

BROOKLYN JOURNAL OF INTERNATIONAL LAW

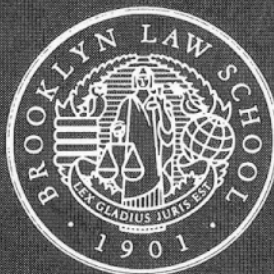
VOLUME XXVI

2001

NUMBER 4

FROM THE BOTTOM UP: TAXING THE INCOME OF FOREIGN CONTROLLED CORPORATIONS

H. David Rosenbloom



PANEL III: U.S. MULTINATIONAL AND INTERNATIONAL COMPETITIVENESS

PRINCIPAL PAPER

FROM THE BOTTOM UP: TAXING THE INCOME OF FOREIGN CONTROLLED CORPORATIONS

*H. David Rosenbloom**

I. INTRODUCTION

From time to time I have occasion to offer advice in regard to other countries' income tax systems, and therefore to think about income taxation in general, but very practical, terms. For the most part these assignments concern developing countries with so-called emerging economies. I never have sufficient time to understand fully the context in which the tax system must operate in these countries, but I do my best to learn about the problems and issues that others more familiar with the territory have identified, and I attempt to tailor my comments to the circumstances as I come to understand them. Clearly there is no single income tax system that fits the needs of all jurisdictions. The principal supports of the local economy, the country's history with taxation, the question whether the

* The author is a Member of Caplin & Drysdale, Chartered, Washington, D.C. He joined the firm as a Member after serving as the International Tax Counsel and Director, Office of International Tax Affairs, at the Department of Treasury. The author has written extensively on international and comparative tax topics, lectured at numerous educational institutions, and consulted with the U.S. government and various international organizations on international tax matters. He also has served as a tax policy advisor to the U.S. Treasury, the Organization for Economic Cooperation and Development (OECD), the United States Agency for International Development (AID), and the World Bank. He is a graduate of Princeton University, Harvard Law School, and studied as a Fulbright Scholar at the University of Florence.

country is, or could eventually become, a capital exporter as well as an importer, its tax and general economic relationships with other countries, all enter into the calculus of what might be appropriate in any given case.

There do seem to be some constants, however. Any country that has a government must find a means of paying for that government and that means, however implemented in rules and actions, usually will require some form of mandatory contribution from the public. It is not necessary that any such concept as tax law, or even law, exist for this purpose. A country that borrows, or that prints money to pay expenses, or some combination of these options, would still impose a "tax" in a broad sense of that term, because the effects of these actions would have a cost that the populace of the country would be required to bear. In this sense, running large deficits, tolerating inflation, paying interest out of public resources—all of these involve taxation. Thus, a "tax reduction" that contributes to deficits or inflation merely shifts the burden from one set of "taxpayers" to another.

If there is to be a formal tax system in a country—and most countries clearly believe (though not always for clearly articulated reasons) that they should have such a system—there are additional constants irrespective of where in the world the question is posed. For one thing, the system should have as little adverse effect as possible on other interests deserving of government encouragement or protection. Taxes are, by definition, undesirable insofar as the person called upon to pay them is concerned. It is obvious that the incidence of taxation—the combination of circumstances that give rise to an obligation to pay tax—is burdened by the tax, and to that extent disadvantaged, discouraged. Since most countries impose taxes upon some form of economic activity, and since a rational nation has an interest in supporting economic activity of persons subject to its taxing jurisdiction, the nation generally will wish to impose its tax with as much care as possible to preserve maximum room for that activity, given the necessity of the tax. This may be difficult in particular situations, but the general directive is clear: As between two taxes having the same effect, the one that interferes less with economic freedom is to be preferred. More broadly, it could be argued that general freedom of decision-making is a "good" meriting government protection, and taxes therefore should be

imposed with as much leeway as possible for such freedom. Such considerations are commonly referred to as "efficiency."¹ Professor Gergen invokes instead, and probably more fittingly, "the natural law of the parasite: Do the least damage to the host in extracting sustenance from it."²

A second desirable feature in a tax system, no less important than efficiency, is what some refer to as "equity." This condition obtains when persons who stand in the same place insofar as the relevant target of tax is concerned are treated similarly by the tax regime. The point is important because tax systems in countries that are not totalitarian ultimately depend, to a large extent, upon the (sometimes grudging) consent of the taxed. If the system does not operate in an equitable way, that consent is difficult to acquire and more difficult to retain, with the result that those subject to the system will devote greater energy to frustrating, avoiding, or evading it. Such actions, in turn, render the system more difficult to administer and enforce in an equitable way which, in turn, only will add to the frustration of persons subject to the regime. For this reason, equity is needed in a tax system for the most pragmatic of reasons, to permit the system to function.

The term "equity" is sometimes also used to describe a progressive system of taxation, in which persons who have more resources from which to contribute to government revenues, or perhaps who have benefited more from government actions supported by such revenues (often the same folks), should contribute more than others by paying a higher amount. I do not disagree with this view, but it seems a different matter from the proposition that those persons standing relevantly in the same place should be treated (more or less) the same by the tax regime. One could envision a tax system without progressivity, a debatable subject in its own right. That subject may not be intrinsic to thinking about the "fundamentals" of taxation, and I propose to leave the matter

1. See, e.g., DAVID F. BRADFORD, AND THE U.S. TREASURY STAFF, BLUEPRINTS FOR BASIC TAX REFORM 1-3, 2 (Tax Analysts 2d ed. 1984).

2. Mark Gergen, The Common Knowledge of Tax Abuse, Paper presented to the Ernst & Young Tax Policy Seminar at Georgetown University (Sept. 22, 2000) (on file with author). This recalls Colbert's "art of plucking the goose so as to get the largest possible amount of feathers with the least possible squealing." GEORGE ARMITAGE-SMITH, PRINCIPLES AND METHODS OF TAXATION 36 (John Murray ed., 1907).

here—and, as explained in more detail below, take no detailed position (for the moment) on the topic of corporate integration, which could be viewed as an element of progressivity.

The third fundamental characteristic of a sound tax system is "simplicity," which means favoring the less complex over the more complex to the extent a choice is available. Simplicity, like efficiency but perhaps not quite like equity, is a general goal, not capable of being attained in anything resembling a pure state. It is valuable in its own right and also because it contributes to other aspects of a well-functioning tax system: Administrability (the capability of government officials themselves to understand the relevant rules and see to their implementation in practice); and transparency (the ability of the public to understand the rules, so that obligations are clear and the companion goals of efficiency and equity can be evaluated and intelligently discussed). If the tax system cannot be understood and administered, then in actual practice it may become something very different from what its authors envisioned. And while they go on finely spinning rules, some other regime for raising taxes comes to operate in practice.³

Perhaps it is years of working with and under the U.S. tax system that leads me to place a special premium on simplicity in matters of taxation. There are too many rules in that system, and the complexity of those rules impedes assessment of their merits on other grounds. Furthermore, there is all too little consideration by the creators of U.S. tax legislation of what and who will be involved in translating tax laws into working reality. For these reasons, simplicity and administrability of rules hold a special place for me. Efficiency, equity, and simplicity are all virtues in matters of taxation, but the greatest of these virtues is simplicity.

Advising other countries on tax matters, I try to take all of these factors into account. This is, of course, no easy task, since not only are efficiency, equity, and simplicity all abstract concepts subject to considerable doubt and interpretation when applied in the evaluation of specific provisions, but the factors

3. This long has been the case in the United States, where, in my experience, there are in force two parallel systems of taxation having at best only a resemblance—one, enacted in Washington and the other as applied by the Internal Revenue Service in the "field," in (for example) San Jose, Des Moines, and Cleveland.

actually conflict with one another when any of them is pursued with a single mind. Clearly, the goal of simplicity is best served by rules that do "rough justice" in the sense of assimilating different inputs into categories—persons, circumstances, amounts, etc.—even though it is known, indeed obvious, that there are differences within the categories and that item A is not at all the same as item B, but only similar to item B in a particular way. The call of equity may be strong in these circumstances. Does not each item deserve its own rule, or sub-rule, or exception? An affirmative response translates into discarding a key element of simplicity.

The same conflicts are present with respect to efficiency, though they may be more subtle. There are circumstances where a simpler rule or one that responds more closely to considerations of equity pulls in a direction that may not be the most efficient. Thus, in weighing the implications of efficiency, equity, and simplicity, it is necessary to engage in a constant process of judgment, revision, and compromise. The overall system will be an amalgamation of the disparate results of this process.

Recently, I had occasion to think about all this in a context that was unusual for me. The country in question had not only agricultural and mineral sectors, but a substantial manufacturing base. It was not only a capital importer, but a nation of real wealth, with substantial capital exports and possibilities for more. It was relatively modern, with a reasonable number of highly educated residents. Yet, its tax system was underdeveloped as a result of historical factors which, perhaps, were on the wane. In other words, here was a country with a need for a modern tax system. There were certain unusual factors that might impede movement from the existing—quite old, quite odd—system to one that appeared capable of working better in the future. The transition might be painful, and there were problems stemming from a large indigent population and substantial disparities in the distribution of wealth. Nevertheless, here was a chance to concentrate upon sensible taxation in a complex country, and to develop proposals that might not be weighted down by years of politics, inattention, habit, or ignorance.

A. *Explanations, Disclaimers, Excuses, Apologies, Etc., Etc.*

By now even the inattentive reader may have realized that the author is neither an economist nor someone who approaches taxation from the perch of high theory in any other discipline. I am interested in what works, in practice, on the ground. My only qualification to be writing at all is that I have worked on tax matters for nearly 35 years in the private sector, government, and the classroom, and have witnessed at close quarters the operation of many of the world's tax systems. Some of my notions may function better in practice than in theory.

The starting point for this paper is a hunch that a good deal of the current U.S. debate about subpart F is misplaced: It is either focused upon what happened in the distant past (1961-1962, to be precise), or about what occurred to produce the numerous *ad hoc* adjustments over the years to the original understanding, or about anecdotal evidence of the difficulties U.S. companies face in operating under the strictures of U.S. law, particularly in competing against companies from other countries that are not subject to similar regimes, or about the implications of banalities such as "capital export neutrality" and "capital import neutrality." The debate has been heating up (again) in recent years.⁴ It seems to me, however, that debating on the basis of what originally was contemplated or not contemplated is not likely to be fruitful, since we are not speaking of a constitution but a set of tax laws, a quite different proposition. Tax laws (not subpart F in particular, thank goodness) are probably the most important laws in the United States as a practical matter, but there is no obvious reason why, in revising them, we should be saddled today with the "intention of the framers." Anything is possible and worthy of consideration. It would be foolish to operate on the assumption that what may or may not have been right in the early

4. See, e.g., NATIONAL FOREIGN TRADE COUNCIL, THE NFTC FOREIGN INCOME TAX PROJECT: INTERNATIONAL TAX POLICY FOR THE 21ST CENTURY (1999). Largely as a result of the strong public and congressional reaction to Notice 98-11, 1998-1 C.B. 433, involving "hybrid branches," and its aftermath, the U.S. Treasury announced on December 11, 1998, that it would study "the extent to which changes in our anti-deferral rules are warranted." *Id.* The Treasury's report, "The Deferral of Income Earned Through U.S. Controlled Foreign Corporations," was issued in December 2000.

1960s should have substantial force in the new century. Lengthy reports are not needed to demonstrate that the world has changed since 1962.

Reasoning from practical application of present-day rules is even worse. The "truth" about competitive and other effects of the rules is elusive, changing, unverifiable, and unknowable. Something of interest probably can be gleaned from the decibel level of corporate complaints at any given time, but that something is not likely to tell us that today's rules should be any better than what some congressman thought in 1962. Moreover, the evident self-interest of participants in the debate renders it difficult to credit the complaints without independent and objective evaluation.

Perhaps it would make sense to consider the subject from a different perspective. Instead of thinking about how the past is apt to resemble the future, perhaps it would be useful to begin with a blank page and ask what would constitute sound and appropriate treatment of the income of foreign controlled corporations as a matter of general tax policy. In other words, maybe the United States should be viewed as a candidate for true tax reform.⁵

Approaching the topic from this vantage point, I mean no disrespect for the substantial scholarship that has been devoted over the years to the question whether, and how, the United States should tax income earned by foreign corporations controlled by U.S. persons.⁶ That scholarship is formidable, and offers numerous insights into both the ways in which the stat-

5. The term "true tax reform" is employed in contradiction to the "tax reform" label that Congress routinely slaps on tax legislation, as in 1969, 1976, 1982, and 1986.

6. The past few years have witnessed an array of substantial and thoughtful legal writings devoted to this topic. See, e.g., Melvin S. Address et al., *The Erosion of Deferral After the 1993 Act*, 47 TAX LAW 933 (1994); Stephen E. Shay, *Revisiting U.S. Anti-Deferral Rules*, 74 TAXES 1042 (1996); Robert J. Peroni, *Back to the Future: A Path to Progressive Reform of the U.S. International Tax Rules*, 51 U. MIAMI L. REV. 975 (1997); Stuart Leblang, *Deferred Gratification: A More Rational Approach for Taxing U.S. Multinationals*, 27 TAX MGM'T INT'L J. 78 (1998); J. Clifton Fleming et al., *Getting Serious About Curtailing Deferral of U.S. Tax on Foreign Source Income*, 52 SMU L. REV. 455 (1999); Roseanne Altshuler, *Recent Developments in the Debate on Deferral*, 87 TAX NOTES 255 (2000); J. Clifton Fleming et al., *Deferral: Consider Ending It, Instead of Expanding It*, 86 TAX NOTES 937 (2000); Keith Engel, *Tax Neutrality to the Left, International Competitiveness to the Right, Stuck in the Middle with Subpart F*, U. TEX. L. REV. (forthcoming 2001).

ute developed and the alternatives that have been considered and rejected (sometimes by repeal, after enactment) along the way. It is interesting to consider the relevance of arguments made forty years ago for the world of the twenty-first century. Further, I can not categorically reject the methodology of attempting to determine "how should subpart F be altered to fit the needs of today?" My approach, however, is different. I propose to think about constructing a tax system, using building blocks, experimenting and rejecting, in much the same process I would employ (have employed) in counseling other countries. This methodology offers the possibility of opening for discussion propositions that might be viewed as too certain or immutable to merit comment in the context of the existing system. That, in and of itself, has to be salutary.

Of course, the economic system of the United States is complex, and rethinking the enterprise is a Herculean proposition. Many adjustments are doubtless needed in attempting to transfer rules developed for other jurisdictions to the U.S. context. Moreover, there is no way of "unlearning" our experiences with the present statute and every reason to believe that the forces that shaped it will continue to operate on whatever might stand in its stead. Nevertheless, it seems possible that we are unduly intimidated by the monster that lies before us. It may not have to look like that.

I approach the subject with few illusions. Ultimately, how U.S. income tax will apply to income of foreign corporations controlled by U.S. persons will be subject to the same political forces that have always determined the outcome of the discussion (though that outcome varies from time to time, as the political forces themselves mutate). However, it even may be useful to note that the debate *is* political, that subpart F is neither going to be expanded into a complete repeal of deferral nor itself repealed on the basis of which view is "right." The question is who has the votes, not which side is "right." In these circumstances the notion of "starting over" as a basis for considering changes in this important body of law may seem ludicrous. On the other hand, there are few things more risible than the rules presently on U.S. books.

II. RESIDENCE-BASIS TAXATION AND ITS CONTENTS

There are two well-recognized and internationally accepted "jurisdictional" bases for an income tax: source and residence. Source-basis taxation depends, more or less, on the proposition that the country where income originates has a legitimate claim to tax that income. Residence-basis taxation relies on the notion that the country where the taxpayer resides legitimately may impose tax in order to support the normal government activities that residents enjoy.

Most countries rely on both source taxation and residence taxation for their income tax base, and there is really no need to choose between these two jurisdictional grounds. A "mixed" system is common, justifiable, and reasonable. What is more important, for this paper, is that residence-basis taxation is hard to quarrel with as a matter of tax policy. Such taxation certainly is equitable, since it treats equally taxpayers having similar amounts of income, irrespective of where that income was derived. In contrast, a system that relied exclusively on source-basis taxation would favor residents benefiting from foreign-source income, a benefit that modern technology and communications make much easier to achieve than in years past.

From the standpoint of efficiency, there is no obvious gain in an exclusively source-based system because a government's interest in favoring foreign-source income is difficult to rationalize. Most countries may be thought to have the converse interest—favoring domestic income over foreign, so that the domestic use of capital may work to produce non-tax benefits in the form of economic activity and employment. And, from the standpoint of simplicity, there is nothing inherently complex in defining who is a resident, although there are competing definitions from which to choose and it would be easy to devise others.⁷

In short, it is possible, without much effort, to defend the residence basis as a jurisdictional ground for income taxation.

7. The United States, idiosyncratically but understandably in light of twentieth century events, views citizens as enjoying many of the same government-funded benefits as residents and, therefore, effectively treats U.S. citizens the same as residents for purposes of jurisdiction to tax. That is a fine point for present purposes.

It fits nicely within all criteria of a good and proper income tax, does no violence to international understandings, and probably should be used by any country that has a formal income tax. The most common objection—that the worldwide taxation implied by residence basis jurisdiction creates difficult problems for tax administration because income sources outside the country cannot be easily verified—has validity. But the desirable features of residence taxation and the undesirable implications of an exclusively source-based system argue strongly in favor of making the attempt. The results of not doing so will be distortions in the patterns of income-producing activity and dramatic inequality among taxpayers having similar amounts of economic income.

Taxing on a residence basis does, however, definitely imply taxation of global income, "from whatever source derived" in the resounding words of section 61 of the U.S. Internal Revenue Code. If less than all worldwide income is taxed to residents—or, more specifically, if residents are taxed only on some geographically limited slice of that income—the result is something less than true residence-basis taxation but rather (depending on how the slice is defined, though it generally would be limited to some version of domestic source) an expanded version of source taxation. Residence-basis taxation ultimately is based on the proposition that geographic distinctions among income flows are irrelevant.

There is nothing inherent in the concept of residence-basis taxation that speaks clearly to the question of how to tax income of foreign controlled corporations. However, two attributes of such corporations are more eloquent. First, corporations are a complicating factor. Their presence in a tax system requires rules of many different sorts—not least troublesome of which is identifying exactly what a corporation is.⁸ Respect for the corporation as an entity separate from its controlling shareholders leads to difficult questions about when income enters or leaves corporate solution, the need to police inter-corporate dealings, and inevitable ambiguities in assessing the

8. The United States virtually has thrown in the towel on the point, having adopted rules that generally permit corporate status to be elected by merely "checking the box." See *Treas. Reg. § 301.7701-2, -3* (as amended in 1999). The prior rules based the definition on a weighing of "factors" that, over time, became increasingly arcane, abstract, and ephemeral.

relationship between the corporation and those who control it.

Second, the only persons a country has available to tax are, in the final analysis, individuals. Corporations, trusts, and more exotic types of entities are all pieces of paper—legal constructs, adopted at one time or another for one purpose or another. Without disparaging those purposes or those times, the results need not be accepted for all purposes. The existence of the constructs holds many legal implications, but those implications exist exclusively at the sufferance of laws and lawmakers and, in that sense, the constructs are not “real.” Insofar as taxation in particular is concerned, there is no compelling reason why those implications must be respected. It is possible to make a reasoned and independent judgment whether to accept and respect the legal constructs *in tax matters*.

This paper is focused on taxation of the income of foreign corporations controlled by resident taxpayers. One of the building blocks I would propose for such taxation is disregard of the corporate form, because the benefits of accepting that form in a control situation—treating it as an entity separate from those who control it and potentially representing a taxpayer in its own right—do not seem compelling. The corporate form is easily obtained and insubstantial. Especially in today's world, there are few inhibitions to adopting or discarding it in any geographic location. The costs of maintaining the form in existence are insignificant. There is no difference in substance between a single controlled corporation and twenty such corporations. In the United States, as a result of the check-the-box regime, the form easily can be made transparent (non-existent) in one jurisdiction but opaque in another. The decision whether to operate in corporate form is, for the controlling shareholder, simply an election.⁹

9. The point was made clearly and irrefutably by Sidney I. Roberts, *From the Thoughtful Tax Man*, 40 TAXES 355 (1962):

If a taxpayer had foreign income and decided he did not want to pay tax on that income, he went to the Wizard of Og to secure a Talisman.

Now you would have thought that the road to Og was long or difficult or expensive. Not so! You would draw your Charter pretty much as if you were forming the ordinary garden-variety corporation, say, in Delaware or New York. Then you would mail it to counsel in Og and for \$500 he would arrange to have affixed the Talisman, which was merely a red seal symbolizing that you were incorporated under the laws of Og. In other respects, this corporation could operate in much the same places

Without being absolute on the subject, I think elections in tax matters are suspect. They arguably promote efficiency through the element of taxpayer choice, and in some cases may do no serious violence to the goal of equity. But they are not simple. By definition elections require the development of at least two sets of rules where, but for them, one would have served. Moreover, elections may become a threat to equity because, although they begin by allowing different results for situations that taxpayers, at their option, deem different, they commonly end up distinguishing between situations that are similar.

A foreign corporation represents an election by controlling shareholders in the residence country not to recognize income and loss, or credits, currently. The shareholder facing positive income and relatively low credits may be expected to make the election and thus not recognize the income or claim the credits. A shareholder anticipating losses usually will make the contrary election, because losses have a current value that the taxpayer will not wish to defer. But the situation may change. The foreign corporation that suffered losses begins to earn income; the one that anticipated income endures difficult years. Residents now in similar situations continue to be treated differently. If the tax system opts to address this inequity, it will adopt rules, invariably complex, for permitting the election to be reversed.

Nor is the election limited to recognition versus non-recognition, current taxation versus deferral. That is merely a starting point. When a resident shareholder chooses to earn income through a foreign controlled corporation, the election to defer income opens up a panoply of further elections because non-recognition of current income of a foreign corporation historically has implied an optional regime for when and how much recognition will occur at subsequent times. Since income is apt to be a driving force under other provisions of the tax regime—for example, the limitation on certain deductions or

and with much the same people as if it were a Delaware or a New York corporation. But because of the Talisman affixed to its Charter—which nobody but the lawyers ever so much as looked at or noticed—the laws of this Kingdom specified that a corporation with this Talisman paid no tax on its foreign income.

Id. at 355.

certain credits, including the foreign tax credit—these other provisions also become elective in substantial part. The result is additional rules to govern or restrict these secondary elections.¹⁰

This is not to condemn elections in all instances—there are few such black letter postulates in the business of developing a tax system. But tax choices having no non-tax consequences are problematic. Taxes are, and are meant to be, compulsory. To the extent elections introduce elements subject to the taxpayer's control, they tend to undermine the compulsory nature of the system and produce unfairness and inequity, in the basic sense of treating similar persons differently.

The notion of residence-basis taxation without respect for the corporate form is not radical in situations involving foreign corporations and control. The U.S. rules relating to the "deemed paid foreign tax credit" long have applied to corporate residents owning 10 percent or more of the voting stock of a foreign corporation.¹¹ These "indirect credit" provisions, which apply at ownership levels much lower than control, are at odds with the concept that the foreign corporation is separate from its shareholders. If the corporation is in fact separate, why is a credit allowed to the shareholder for taxes paid by the separate entity? In fact, the indirect credit provisions recognize that the foreign corporation is separate only in a formal or legal sense. In the context of a regime for avoiding international double taxation, it has seemed appropriate to cut through such formalities and allow a credit for taxes incurred by *the enterprise* on foreign income-producing activities. The gross-up of section 78, which prevents *the enterprise* from simultaneously benefiting from a credit and a deduction for foreign taxes paid completes the picture: The shareholder is called upon to recognize the income out of which the foreign tax was paid, making clear that both income and tax "really" belonged to the shareholder in the first place.¹²

10. Thus, the deferral regime in the United States fueled elections under the allocation and apportionment rules of Treasury Regulation section 1.861-8, which depended on the amount of current income recognition. These secondary elections came to be seen as excessively generous, and were eventually circumscribed (in part) by additional rules and limitations.

11. See I.R.C. §§ 902, 960 (1988).

12. The United States restricts the indirect credit to *corporate* shareholders, a restriction that derives from the classical system of taxation of corporate earnings.

There are two important offshoots of the suggestion of corporate transparency, each representing something of a diversion, but each worthy of note. First, the suggestion pertains to control situations, not necessarily to other instances of income earned through foreign corporations. This is because control situations are fundamentally different from situations in which the shareholder lacks control. The proposed rationale for disregarding the corporate form for controlling shareholders is that, taxes aside, the corporate form amounts to a simple election. In a world where limited liability companies are common, it is no longer necessary to adopt the corporate form even for the purpose of limiting liability. But it is only in situations involving control that the election is without non-tax consequences; in other circumstances the corporate form represents a structural choice having potentially important effects beyond taxation. In a case of control, the shareholder elects whether to operate directly or in a form that the tax laws may view as separate from him. In the absence of control, the shareholder may or may not engage in income-earning activities through a corporate vehicle, but the decision to employ that vehicle involves a surrender of decision-making authority to other persons, or at least a sharing of such authority. For this reason, the suggestion that the corporate form be disregarded or viewed as transparent in a control situation does not necessarily imply disregard of that form in other situations. Of course, an underlying assumption here is that it is possible through suitable definitions to distinguish control from non-control. Except at the margin, where all cats are grey, that assumption does not seem unreasonable.

Second, disregarding the corporate form when that form is foreign need not hold implications for corporate integration within the residence country. The so-called classical system involves taxation at the corporate level and again at the shareholder level. That system does not have to depend upon the "person-hood" of the corporation; it can be defended as an imperfect element of progressivity, without holding any implications for the separateness of corporation from shareholder except in the practical sense that a corporate-level tax requires some understanding of what a corporation, and the corporate tax base, are. On this view, the corporation is simply a convenient place to situate a second tax on certain earnings. Although the classical system doubtless has underlain at least

some thinking about taxing the income of foreign corporations, questioning the substantiality of such corporations does not necessarily imply dispensing with the corporate tax at home. Corporate residents represent a well-known and long-understood type of taxpayer, and on these grounds alone a very different matter than foreign corporations. The U.S. check-the-box regime, with its distinctions between U.S. and foreign corporations, appears to make a distinction of precisely this sort.

In sum, viewing the foreign control situation as an insubstantial election, or series of elections, says nothing compelling about corporations in other contexts, where they do not function as an election and hold substantially different consequences for the residence country tax base. A tax system could function without accepting the separateness of the foreign controlled corporation from its controlling resident shareholders while continuing to view both non-controlled foreign corporations and domestic corporations as independent and separate taxpayers or potential taxpayers.

The proposition that there may be no difference between income earned by a resident through a foreign controlled corporation and income earned by the resident directly is not the end of the matter, however. That proposition serves to simplify and may induce clear thinking about taxing the income of foreign controlled corporations, but it does not dictate the tax rules to be adopted. Residence-basis taxation implies taxation of worldwide income, but there are considerations of international comity and double taxation that also bear importantly on the subject. Those considerations are important without regard to the separateness of the corporate form, and quite apart from notions of global neutrality or competitiveness, the main linchpins of the arguments that have been advanced in the United States against, and for, deferral.¹³ Comity and double taxation draw the debate away from these abstract and elusive subjects, and into the distinct area of how best to deal with impediments to international commerce. The topic is integral to the taxation of foreign controlled corporations and, as a practical matter, cannot be shunted aside for separate consideration.

13. See Engel, *supra* note 6.

III. THE PROBLEM OF INTERNATIONAL DOUBLE TAXATION

It may be a basic tenet of residence-basis taxation that the tax base should include all income irrespective of source, but it also is indisputable that source-basis taxation exists commonly in the world; indeed, most countries have such taxation in their laws. The residence country may conclude—as countries around the world decades ago similarly concluded—that it is excessive for two taxing jurisdictions to impose the same type of tax (income) simultaneously on the same base; one because it sees itself as the origin of that base and the other by reason of its claim on the person of the taxpayer.¹⁴ Traditionally, the claim of the source country comes first, with the residence country assuming the responsibility of alleviating double taxation because it is in the best position of any country to do so. This responsibility may be discharged by a system allowing credit for income tax imposed by the source country, by exempting income earned in the source country, or by some combination of these methods. The United States, of course, has a well-developed foreign tax credit system.

In an industrialized and tax-sophisticated country the inherent logic of such a system threatens to engulf it. This leads to a regime that is either terribly naïve or terribly complex—and neither attribute is, ultimately, tolerable. A theoretically proper foreign tax credit system would allow credits for qualifying foreign (source country) tax on each item of income subject to tax in both the source country and the residence country, and prevent foreign taxes in excess of the residence country tax on any item to be used to offset the residence country tax on other items. There appears to be no principled justification for mitigating double taxation through cross-crediting, allowing the foreign country's "excess" tax on certain income to reduce residence country tax on other income. And yet, the "per item" approach, clearly, is impractical. Multinational enterprises cannot be expected to subdivide income into bite-sized pieces for the purpose of determining whether a credit is available. Even if they could, tax administrations cannot be expect-

14. This is distinguishable from a revenue-sharing situation, in which similar taxes are imposed at national and subnational levels within a single jurisdiction. There are various reasons born of history and practice why the same concern for "double taxation" need not apply with equal force in both situations.

ed to police the resulting determinations. There also lurk questions about the meaning of an "item," the problem of taxes imposed on the same "item" in different years, and the difficulty of determining how much foreign tax has been applied to each item (since foreign countries will not itemize their taxes so that items perceived as separate by the residence country are taxed separately by the country of source). These problems are overwhelming. For good reason, the per item approach has never been employed by any country.

The next best solutions, like most next best solutions in tax matters, carry far from the optimum. They all involve compromises and limited cross-crediting: Allowing excess source country foreign tax on certain items as a credit against residence tax on other items. The cross-crediting may be geographically general (worldwide) or specific (country-by-country). It may involve various categories of items, which in turn may be grouped on a worldwide basis or according to some other geographical or other delineation. The possibilities are numerous. The results will be a series of limitations on the credit in a way, and to an extent, that policy-makers conclude (for the moment) is reasonable.

Taxpayers, of course, will wish to have as few categories as possible apply to themselves, irrespective of what categories may be created. The important thing for a resident taxpayer is that, in its particular situation, foreign taxes giving rise to potential credits not be disassociated from income categories on the basis of which the credit limitation is computed. The fewer the applicable categories of taxes and income, the better the taxpayer will fare.

In such a regime, it is clear that accepting foreign corporations as entities separate from shareholders constitutes a complicating factor of enormous proportions. When foreign corporations are viewed as separate from shareholders and credits are allowed for foreign taxes imposed on the corporations and "deemed paid" by resident shareholders, logic and integrity suggest that the limitation be refined. An item of income must be assigned a category for purposes of the limitation regime when it enters into the tax return of the resident shareholder. The same holds true for foreign taxes eligible for credit. If the residence country wants to forestall manipulation of its system, taxpayers must be precluded from altering limitation categories by transactions with themselves (that is, transac-

tions involving related, commonly controlled, foreign corporations) after the income has been earned by a foreign affiliate, but prior to the time when it becomes taxable, and credits available, in the residence country. If each corporate form represents a person for tax purposes and no tax applies to the current income of foreign corporations, separate corporations are relatively free to transact business with each other and, potentially, adjust credit limitation categories to their benefit. It is, therefore, necessary to establish rules to "trace" income and credits back from the time when they are reported on the resident's tax return to the moment when they first became available to the enterprise, that is, when they were first taken into account for tax purposes by a foreign corporation that constitutes part of the enterprise.

As current U.S. law amply demonstrates, a regime for "basketing" income and foreign taxes is complicated enough. However, complications are turbo-charged by the elaborate rules needed to "look through" transactions between and among foreign corporations.¹⁵ Additional rules are necessary for handling losses and deficits within categories, both during the period when income and credits remain in foreign corporate solution before reaching the resident's return and as of the moment when one or more of the categories on the return are themselves negative. Losses in a category may be provisionally applied to reduce other categories,¹⁶ without actually moving into those other categories, or they actually may shift over, "borrowed" by other categories, subject to rules for eventual repayment to the category whence they came.¹⁷ It is a separate question whether foreign taxes associated with the loss category should move as well.¹⁸

To determine the amounts, positive or negative, in the categories, it is necessary to provide for the allocation and apportionment of deductible expenses, both while income remains in foreign corporate solution and when income and credits arrive on the residence country tax return.¹⁹ Conceptually and logically (if not politically) unassailable, this detailed,

15. See I.R.C. § 904(d) (1989).

16. See I.R.S. Notice 88-71, 1988-2 C.B. 374, 375.

17. See I.R.C. § 904(f)(5) (1989).

18. See Treas. Reg. § 1.904-6 (1989).

19. See Treas. Reg. § 1.861-8 (1989).

judgment-laden process results in "stealth" deductions assigned to limitation categories but which may be totally unknown in the foreign jurisdiction that imposes tax. The effect is a regime for avoiding international double taxation that floats free, with only a tenuous connection to what is occurring in the source country.²⁰

The problem is not simply that this tangle of rules is complex, much less that it is illogical or unnecessary. The rules fit together nicely in a rational unfolding of the basic notion that the foreign tax credit should be limited so as to preclude "excessive" cross-crediting or the use of credits to offset tax on income from within the residence country. It is certainly unclear where in this unfolding the proponents of the rules strayed from the necessary and rational. Nor is the problem simply that the limitation may have been spun too fine for its own good. The more serious point is that the complexity is bound to engender inequality of treatment among taxpayers. A great deal clearly escapes audit attention, and the odd case that becomes a discussion with tax authorities tends to produce (in me, at least) a nagging feeling that many others, indistinguishable, must surely pass without drawing attention.

Treating foreign-controlled corporations as transparent is no panacea. This step would not dispense with the need to deal with cross-crediting and determining net income in individual credit categories. Further, the "deemed paid" credit rules—and all they require in the name of defending purity of the limitation categories—still would have room for operation in noncontrol situations. Respecting the separateness of foreign corporations magnifies the conundrum of limitation, but the origins of that conundrum lie in the foreign tax credit regime itself.

The tax policy choices that have been the object of the obsessively intricate U.S. rules are inherent in the laws of any nation that employs a credit as the means of alleviating international double taxation. Those choices seem to lead to any of three conceivable results: large dollops of electivity; rules so generous on the issue of cross-crediting as to make elections virtually unnecessary; or a fiendishly complex, ultimately self-

20. For a particularized example, see *United States v. Goodyear Tire & Rubber Co.*, 493 U.S. 132 (1989).

defeating, series of provisions designed to police the limitation categories and the rest of the regime.

Exemption may offer a better alternative. In considering that possibility it is worth taking note that most substantial business activities occur in countries with formal and serious tax systems. The amount of "residual" residence country tax to be derived after a foreign tax credit is allowed with respect to income from such activities is small. A credit system in these circumstances operates prophylactically, to protect the residence country tax base. Viewed from that perspective, however, the system may be extravagant. It costs the residence country a great deal in terms of compliance, tax administration, efficacy and honesty of the rules. Weighing such costs, a residence country might conclude that an exemption carefully trained upon the principal sources of international double taxation would be an improvement.

The residence country might also note that all taxing jurisdictions in the world are not equal, and there is no reason to treat them as if they were. Even as a political matter, it is unclear that equality should be the norm. If France and the Cayman Islands are viewed *in pari passu* insofar as residence-country taxation is concerned, it inevitably will be necessary to adopt rules not needed for France because the same rules must contend with the Caymans. For such reasons, tax policy addressing foreign income earned by residents can and should contain means of distinguishing between jurisdictions anticipated to impose substantial income tax and those that will not. The aim is not necessarily to find a match for residence country rules but, more modestly, to identify jurisdictions that have comprehensive rules of income taxation. The possibility of exemption should be reserved for such jurisdictions.

It is not, of course, enough for the residence country to make a distinction among countries and leave the matter there. That country would have to remain vigilant and adopt a dynamic method for distinguishing between the Frances of the world and the Caymans. Any jurisdiction may find it necessary/expedient/profitable to convert to low-tax status, either in whole or in substantial part. Countries that previously have been oblivious in matters of taxation suddenly may perceive gold in haven status and embark on programs intended to attract investment from residence countries. Or, more subtly, France may decide for any number of reasons that Alsace (for

example) should become a special enterprise zone, with privileged tax rules. Without proceeding so far as a new view of the national tax system, and perhaps for reasons other than those that induce a nation to turn itself into a fiscal paradise, geographical or industrial or other distinctions may be adopted that have the result of precluding application of "normal" tax rules. This, too, would be problematic from the standpoint of the residence country.

For such reasons, the residence country will not want simply to prepare a list, include France (or, conversely, the Caymans), and rely on the list for operation of its rules. The subject requires periodic revisitation, and current information about both actual practices and new developments.

The best tool for this purpose is the residence country's tax treaty network. A sensible country will use this network, in combination with its internal law, to advance its national tax policy goals. If an element serving those goals is distinguishing between France and the Cayman Islands on a dynamic basis, and perhaps making distinctions within France as well, the treaties readily lend themselves to the task. They can be used with precision, changed rapidly, offer the possibility of ascertaining current information, and ought to be the instrument of choice for identifying, on an ongoing basis, those jurisdictions where an exemption system could apply.

There are some risks, particularly in the discretion that must be vested in government officials charged with tending the treaty network, but they do not seem so huge as to be unbearable. The suggestion is not that compiling a list of countries qualifying for exemption be left entirely to the treaty program, but that the program be employed to prepare, review and, if necessary, change the list. Nor is reliance on the treaties inconsistent with oversight and correction by the legislature. The treaties are not the only means of establishing and reviewing the sort of list that has been described, but some means of distinguishing among jurisdictions is indispensable.

Normal business income in countries appearing on the list of exemption jurisdictions does not appear to require a foreign tax credit system. If exemption was instead employed for the core case—business income attributable to a substantial presence within such countries—there is a potential for real improvement in the tax system, judged in terms of efficiency, equity, and simplicity.

Under the proposal, manufacturing income earned in France would not be taxable in the residence country, either when earned or when repatriated. Sales income in France, even from sales into Germany, similarly would be exempt, provided the income was linked with activities carried on in France. The so-called "base company" concept should not be controlling in this context, as the "high tax exception" of subpart F recognizes in a different way.²¹ That exception, however, mechanical and static, is not equivalent to exempting income in the first instance. The exemption would apply not only to income earned directly by the resident taxpayer but, since foreign controlled corporations would be transparent, to all foreign corporations subject to the taxpayer's control, wherever organized and wherever managed and controlled, at whatever tier in the chain of ownership.

Would some income escape taxation? Certainly. In some instances income would qualify for exemption under the proposal yet not be taxed by the source country. In others, the source country's tax rate would be low enough that potential residual taxation in the residence country would be foregone. Would there be tax planning opportunities for professionals and tax directors in the residence country's businesses? Surely. Exemption is a powerful magnet and residence country taxpayers would pay close attention to it. The question, however, is not whether the proposal places a hermetic seal on income that might, in the abstract, be subject to tax in the residence country, but whether costs of the described nature will be so large as to result in assaults on the goals of efficiency, equity, and simplicity, particularly by comparison with the system presently in force in the residence country. Seepage exists in the most detailed tax system, and no approach to taxing the income of foreign controlled corporations is capable of preventing it. Aiming for perfection will, inevitably, fall short of the mark with respect to persons determined to avoid tax while (at best) inconveniencing everyone else.

To be sure, the proposal (like any other dealing with this subject) calls for important definitions, such as what is control, what is business income, and when is such income to be viewed as earned through a substantial presence in a listed

21. See I.R.C. § 954(b)(4) (1989).

foreign country? Each of these crucial concepts merits careful consideration, but it is relatively easy to identify starting points.

For "control," it is tempting to recur to the definition used in the transfer pricing area—"any kind of control, direct or indirect, whether legally enforceable or not, and however exercised or exercisable."²² The vagueness of the phrase may rule it out as a sole test, however. The "safe harbor" that lies at hand is direct or indirect holding of a majority of either vote or value.²³ Shareholders not within the control group,²⁴ even if substantial, should be treated separately, since notwithstanding the size of their holdings it cannot be said that the foreign corporation represents, for them, merely an election.

For "business income" the leading definition is probably the treaty concept of business profits. This would include passive income recharacterized in accordance with the circumstances in which it is earned. The residence country would have to make a judgment, in developing its exemption list, whether such income likely would be subject to tax in foreign countries. Incidental income is going to be the focus of planning activity, and in jurisdictions where such income is apt to escape tax, adjustments to the list would be indicated.

To determine when income is earned through a substantial presence in a foreign country, the concepts of permanent establishment and attribution seem appropriate. These concepts are used around the world as a result of the international web of tax treaties and therefore, in most jurisdictions, offer the hope that they truly will identify cases in which the source country will tax. Although the precise contours of the permanent establishment concept are not crisp and a number of fact patterns (more numerous, no doubt, by reason of the e-commerce phenomenon) are bound to require interpretation, any competing concepts (for example, the "trade or business" and "effectively connected" standards employed for inbound taxation in the United States)²⁵ are unlikely to achieve wide acceptance and could be idiosyncratic in application. The notion of business

22. Treas. Reg. § 1.482-1(i)(4) (1989).

23. See I.R.C. § 957 (1988).

24. Constructive ownership rules would, of course, be used for this purpose, though the rules of I.R.C. Code section 958 usefully could be rationalized.

25. See I.R.C. § 864(b), (c) (1989).

profits attributable to a permanent establishment has a clear basic meaning, one that receives endorsement and interpretation through ongoing work of the Organization for Economic Cooperation and Development (OECD). So the suggestion is that business income attributable to a permanent establishment in designated countries would be exempt in the residence country. Permanent establishment would be defined by law in a general way—for example, adopting the OECD concept—though the definition could be adjusted by negotiation with individual treaty partners.

The residence country would be the arbiter of these definitions, since the rules would represent its domestic law, even though the terms are borrowed from the treaties. There might, of course, be instances where the law of the residence country would pose a question not asked by the source country for purposes of its own taxation, for example whether a controlled corporation considered by France to be a resident had a permanent establishment in France. France, taxing corporations on a residence basis, might not have any interest in the inquiry. There also might be jurisdictions, even designated jurisdictions, that do not tax at source all income that, in the eyes of the residence country, is attributable to a permanent establishment in those jurisdictions. If there likely is not to be a source country tax on a clearly envisioned class of income—the operative word here is likely, not certain—adjustments to the list, as suggested above, should be made. In particular, a source country exemption for foreign income attributable to a permanent establishment in that country cannot be accepted in this regime. Systemic holes in a tax system are like the drain in a bathtub; the fact that they are limited in diameter is of little importance.

As for the Caymans, as for income from Alsace, the implications of the proposal are current tax in the residence country and a deduction for foreign taxes imposed on such income. Like the proposed exemption, this rule would apply regardless of whether income was earned directly or in foreign controlled corporate solution, and irrespective of how many layers of foreign controlled corporations were interposed between the resident and the income. The taxpayer that finds itself in a position in which it does not derive maximum benefit from the tax regime can obtain that benefit by removing itself from that position. Relieving international double taxation is a worthy

goal for a residence country, but that goal need not be pursued in exactly the same way in every country in the world.

My inclination would be to favor a similar approach to passive income, not qualifying as business profits. It has never been clear why a foreign tax credit should be made available for such income. The earning of income from portfolio investments in a source country is clearly in the economic interests of that country, which finds itself in a conflict. It wants and needs the investments, but the earnings are a natural part of its tax base. The result is likely to be a modest regime of taxation, with exemption perhaps for particularly favored investment forms. The residence country does not have a strong interest in wading into this conflict and making life easier for the source country by shouldering the burden of whatever tax the latter country chooses to impose. (The existence of a foreign tax credit regime that is likely to be misunderstood in the source country probably contributes to a higher level of source country tax than would otherwise be the case.) A deduction for foreign taxes imposed on income not qualifying as business profits attributable to a permanent establishment would treat such income in the same manner as if it was earned in the residence country and subject to taxation at the sub-national level.

It is true that not every residence country will be prepared to contemplate this binary view of the world, with an "exemption zone" carved out from a general rule of current taxation and no foreign tax credit. Much will depend upon the extent of the foreign activities carried on by residents of the particular country. Especially if those activities are likely to be widely dispersed, it may be necessary to interject a direct foreign tax credit, subject to some form of limitation to control cross-crediting, for certain situations. Ideally, this "third way" would be limited to business profits and activated solely by means of negotiated treaties. There would, of course, be a cost in terms of complexity. But if the residence country could achieve at least elimination of the deemed paid credit, gains for the cause of simplicity still could be substantial.

Even with neither foreign tax credit nor exemption for income earned in the Cayman Islands or (on the previous hypothetical) Alsace, a deduction would be allowed since there is no reason to treat such income more harshly than income earned within the borders of the residence country. The same

rule would apply to business profits from a listed country but not attributable to a permanent establishment. Source rules still would be needed, if only to govern source-basis taxation in the residence country. But the focus on income attributable to a permanent establishment would diminish the importance of such rules in the case of residence-basis taxation.

Income earned by foreign corporations in a non-control situation—either the corporation is not controlled by any one shareholder or controlling group of shareholders or the residence country taxpayer is not part of the control group—presents a different question. The proposal relating to control situations does not indicate how best to deal with the problem of international double taxation when control is lacking, and that subject is not the focus of this paper. Nevertheless, the subject is so closely related to the case of foreign control that a few observations are warranted.

The case for non-transparency of the corporate form finds support here in an eminently practical consideration—the residence country will not wish to place taxpayers in a position where they may be without sufficient information to comply with the law. That is probably a sufficient basis for general acceptance of the separateness of the non-controlled foreign corporation from its shareholders. On the other hand, if income earned through a non-controlled foreign corporation is not taxed currently to resident shareholders, there will be avoidance possibilities that would justify a regime akin to the U.S. rules relating to passive foreign investment companies.²⁶

A greater problem pertains to business profits attributable to permanent establishments. Suppose a residence country taxpayer enters into a joint venture with an independent party from another country to carry on business in corporate form in an exemption jurisdiction that imposes a substantial income tax on earnings of the venture. It might be reasonable to provide for exemption of dividends from such foreign corporations, at least (in a classical system), insofar as *corporate* recipients in the residence country are concerned. Further, there is no obvious justification for a minimum threshold of ownership,

26. See I.R.C. §§ 1291-1298 (1989). The word "akin" is used advisedly. It is hard to imagine a rational residence country intentionally replicating the passive foreign investment rules (PFIC), but there are doubtless simpler ways of targeting non-business income earned through foreign entities.

like ten percent of voting stock as employed in the United States to govern the deemed paid foreign tax credit.²⁷ In the case of income that would qualify for exemption if earned directly by the resident or through a foreign controlled corporation, the circumstance of non-control is not a reasonable basis for withholding double taxation relief. Nevertheless, exemption would have to be conditioned on availability of sufficient information to allow residence country tax authorities to verify the nature of the income; in the absence of such information, taxation would attach to the dividends received, with a deduction for foreign taxes imposed on the dividends. A direct credit might be considered, but in no event would a deemed paid credit be available; a foreign corporation would not be both separate from its shareholders and not separate at the same time.

To the extent of exemption, whether in a control or non-control situation, expenses incurred by the resident would be denied deductibility based on an appropriate allocation and apportionment to exempt foreign income. This would not be simple, but the allocation and apportionment rules presently in place in the United States, for example, serve an essentially similar purpose.

IV. PRESSURE POINTS

When the building blocks are assembled, the resulting system relieves foreign business income from residence-basis taxation, but in the name of alleviating international double taxation, not protecting import neutrality or promoting competitiveness. The system is precise, subject to the scrutiny and control of residence country tax authorities, and flexible. Exemption is afforded to income earned through substantial activities in designated jurisdictions. Other income—passive income not constituting business profits, business profits not attributable to a permanent establishment, income from jurisdictions not designated on the list—is taxed currently, whether earned directly by a resident or through foreign controlled corporations. A direct foreign tax credit for taxes imposed on the resident might be allowed in some of these instances, but the general rule would be deduction only.

27. See I.R.C. § 902 (1989).

In such a regime, the foreign tax credit would have relatively little scope for application. The rules relating to transfer pricing also would have reduced importance, particularly if the definition of control is borrowed from the transfer pricing area, though similar rules would be needed to govern the concept of attribution to a permanent establishment. More prominent would be the determination of what is a permanent establishment and what income is business profits. These are concepts that must be applied by countries around the globe in their role as source-basis taxing jurisdictions, and that are relatively familiar from decades of application in an international context.

The result would favor business investment and business earnings in major trading partners of the residence country. There would be no concept of "base companies," and no traps for the unwary in the rules relating to international double taxation. On the other hand, it would be more difficult to use foreign corporations to squirrel away passive income without tax, and there would be no special incentive to retain earnings in foreign corporate solution.

Without doubt there are many fault lines in the proposal, and experience would surely bring these to the attention of tax authorities. Several important issues, however, do not require such experience and can be identified now.

As suggested, rules similar to those that govern transfer pricing would be required to regulate the issue of what income is attributable to a permanent establishment. There does not appear to be any reason, however, why those rules need be any more complex than a transfer pricing regime. In addition, since the system is based on the notion of avoiding international double taxation, it may be possible to build upon the views of the source country, at least to some extent. This should not go so far as a "subject to tax" test, which would tend to embroil residence country tax administrators in the unhappy task of understanding laws of the source country as applied on a case-by-case basis. A lesser standard—for example, a requirement that the taxpayer demonstrate consistency of factual representations in both countries—might not be nearly so difficult to administer. The test would not conclusively establish attribution, but might be a necessary condition for such a claim.

The residence country also would have to address transfers of appreciated property to a permanent establishment in a

country qualifying for exemption. Such transfers should give rise to immediate taxable gain, regardless of whether the asset in question is "purchased" by the permanent establishment. There thus would be a "price" for entering the exemption zone with assets that had acquired value outside it. Alternative approaches would place too much pressure on the question of what is, and what is not, attributable to the permanent establishment. Other conceivable responses to the "transfer in" issue likely would prove dauntingly complex in practice.

The proposal would result in a "misallocation" of tax revenue in some instances, particularly when deductible expenses have been incurred outside the exemption zone and a not yet highly appreciated asset is transferred into that zone. The proposal accepts the resulting misallocation as a fact of life, given the concept of an annual accounting period. Similar mismatches inhere in any system that allows current deductions for expenses, like research and development costs, that produce future value. My inclination would be not to attempt to police the mismatch through detailed rules governing the transfer to the exemption jurisdiction,²⁸ but instead to rely upon a combination of an immediate tax upon gain and the expected tax in the source country to inhibit transfers having little business purpose.

Finally, perhaps most importantly, the proposal draws a sharp line between designated jurisdictions where exemption could apply and everywhere else. The resulting difference in treatment would place continual pressure upon the residence country to expand its list of exemption jurisdictions. Clearly, not every jurisdiction is either a France or a Cayman Islands. How is the residence country to treat Morocco or Brazil? Hungary? Gabon? Nations have different views about taxation, different capabilities for implementing a tax system, different economic attractions for the resident. Some pressure would be relieved if it was determined to allow a direct foreign tax credit in specific situations, preferably through treaty negotiations. But with every agency in the residence country doubtless viewing itself as a custodian of tax policy, it may be difficult to keep the exemption list to its intended purpose. Nevertheless, there are substantial dangers in loosening the grip. *In concept*

28. See I.R.C. § 367 (1988).

the list should include only foreign countries that have full-blown, purposively administered, income tax systems, and which can be trusted, in most cases, to impose tax on persons having a substantial nexus with their soil. That does not necessarily imply a restriction to OECD members (or, for that matter, inclusion of all OECD members), but the criteria for inclusion should be high. It would be strange indeed for a residence country, dubious of its ability to administer such criteria, to opt instead to place all foreign taxing jurisdictions on the same plane and structure its rules for foreign income accordingly.

V. CONCLUSION

There is no way to drain complexity from the regime of a modern capital-exporting country for taxing income of foreign corporations controlled by residents. The history of this subject contains many lessons. But, the lessons are themselves in conflict and ultimately unclear; some do not find concrete expression in existing rules of law. Considerations of economic encouragement or discouragement do not point clearly to any particular solution; and, in any event, the *tendency* of a given rule to induce or discourage certain behavior is often a weak foundation on which to create a superstructure of more detailed rules. What is left, at the end of the day, is the need to deal with international double taxation and to protect the residence country's tax base. The proposals sketched above, involving a limited exemption for business profits attributable to permanent establishments in certain specific foreign countries, aims at these objectives.

Any country—the United States, for instance—having a different set of rules presently in place for taxing the income of foreign controlled corporations would have to address many transitional issues in passing to the proposed regime. The treaty network would have to be studied with a view, eventually, to reworking it to accommodate the proposal. All that is no doubt of great technical and political complexity. But it is a separate subject.