exceed the amount of tax which the United States would impose on the taxpayer's income from all sources without the United States.

The alternative limitation is the per-country limitation. Under this limitation the same calculation made under the overall limitation is made on a country-by-country basis. The allowable credits from any single foreign country cannot exceed an amount equal to United States tax on worldwide income multiplied by a fraction the numerator of which is the taxpayer's taxable income from that country and the denominator of which is his world-wide taxable income. Taxpayers are required to use the per-country limitation unless they elect the overall limitation. Once the overall limitation is elected, it cannot be revoked except with the consent of the Secretary or his delegate.

Congress has spotted a present abuse in the ability to use the per country limitation method and the proposed legislation seeks to eliminate this alternative method of claiming the foreign tax credit. The essence of the abuse is one of double tax benefit. It is possible in some years to have a foreign country operation's losses reduce United States taxable income in the loss year and then later take the tax credit in gain years without taking into account the previous tax benefits stemming from losses claimed in loss years.

The abuse and its cure is explained in the Committee reports as follows:

> The use of the per-country limitation often permits a U.S. taxpayer who has losses in a foreign country to obtain what is, in effect, a double tax benefit. Since the limitation is computed separately for each foreign country, losses in any foreign country do not have the effect of reducing the amount of credits allowed for foreign taxes paid in other foreign countries from which other income was derived. Instead, such losses reduce U.S. taxes on U.S. source income by decreasing the worldwide taxable income on which the U.S. tax is based. In addition, when the business operations in the loss country become profitable in a subsequent tax year, a credit will be allowed for the taxes paid in that country. Thus, if the foreign country in which the loss occurs does not have a net operating loss carry forward provision (or some similar method of using prior losses to reduce subsequent taxable income), the taxpayer receives a second tax benefit when income is derived from that foreign country because no U.S. tax is imposed on the income from that country (to the extent of foreign taxes paid on that income) even though earlier losses from that country have reduced U.S. tax liability on U.S. source income.
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> Your committee does not believe that taxpayers should be permitted to obtain the double tax benefits described above. Accordingly, your committee believes that the per-country limitation should be repealed. . . .[36]

PORTFOLIO INVESTMENT BY NONRESIDENT ALIENS AND FOREIGN CORPORATIONS

The final point concerns a modification originally in the Act before the final vote of the House of Representatives. When the Act was passed by the House, the modification to be discussed was no longer part of the proposed reform. However, since it was a significant change in the law and is still the subject of consideration by the Senate Finance Committee, and may be part of the final bill, it will be briefly reported.

Under present law, interest, dividends and similar types of fixed or determinable annual or periodic gains, profits, and income earned in the United States by a non-resident alien or foreign corporation are generally subject to a 30 percent tax on the gross amount paid so long as the income represents a passive investment in the United States.[37] A number of exemptions have been granted. Of major significance is that one which excludes from the 30% tax interest earned on deposits with persons carrying on the banking business.[38]

The proposed change, not accepted by the House, would have allowed that exemption from the 30% tax to be extended to both interest and dividends earned by nonresident aliens and foreign corporations if paid by United States persons . . . (So long as the investment was a mere passive investment and the United States person payor was not more than 50% foreign owned). A United States person would be defined as a citizen or resident of the United States, and United States partnerships, corporations, estates or trusts.

The House Ways and Means Committee's rationale for this unadopted reform was:

> Your committee believes that the imposition of a withholding tax on obligations issued by U.S. persons can impair the ability of U.S. corporations to raise capital in foreign markets. International bond issues are often exempt from withholding taxes and estate taxes imposed by foreign governments. In contrast, the United States' withholding tax is generally imposed, although as indicated above there are numerous exceptions to the general rule depending upon the nature of the issuer or the residence of the recipient of the interest income. The lack of a broad exemption under present law has in some cases made it difficult to trade U.S. obligations in international bond markets, since holders of international obligations wish to be assured that there will be no withholding tax imposed on any interest income which they may derive. To satisfy this desire of foreign lenders, U.S. borrowers often have to agree to reimburse holders of its debt instruments for any U.S. withholding tax which may be due. This raises the cost which a U.S. borrower must incur when it goes into foreign markets to raise capital.[39]

NOTES

[1]Int. Rev. Code of 1954 § 911 (a) Hereinafter "Code §"

[2]*Code* §911(c).

[3]S. Rept. No. 781, 82d Cong., 1st Sess. (1951) and *Swenson v. Thomas* 164 F 2d 783 (5th Cir. 1947).

[4]The Act §1011. 94th Cong. 1st Sess. (1975). (Hereinafter "The Act").

[5]H. Rpt. No. 94-658 p. 200, 94th Cong. 1st Sess.

[6]*Code* §921.........

[7]Rev. Rul. 55-105, 1955-1 C.B. 94.

[8]*A. P. Green Export Co. v. United States,* 284, F. 2d 383 (Ct. Cl. 1960).

[9]*Code* §922.

[10]Note 8, *supra.*

[11]The Act §1051.

[12]H. Rpt. No. 94-658, p. 259-260.

[13]*Code* §992.

[14]*Code* §933(a).

[15]*Code* §993(b).

[16]The Act §1101(b).

[17]The Act §1101(a)(4).

[18]H. Rpt. No. 94-658 pp. 263-264.

[19]*Code* §11(f), 882.

[20]Bittker & Eustice, *Federal Income Taxation of Corporations and Shareholders,* 1974 ed. ¶ 17.31.

[21]*Code* §1248.

[22]Comments on Proposals for Legislation to Change United States Income Taxation of Foreign Manufacturing Operations, *The Tax Lawyer*, Vol. 29, No. 2, Winter 1976.

[23]Bittker and Ebb, United States Taxation of Foreign Income and Foreign Persons 1968 ed. p. 338.

[24]*Code* §1248.

[25]*Code* §§951-957.

[26]*Code* §§951, 957.

[27]*Code* §954.

[28]*Code* §§951 and 956.

[29]H. Rpt. No. 94-658 p. 216.

[30]*Code* §955 repealed by the Tax Reduction Act of 1975, defined a less-developed country as any country so designated by the President by Executive Order.

[31]H. Rpt. No. 94-658 P. 218.

[32]*H. H. Robertson Co.*, 59 T.C. 55 (1972).

[33]*Code* §902.

[34]Note 30, *supra.*

[35]H. Rpt. No. 94-658 p. 230-231.

[36]H. Rpt. No. 94-658 p. 225.

[37]*Code* §§861, 871, 881.

[38]*Code* §§861(a)(1) and 861(c).

[39]H. Rpt. No. 94-658 p. 236.