On the Record

TNI Interview: H. David Rosenbloom

Tax Notes International is presenting a series of interviews with people who have had an impact on international taxation. We hope to preserve for the record interviews with a variety of leaders in tax policy. This week's interview is conducted by Tax Analysts' Cindy Heyd.

H. David Rosenbloom is an attorney specializing in international tax matters, a member of the law firm of Caplin & Drysdale, Chartered, in Washington, and director of the International Tax Program at New York University Law School. Born in New York in 1941, he attended Princeton University, the University of Florence in Florence, Italy, and Harvard Law School.

He joined Caplin & Drysdale in 1968, and rejoined the firm in 1981 after serving as international tax counsel and director of the Office of International Tax Affairs in the U.S. Treasury Department from 1978 to 1981. A frequent speaker and author on tax subjects, Rosenbloom has taught international and comparative taxation at Stanford, Columbia, the University of Pennsylvania, Harvard, and New York University law schools, and at educational institutions in Taipei, Mexico City, Milan, Sydney, and Pretoria.

He also is a member of various professional organizations, including the International Fiscal Association and the American College of Tax Counsel.

Photo courtesy H. David Rosenbloom

TNI: Going back to the early years of your legal career, what inspired you to specialize in international taxation, and who were your major influences?

Rosenbloom: My major influences were my parents. My father was a lawyer who specialized in copyright law and was a participant in many of the major cases in that field in the 1930s, 1940s, and 1950s. My mother had a keen interest in all things international. She had been brought up in upstate New York, and Montreal was an early beacon. Her receptivity to other cultures and peoples beyond the borders of the United States was a lot less common in the 1940s and 1950s than it is today. Both my father and my mother were first-generation Americans, and they were acutely aware of the privileges afforded by this country. They were insistent that I had an obligation to serve the public.

I was a language and literature person in college — still am, to some extent. My area of specialization was French, and I spent about 16 months in the early 1960s in France. I then studied Italian and went to the University of Florence, after which I spent time at the Goethe Institute studying German. All of that I put aside to go to law school, eventually finding my way — not especially enthusiastically — to tax law.

I stumbled into international taxation because it represented a natural extension of the two very different strands of my education. In 1977, when the Carter administration came into office, some senior lawyers in my firm who had worked in the

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Treasury and at the Internal Revenue Service in the Kennedy and Johnson years encouraged me to apply for a government position. At first, I was interviewed for the tax legislative counsel position at Treasury, but once I learned what the international tax counsel does, I knew that was the job for me. The notion that it might be possible to speak and negotiate for the United States in an international setting was overwhelmingly attractive. At that point, I had done some work in international taxation, but this was hardly an area in which I had specialized.

A wide range of extremely capable people at both Treasury and the Service, as well as in the private sector, taught me a great deal of international tax law in the years 1977 to early 1981, at which time I left Treasury to return to specialized practice and teaching in that field.

TNI: Many observers maintain that the U.S. government's emphasis on preserving American businesses' global competitiveness would be best served through the reform of subpart F of the Internal Revenue Code, which currently taxes the sales and service income earned by U.S. companies' overseas operations as a deemed dividend. Besides your suggestion that the United States provide a tax deferral, or exemption, not only for foreign base company income but also for base company income earned in the United States, what else would you change about subpart F?

Rosenbloom: A response to this question calls for an initial distinction between a fundamental rethinking of the international tax rules, on the one hand, and making incremental changes — to a greater or lesser extent — within the framework of current law, on the other hand. In the first category, my preference for subpart F — and the foreign tax credit, and the entire regime of inbound taxation — would be to recast the rules completely. For subpart F, as I sketched out in an earlier article,[1] I would propose ending deferral for controlling U.S. shareholders of foreign corporations and exempting active business income earned in countries with real tax systems roughly akin to our own.

The political will even to consider such a proposal is probably lacking at the present time, since the proposal would surely affect some persons adversely. Although the proposal would help others, we know from recent observation of the [U.S. House] Ways and Means Committee that trade-offs at the macro level can prove hard to sell. That, of course, does not mean the proposal is unworthy of debate or consideration.

All this is very different from my suggestion of a domestic base company. That suggestion implicitly accepts the present rules of subpart F, but would adjust them in ways intended to improve the statute. There are many other ways in which I would propose changing subpart F while maintaining its basic structure.

First, the Treasury should be authorized to promulgate regulations that will interpret and, at the margin, expand the statutory rules. One of the major problems with subpart F is that it is frozen in time as of 1962, with little room for expatiation, as we saw in the Notice 98-11 imbroglio, where an effort was made to expand the branch rule of section 954(d)(2) beyond the sales area. The process of developing a grant of regulatory authority would require Congress to be more specific about at least the general policies of subpart F — a good, if politically difficult, thing. I do not much care how extensive the regulatory authorization is, but modern U.S. tax statutes allow for a fair amount of interpretative flexibility.

Second, ethnocentric aspects of the statute — most prominently, the assumption that other countries use the U.S. concept of place of incorporation as the test for corporate residence — should be eliminated. It is presently too easy to gain advantage from the false assumption that our own rules are employed everywhere. There is no reason for that assumption as a matter of tax policy.

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Third, the problem of contract manufacturing should be addressed. My preference would be to include in foreign base company income the profits of a foreign company that is just a mailbox[2] while all real activity is carried on by others, related or not related, under contract. This is a big-ticket item, and would be very controversial. A recent and, in my opinion, ineffectual proposal in the Senate to address the issue of contract manufacturing clearly rang the Washington decibel meter, indicating that the proposal struck close to a nerve.

[1]"From the Bottom Up: Taxing the Income of Foreign Controlled Corporations," Vol. XXVI:4 *Brooklyn Journal of International Law* 1525 (2001).

[2]*See Vetco, Inc. v. Commissioner*, 95 T.C. 579 (1990).

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Next, the branch rule should be expanded to accommodate the kind of rules set forth in Notice 98-11. This would also be very controversial, but the expansion would probably be consistent with the original understanding of subpart F even though it is not, in my view, authorized by the present statute. As a more general matter, it is regrettable that the United States must rely on taxation by other countries as a means of effecting our own tax policies, but given the current structure of subpart F, I do not see good alternatives.

Finally, lying somewhere between a substantial incremental change and full-blown rethinking of the rules would be adopting a black or, probably better, white list of countries, and developing subpart F rules that accord with the distinction. We are approaching international taxation with both hands tied behind our back if we persist in equating the Cayman Islands and Germany.

TNI: A recent article by Ken Brewer of Deloitte (see *Tax Notes Int'l*, 15 Mar. 2004, p. 975) commenting on your essay "Why Not Des Moines?" (see *Tax Notes Int'l*, 8 Dec. 2003, p. 895) makes the point that there are two different ways to look at the competitiveness concern: "promoting the competitiveness of the United States as a place for companies (whether U.S. or foreign) to conduct business activities," and "rectifying a competitive disadvantage of U.S. companies versus foreign companies regarding business activities conducted abroad." Is there a single tax solution that addresses both views?

Rosenbloom: The dichotomy identified by Ken Brewer surely exists, but I do not believe it has anything to do with my essay.

The United States has had tax policies aimed at "promoting the competitiveness of the United States as a place for companies . . . to conduct business activities." Think, for example, of the investment tax credit, or accelerated depreciation for investments made in the United States. My essay was not dealing with such policies.

Rather, the essay was intended to probe the general concept of competitiveness, a term that rolls off the tongue but the substance of which is seldom explored or explained. My sense is that the competitiveness concern translates, not so roughly, into overly high taxes. The position that subpart F foreign base company income should be exempted from tax in the name of competitiveness means, in effect, that a particular slice of income — base company income, particularly base company sales income — should escape taxation, thus improving competitiveness by rendering overly high taxes lower.

Base company sales income is inherently mobile. It need not be situated in any particular place. It is not firmly linked with either the manufacturing process or the relationship with ultimate customers.

There is no obvious reason why the exemption for this income, if justified, must be housed in an offshore entity. The basic question I asked was why, if this income must be exempt on competitiveness grounds, the exemption should apply only to controlled foreign corporations. This is really the same question that Jack Nolan and the original DISC proponents asked, but they asked it only with respect to exports. I am not limiting the question to exports, thus avoiding a variety of trade issues.

To be clear, my points are that: (a) if foreign-controlled companies have a competitive advantage over U.S.-controlled companies, there is no reason why that disadvantage has to be rectified by exempting the income of a foreign corporation; and furthermore, (b) if the alleged competitive advantage exists, it probably exists and calls for a remedy inside, as well as outside, the United States.

Allowing elective use of different systems is pernicious and, ultimately, contrary to the very notion of a compulsory tax system.

I therefore asked why not cure the disadvantage suffered by U.S.-controlled companies by giving a compensating advantage to designated companies within the United States, and keeping whatever jobs are involved at home? Again, this would be for both exports and domestically consumed goods. Upon further reflection, I came to wonder whether the domestic base company would be a good idea not only in addition to foreign base companies but, perhaps, instead of foreign base companies. Such a domestic company would not be a means of promoting competitiveness only within the United States. Rather, it would house exemption for a slice of income, and thus promote competitiveness across the board, including for business activities conducted abroad.

TNI: What is your reaction to U.S. Internal Revenue Service Notice 2004-19, which withdraws the economic profit test established in Notice 98-5 to identify abusive foreign tax credit transactions? Do you support the apparent move toward income matching implied in Notice 2004-19?

Rosenbloom: The foreign tax credit, as it appears in the statute, is very mechanical. It is difficult to insert extrastatutory considerations into

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the scheme without clear legislative authorization. The mechanical nature of the statute does not always operate to the detriment of the fisc, as illustrated by the *Goodyear* case.[3]

For these reasons, I was not surprised that the Revenue Service had difficulties both in administering and defending in court the position taken in Notice 98-5, which, incidentally, in its tacit approval of entity and instrument arbitrage techniques was really quite favorable to taxpayers. I am neither surprised nor particularly disturbed by the demise of the notice.

Insofar as attempts to match income and credits are concerned, any general effort of this nature will create problems. There are many situations in which foreign concepts of income, and thus foreign taxes, differ substantially from U.S. concepts of income — for example, when the United States and a foreign country adopt drastically different depreciation rules. Drawing lines here will be difficult, and general rules attempting to match income and taxes will, I believe, be nearly impossible to administer. It is, however, conceivable that very specific rules targeting certain deliberate mismatches of income and credits — through the use of partnerships, for example — could be adopted, but I would regard these as limited efforts to address particular problems, rather than as a general attempt to deal with foreign tax credit abuse. Even these limited efforts will doubtless have more to do with other statutory and regulatory provisions — in the partnership area, for example — than the foreign tax credit rules. See, for example, the just issued proposal to amend the section 704 regulations to "provide rules for the proper allocation of partnership expenditures for foreign taxes."[4]

TNI: Several years ago, the Treasury Department requested public comments on a revision of the foreign branch currency rules under IRC section 987. Revised regulations have not yet been issued, but sources indicate they soon may be forthcoming. Several commentators have suggested that the new regulations should provide that exchange gain or loss be recognized only on remittances of earnings from qualified business units, excluding remittances of capital. Others have suggested that the rules for functional currency conversions be modified to replace the daily netting rules with an annual netting procedure. To what extent would you agree with those comments, and what other observations do you have concerning the section 987 project?

Rosenbloom: The section 987 project is much more important today than it was when the section was enacted in 1986 because the check-the-box regime has given rise to numerous branch situations. Prior to that development, section 987 was, I think, primarily applicable to financial institutions, limited in number, who coped with it as best they could.

As a general matter, I favor rules that achieve rough justice over those that aim for perfect logic or exact measurement. We have altogether too many rules of the latter type in U.S. tax law, and they have served to make the statute nearly incomprehensible.

On the other hand, whatever rules are adopted should, in my view, be adopted across the board, for everyone. Allowing elective use of different systems is pernicious and, ultimately, contrary to the very notion of a compulsory tax system.

Within that framework, I have no brief for any particular set of rules to interpret section 987. If annual netting would promote administrability, I would tend to favor it. On the other hand, I would have to be persuaded that remittances of capital should be immune from exchange gain or loss effects, since capital has been placed, by hypothesis, in foreign functional currency solution, and I do not perceive the justification for a hybrid system in which a partnership model is adopted for some aspects of foreign branch taxation but not for others.

TNI: You've stated in the past that you question the interest deduction in cases of related-party debt because — at least in a corporate context — you perceive the transfer of funds to more closely constitute equity than debt. What alternative tax treatment do you think would best address the issue of related-party debt?

Rosenbloom: As an objective matter, purported debt between related entities — not necessarily in other related-party situations, such as parent and child — is not really debt. If one considers carefully and objectively the judge-made rules that have been developed to distinguish debt from equity, and applies substance-over-form principles, there is no debt here — no enforceable intention to repay, no real creditor's rights, and arguably only a single party in interest. The Tax Court came very close to making this point in *Laidlaw*.[5] A great deal could be achieved by treat-

[3]*United States v. Goodyear Tire and Rubber Company*, 493 U.S. 132 (1989).

[4]T.D. 9121 (25 March 2004).

[5]*Laidlaw Transportation, Inc. v. Commissioner*, T.C. Memo 1998-232.

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ing transfers of value in exchange for such purported debt as contributions to capital or distributions. However, this notion clearly entails a major rethinking of the tax laws. It runs counter to all the accepted wisdom and would have substantial consequences for current tax planning.

TNI: In your article "Banes of an Income Tax: Legal Fictions, Elections, Hypothetical Determinations, and Related-Party Debt" (*Tax Notes Int'l*, 15 Dec. 2003, p. 989), you theorize about the tax simplification that could result from the fiscal reclassification of a CFC from the current, nontransparent legal person to a transparent economic business unit. What kind of corporate tax regime would ensure appropriate taxation of the business entity while still looking through that entity to its controlling shareholders?

Rosenbloom: The proposal you describe is set forth at greater length in the *Brooklyn Journal* article I referred to earlier. Both there and in "Banes," I focused on the international context and, specifically, on controlled foreign corporations. My proposal would be to end deferral for members of the control group, regardless of how many tiers of corporate entities there may be. At the same time, I would provide for complete exemption for active business income derived in real foreign taxing jurisdictions and perhaps — and by treaty — in other, carefully circumscribed, cases.

TNI: You've pointed out a number of problems with hypothetical determinations such as the arm's-length method in related-party transactions, while acknowledging that they probably are a necessary evil of tax administration. Can you envisage an alternative to the arm's-length method that would be more accurate and less easily manipulated?

Rosenbloom: The obvious alternative is some type of formulary taxation, and that surely presents its own share of different problems. My sense is that the substantial bells and whistles that the United States has brought to the transfer pricing area in the past 10 years — as opposed to procedural innovations like documentation — have not been of much benefit to anyone other than the legal, accounting, and economics professions. First choice might be adoption of rough presumptions — not safe harbors — perhaps in the form of a modest return on capital employed, with an unshiftable burden squarely placed on the party contending for a different result in any particular case. However, there are no facile answers here, and this suggestion requires a great deal more thought.

TNI: U.S. Senate Finance Committee member and presidential candidate John Kerry, D-Massachusetts, recently unveiled an economic agenda that includes a sweeping, long-range plan for international corporate tax reform. Among other things, he proposes a 5 percent reduction of the corporate tax rate and a one-year, 10 percent tax holiday to encourage U.S. companies to repatriate their excess foreign earnings. What long-term effect, if any, do you think those measures would have on the global competitiveness of American businesses?

Rosenbloom: A low corporate rate is a good idea, and I have no problem with a one-time amnesty as a transitional means of moving to a different, and better, international regime. The repatriation proposal that Congress has been flirting with represents this sort of transition idea, but there the transition is from the existing regime to . . . the existing regime. I fail to see the sense in this. The objective of any such amnesty-transition should be to move to a superior set of rules for the future, while obviating the existing buildup of income as an obstacle to progress.

As for global competitiveness, I have a simple — possibly simplistic — view. Lowering the corporate rate strikes me as the most direct, fairest, and most efficient means of addressing that issue. Such an approach stands in sharp contrast to suggestions, which appear now and again, that the United States should replicate tax benefits offered by foreign tax systems. The fact that Japan, or France, or Germany may give resident taxpayers certain benefits for investing in, say, Brazil hardly means that we need to follow suit. Some country out there will always offer some benefit not found in the U.S. tax system. I do not believe competitiveness should drive our system to a sort of lowest common denominator.

TNI: Do you think President Bush's proposed dividend exemption for investors would make an appreciable difference in U.S. companies' ability to raise capital, ultimately reducing the outflow of jobs to lower-tax countries?

Rosenbloom: I fail to see the connection. If dividends are exempt, that will doubtless have an effect on capital markets. Debt, including municipal bonds, will be disadvantaged. Also, there will surely be all sorts of secondary and tertiary consequences for corporate behavior. But I do not follow the suggested link to the outflow of jobs. Jobs are generally not moving abroad to lower-tax countries, but to lower-wage countries. To my knowledge, no one is manning telephone response centers and remote X-ray laboratories in Monaco, Bermuda, or the Isle of Man. I do not quite understand how changing the rules of the capital markets will have an effect on the outflow of jobs.

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TNI: The IRS on 1 April issued guidance (Notice 2004-31) that identifies as abusive a tax strategy in which a foreign parent company uses guaranteed payments in a partnership transaction to achieve results similar to the issuance of debt by partners, in effect converting nondeductible interest payments into deductible business expenses. Participants in those types of transactions now must report them to the IRS, and promoters also are subject to stricter disclosure rules. Do you think the IRS response goes far enough in combating such avoidance-based intercompany financing strategies?

Rosenbloom: Not really. The key word in this question is "such." I think piecemeal efforts to deal with particular transactions are illusory: They chase after a potentially infinite number of "such" transactions, since there is really no limit to the imaginations of the geniuses who create these "products." Moreover, the IRS efforts come, invariably, long after the fact, and tend to mislead the public into believing that the enormous tax shelter problem in the United States is being addressed. I am skeptical. I think the problem can only be addressed — or can best be addressed — if greater compliance is institutionalized before transactions are done. My preference would be to adopt general standards and establish a few examples through selective litigation in which meaningful penalties, up to and including criminal penalties, are pursued. It is true that there are some gray areas, but that is no excuse for refusing to distinguish black from white.

TNI: In the months since your 15 July 2003 testimony before the U.S. Senate Finance Committee about corporate tax policy as it relates to U.S.-owned foreign corporations, the Treasury Department and Internal Revenue Service have announced a number of initiatives. What, in your opinion, are some of the more important corporate tax changes on the horizon now?

Rosenbloom: There are few currently proposed corporate tax changes that represent sound tax policy, and even fewer that could possibly be construed as important. A number of the items in the Ways and Means and Senate Finance bills are acceptable, but others are ill-conceived, and I do not much like the trade. Worldwide apportionment of interest could be a nightmare, especially by reason of currency issues; and as drafted, this would be yet another elective regime. The proposed subpart F changes are really just a helter-skelter showering of tax benefits, lacking coherence. On the other hand, I do favor reducing the number of foreign tax credit baskets to three, or even two, and I am strongly in favor of limiting carrybacks of the foreign tax credit on administrative grounds; in fact, I would favor no carrybacks and a reasonable carryforward period.

In any event, the changes on the horizon now do not seem important to me. Rather, they strike me as particularized, generally difficult to administer — and in some cases, difficult to understand — lacking any general theme, and, as usual, exceptionally complex.

TNI: What are your observations about the development of the U.S. tax system over the course of your career?

A functioning, fair tax system lies close to the heart of democracy.

Rosenbloom: For a variety of reasons, which in my opinion can and should be more widely debated, the U.S. tax system has suffered substantial damage over the course of my professional career. I would mark the start of this development in 1969, with the Tax Reform Act enacted in that year. I had and have a great fondness and admiration for Larry Woodworth, but his instincts were to deal with political issues through adding complexity to the statute, and that approach bore some very serious negative implications.

For me, a functioning, fair tax system lies close to the heart of democracy. Having worked on taxation in many foreign countries and taught taxation in others, I can attest that a public perception that government is supported in an equitable and efficient way is both rare in the world and a hallmark of the United States. Our tax system is, very simply, the best there is — notwithstanding efforts over many years, not all of them in good faith, to impugn, undermine, and otherwise harm that system and the people who administer it. Our system has suffered greatly from those repeated attacks. I recognize, of course, that it is difficult to rally public support for taxation, but this country is fortunate that a substantial number of people understand why taxes are levied and what government provides in return. This understanding has been a saving grace for us. But the gradual movement toward exemption of capital income and placing the burden of government on the backs of wage earners seems to me a bad idea that still lurks in the halls of Congress.

TNI: How do you perceive the operation of the IRS today, particularly as compared with previous years?

Rosenbloom: I think the IRS is as good an agency as exists, at any level, in our government. IRS employees work hard, for the most part, for relatively modest compensation, in a way that is generally efficient, honest, and fair.

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This does not, of course, mean that every IRS employee can be so described. In my career I have encountered my share of arrogant, inflexible, and unproductive IRS people. Believe it or not, people like that exist in the private sector, too. As a whole, the IRS is — as I have said before in other contexts — a national treasure, definitely superior to comparable agencies in other countries. It does not deserve the abuse that legislators and others have found it expedient, time and again, to hurl at it. The failure of the Clinton administration to defend the agency when it was attacked in Senate hearings was very, very disappointing.

True, some of the IRS's problems have been self-generated. It appears to have failed repeatedly at the task of modernization, has turned increasingly to managerial models, at the expense of experience and expertise, and has sometimes been too tolerant of employees who stray from appropriate roles. Nevertheless, there is absolutely no reason for national leaders worthy of the name to withhold support from the agency.

In the past few years, it has been fashionable to speak of the IRS as a service organization that deals with customers. There is doubtless a service element to its assigned functions but, inescapably, the IRS is engaged in law enforcement. The emphasis on customer service does not reflect clear thinking — and it generates the kind of breakdown in compliance that we are witnessing now. That is a terrible development because lax enforcement inevitably prompts some taxpayers to take advantage, and that, in turn, fosters doubt in the minds of still other, otherwise compliant, taxpayers, who begin to see themselves as suckers. This is hugely detrimental to the type of fair and efficient system that the United States can and should have.

My concluding thought is this: If Congress really wants to reform the tax laws, it should focus on helping the IRS to do its job. ✦

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