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The Status of United States International Taxation: Another Fine Mess We've Gotten Ourselves Into

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The Status of United States International Taxation: Another Fine Mess We've Gotten Ourselves Into

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" 'Cheshire Puss,' she began rather timidly, ... 'Would you tell me, please, which way I ought to go from here?'

'That depends a good deal on where you want to get to,' said the Cat.

'I don't much care where . . . ,' said Alice.

'Then it doesn't matter which way you go,' said the Cat.

'[S]o long as I get *somewhere*,' Alice added as an explanation.

'Oh, you're sure to do that,' said the Cat, 'if you only walk long enough.' "[1]

I. INTRODUCTION

United States international tax policy in the 1980s and beyond, where are we going and why? The federal income tax has arguably taken a consistent approach to basic international issues since its inception. To this allegedly well balanced compromise between theory and practicality, an increasingly complex maze of rules has been added without much direction. The result is chaos with little apparent benefit. Contrary to the alleged intent of these piecemeal amendments, the changes have complicated, not simplified, the area of the international tax law. In trying to make an inherently imperfect system perfect, monumental administrative burdens have been imposed on United States multinational companies and on Internal Revenue Service personnel. The need for increased man-

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[1] L. CARROLL, ALICE'S ADVENTURES IN WONDERLAND 82-83 (Children's Classics 1988).

power and tax administration is costly and places United States companies at a competitive disadvantage with respect to foreign companies.[2] These burdens may be necessary to achieve certain overriding goals. On the other hand, they may stem from an aimless movement of a Congress that is well intentioned but ill directed.[3] Whether the costs are justified or baseless, the United States international tax law is currently unmanageable, unwieldy, and, at best, an area fraught with many unnecessary complexities. Indeed, the complexity of international tax disconcerts even the sophisticated tax planner as to whether his or her advice is actually sound and up to date. Furthermore, proposals for additional changes in the near future do not seem to help.

This Perspective will examine the current status of international taxation in the United States with regard to the original and present policy goals of the United States government. Two significant changes enacted by the Tax Reform Act of 1986[4] ("the 1986 Act") will be reviewed as well as recent proposals in the international area. Finally, recommendations for the future direction of international taxation in the United States will be made.

II. POLICY OBJECTIVES

What are, or should be, the policy goals behind international tax law? Policymakers certainly do not appear to know.[5] To my knowledge, there has not been any comprehensive reevaluation of the policy objectives of international tax for many years.[6]

In the domestic tax area, the current policy goals underlying the

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2 *See* ARTHUR YOUNG & COMPANY, THE COMPETITIVE BURDEN: TAXATION OF U.S. MULTINATIONALS, (1987). *See also* COMMITTEE FOR ECONOMIC DEVELOPMENT, TOLL OF THE TWIN DEFICITS (JULY 1987)[hereinafter TOLL OF THE TWIN DEFICITS] which states, in pertinent part, concerning the 1986 tax legislation that "these provisions could have serious adverse effects on the competitive position of U.S. firms. . . ." *Id.* at 58.

3 Senate Finance Committee member Max Baucus, Democrat from Montana, commented as he opened hearings on the effect of the tax code on the United States' international competitiveness, "The truth is that, at this point, we really don't understand the relationship between taxation and our international economic standing." *Finance Committee Considers Taxes and Competitiveness*, 37 TAX NOTES 128 (Oct. 12, 1987).

4 Tax Reform Act of 1986, Pub. L. No. 99-514, 100 Stat. 2085 (codified as amended in scattered sections of 26 U.S.C.).

5 To quote Stanley S. Surrey, "everyone engaged in the tax field, be they members of the private bar, academics, government officials or even legislators, should be concerned about our troubled tax policy." Surrey, *Our Troubled Tax Policy: False Routes and Proper Paths to Changes*, 12 TAX NOTES 179, 197 (Feb. 2, 1981).

6 A detailed critique of the international aspects of the Internal Revenue Code recently has been made. AMERICAN LAW INSTITUTE, FEDERAL INCOME TAX PROJECT, INTERNATIONAL ASPECTS OF UNITED STATES INCOME TAXATION [hereinafter INTERNATIONAL ASPECTS](1987).

1986 Act, in theory if not in actuality, are those of fairness, simplicity and economic growth.[7] These same policy objectives do not seem to carry over to international tax issues. Does the international tax area raise additional concerns which make the same goals inapplicable? The answer is a resounding and clear "no".

One reason for the lack of coherent policy goals in international tax is the complex nature of international tax policy which "depend[s] on too many unknown variables to make any reliable answer."[8] This complexity has existed for as long as there have been international tax provisions. International tax policy not only involves balancing a number of conflicting policy considerations to resolve issues, but it requires incorporating many valid, yet competing viewpoints.

Several fundamental policy issues underlie United States international tax legislation. First, economic policy goals play an important role in formulating international tax laws. Some of the concerns ask, for example, what is the relationship between foreign investment and foreign trade to domestic investment, economic growth and jobs? Should we have capital export neutrality, capital import neutrality, or some other economic goal?[9] There is very little consensus in this area. A cynical view of tax policy would suggest that the largest and most powerful lobbying group at the time the law is being changed dominates the policy decision.[10]

Second, policy considerations of equity and fairness have always existed. Tax equity means that persons similarly situated and located in the same tax jurisdiction should be taxed equally. Domestic tax neutrality stands for the proposition that a U.S. investor's decision should not be influenced by tax systems which favor foreign over domestic investment.

Third, preventing tax avoidance and evasion is an ever present and dominant policy consideration. The international area is seemingly more suspect than the domestic area. Congress has always felt, rightly or

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7 Although "simplicity" originally was part of the three word chant of tax reformers in 1985 and 1986, the new concepts and sheer volume of changes enacted by the Tax Reform Act of 1986 quickly forced reformers to drop any claims of "simplification."

8 Surrey, *supra* note 5, at 197.

9 Capital export neutrality is achieved when an enterprise pays the same total rate of tax on foreign profits as on domestic profits. Capital import neutrality is achieved when firms of all nationalities operating in one industry pay the same ultimate tax rate on their profits in the country where the industry is located.

10 In connection with 1978 legislation relating to employment status under employment taxes, Former Representative James A. Burke of Massachusetts made the following observation regarding the behavior of lobbyists: "[t]he systalic chants and cheers emanating from those faineants . . . lends a special and somehow appropriate aroma to the unfortunate legislation." H.R. REP. No. 95 1748, 95th Cong., 2d Sess., 13 (1978).

wrongly, that more opportunities for tax avoidance arise in the international area. For example, Congress may be concerned about subsidizing foreign governments through our foreign tax credit, or about encouraging hidden assets in Swiss bank accounts. Whatever the concern, the zealous response involves designing precise rules in the international area that try to attack every conceivable problem. Perhaps, the hope is that this detailed attack will thwart the efforts of the most sophisticated tax planners in manipulating the system.

Fourth, there remains the foreign policy consideration of accommodating the tax system of the United States to that of other nations. The United States certainly has its own views of what is and is not a proper taxing system. The United States taxes its citizens and residents on their worldwide income. This practice is unique among the world's taxing jurisdictions and underscores the tax system's lack of accommodation. For political reasons alone, the United States should keep in mind the different taxing systems of other countries and their reaction to changes in our system.

Fifth, taking from the domestic context, simplicity is a goal of the tax system. Undue administrative burdens on taxpayers and the Internal Revenue Service weaken the United States' international economic position.

Finally, my belief, along with that of many others, is that the key to sound tax legislation in the international tax area is a prudent balancing of theory and reality.[11] With all the foregoing competing policy considerations in mind, realism and practicality must play a prominent role. The taxing system in any jurisdiction cannot be a perfect one in the sense that it "makes everyone happy" or that it prevents all tax abuse, however minor. A somewhat flawed system should be acceptable if it takes into consideration the administrative reality of corporations, or the need for domestic business to have a competitive edge vis a vis foreign business. Reflection on our goals from all these perspectives is imperative before more changes are made.

III. Historical Perspective Prior to the 1986 Changes

The Revenue Act of 1962[12] ("the 1962 Act") brought fundamental changes to international tax laws, and established most of the original goals for modern foreign tax policy. Prior to 1962, the tax law in the international area generally had been favorable to foreign investment and

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11 *See, e.g.*, Ross, *A Perspective on International Tax Policy*, 36 TAX NOTES 701 (Feb. 18, 1985).

12 Revenue Act of 1962, Pub. L. No. 87-834, 76 Stat. 1006 (codified as amended in scattered sections of 26 U.S.C.).

international business. Deferral of taxes on income of foreign corporations, with very few exceptions, dated back to the inception of the income tax law in 1913. The international tax provisions of the 1962 Act were, in the words of President Kennedy, designed to eliminate the perceived "tax deferral privileges" in developed countries and tax haven privileges in all countries. The specific reasons given for the proposals were: 1) the changing economic conditions at home and abroad; 2) the necessity for increased tax equity between purely domestic business and foreign controlled business; and 3) a strained U.S. balance of payments position.

Deferral of tax on the income of a foreign corporation owned and controlled by United States persons offended these principles. As a general rule, the United States does not tax the foreign source income of a foreign corporation unless and until that income is repatriated to a United States resident in the form of dividends, interest, royalties or other such payments. Congress, in 1962, felt that this system allowed and encouraged United States taxpayers to use tax haven jurisdictions, *i.e.*, countries with significantly lower tax rates than the United States, to defer or eliminate United States tax indefinitely. Prior to the enactment of the 1962 amendments, a United States shareholder could build up profits in corporations located in low tax jurisdictions. When the income was needed in the United States, the foreign corporation was liquidated and under the applicable Code sections taxed in the United States at preferential capital gains, not ordinary income, rates.

Subpart F provisions, and specifically Code Section 951,[13] were enacted to combat this problem. Code Section 951 basically provides that a "U.S. shareholder" of a "controlled foreign corporation" must include in his "gross income" as a constructive dividend some, but not necessarily all, of the controlled foreign corporation's current earnings and profits to the extent those earnings and profits have not been taxed previously by the United States. In hindsight, these significant and far reaching additions to the law were not ideal. Nevertheless, they did achieve a good degree of equity and fairness in the foreign area. Although these complex changes created a fair amount of initial ambiguity, they worked well to curb a significant amount of the abuse in the area. In addition, the foreign tax credit provisions, which will be discussed in detail later in this Perspective, were altered to accommodate the new Subpart F provisions.

In 1976, after significant discussion of issues remaining from the 1962 Act, the Tax Reform Act of 1976[14] ("1976 Act") was enacted. The 1976 Act, comparable to the 1962 Act in its sheer volume of changes in

[13] 26 U.S.C. § 951 (1982).
[14] Tax Reform Act of 1976, Pub. L. No. 94-455, 90 Stat. 1520.

the foreign area, made certain refinements to the Subpart F provisions and the foreign tax credit. Although many of the loose ends left by the 1962 Act were never addressed, the 1976 Act perhaps started the trend in the international tax area to enact provisions based on isolated policy considerations without an integrated approach. The tendency to complicate the area, rather than to simplify it through the development of more holistic approaches, had seemingly begun in earnest.

The tax bills in 1981 (ERTA),[15] 1982 (TEFRA),[16] and 1984 (DEFRA),[17] all contained some foreign provisions and continued the trend of complex piecemeal changes. The changes brought about by these tax bills did not raise fundamental issues. However, there remained the underlying and unarticulated issue of whether the complex morass of unintegrated foreign tax provisions were approaching a point where neither the taxpayer nor the Service could implement them. The sheer frequency of the various changes indicate that they could not have been well thought out with regard to initial policy goals. The changes often substantially modified or effectively repealed earlier legislation so soon after their enactment that it never became clear whether the original legislation had worked. Certainly at this point the government, if only looking out for its own best interests, would have been well advised to take account of the difficulties of compliance in the foreign area. Some of the remaining perceived abuses could have been corrected without sacrificing revenue, increasing complexity, or requiring more Internal Revenue Service resources.[18] Again, Congress seemed bent on further complicating a complex area with little or no well reasoned approach, and with little or no significant revenue benefit.[19]

Since the 1962 Act, and now particularly with the passage of the 1986 Act, the process of legislative adjustment has obscured most of the original goals.[20] Although the original goals of the 1962 Act are intact, a

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15 Economic Recovery Act of 1981, Pub. L. No. 97-34, 95 Stat. 172.

16 Tax Equity and Fiscal Responsibility Act of 1982, Pub. L. No. 97-248, 96 Stat. 324.

17 Deficit Reduction Act of 1984, Pub. L. No. 98-369, 98 Stat. 494.

18 For example, an expansion of enforcement action under existing Code Section 482, 26 U.S.C. § 482 (1982), which allows the Internal Revenue Service to allocate income, deductions and credits among related taxpayers, could have been undertaken. Since this code section gives exceedingly broad powers to the Internal Revenue Service, this approach would definitely not please taxpayers.

19 Again, perhaps much of the blame lies with the skill and power of the business lobbyists and with a few powerful congressional personalities who have moved with skill and vigor to provide most of the legislative chaos in all areas of the tax law. *See* Surrey, *supra* note 5, at 185.

20 "The tax legislation of 1986 contains a series of provisions relating explicitly to the international operations of U.S. firms. It is widely acknowledged that these provisions were developed with little attention to their likely effects on international competitiveness. We are concerned that these provisions could have serious adverse effects on the competitive position of U.S. firms . . . ." TOLL OF THE TWIN DEFICITS, *supra* note 2, at 58.

complicated morass of piecemeal changes has thwarted the fairness, simplicity and economic concerns of the original law without doing much to curb abuses. This problem is illustrated in the two most significant foreign provisions of the 1986 Act: (1) the major revision of the foreign tax credit by adding a "basket approach" to the overall foreign tax credit limitation of existing law; and (2) the modification of certain sourcing rules for income and deductions.[21]

IV. THE 1986 ACT

A. The Foreign Tax Credit Limitation

The 1986 Act substantially revised the foreign tax credit limitation making the limitation theoretically more sound, yet practically more difficult to administer. The varied history of the foreign tax credit and the policies emerging therefrom are important to examine before exploring the chaos created by the 1986 changes.

The foreign tax credit was first enacted in 1918. Prior to 1918, taxpayers were allowed a deduction only for the foreign taxes they paid. A deduction for foreign taxes reduced the amount of income subject to tax. A credit, however, produced a dollar for dollar reduction in tax liability.[22] The change to a foreign tax credit was considered necessary to alleviate the severe burden placed on United States citizens who were subject to high rates of tax imposed by certain foreign countries in addition to the taxes levied in the United States. Without a credit, United States companies would be discouraged from expanding their businesses abroad. At the time, double taxation prevented United States companies from effectively competing with foreign companies and that, in turn, had a detrimental effect on the U.S. economy.[23]

After the foreign tax credit provisions were enacted, Congress soon realized that situations would arise in which taxes imposed by foreign countries at rates higher than United States rates could reduce or effectively eliminate the Unites States tax on income from sources within the United States and, accordingly, have a distinctly untoward impact upon the fisc. As a result, in 1921, an overall limitation on the foreign tax

21 Other significant changes, such as the new branch profits tax, which attempts to treat branches of foreign enterprises on a par with subsidiaries of foreign enterprises, and the new Code provisions dealing with foreign currency, commendable for adding some statutory guidance to a confused area, will be considered at a later date.

22 For example, a deduction of $1,000.00 reduces taxable income by $1,000.00. At a 30% tax bracket this equates to a reduction in tax liability of $300.00. On the other hand, a $1,000.00 credit reduces tax liability by $1,000.00.

23 H.R. REP. No. 767, 65th Cong., 2d Sess. 11 (1918).

credit was enacted. The limitation recognized that while double taxation must be prevented, the United States Treasury must also be protected. Basically, as today, the limitation provided that the amount of the foreign tax credit was not to exceed the United States tax attributable to the taxpayer's foreign source income. The overall limitation formula was as follows:

$$\frac{\text{taxable income from sources without the United States}}{\text{taxable income from all sources}} \times \text{United States tax before credit} = \text{maximum foreign tax credit sources}$$

The overall limitation did allow for the lumping of foreign income from different countries into one group. All foreign source income is put into the numerator and a single overall limitation is produced. Thus, it allowed for an averaging of tax rates between different jurisdictions. For example, if a taxpayer operated in both a high tax jurisdiction like Germany and a relatively low tax jurisdiction like Switzerland, the foreign source income from both jurisdictions would expand the limitation by increasing the numerator of the fraction.

In 1932, the per country limitation was enacted, and taxpayers were limited to the *lesser* of the overall limitation or the sum of the per country limitations. With the per country limitation, a separate limitation is stated for each foreign country from which the taxpayer derives foreign source income. The per country limitation was designed to prevent averaging between income from high tax and low tax jurisdictions as in the German and Swiss example. The total of such separate limitations is often lower than the overall limitation. Before the per country limitation was enacted, Congress had considered a complete repeal of the foreign tax credit because the United States economy was suffering from the Depression. Apparently, however, Congress felt compelled to encourage investment in the United States as part of a protectionist policy. The adoption of the per country limitation served as a political compromise between the overall limitation and a complete repeal of the foreign tax credit.

The overall limitation was repealed entirely in 1954. The reason for the change was that the overall limitation discouraged a company operating profitably in one foreign country from going into another country where it might have expected to operate at a loss for several years. For example, if a company operated in two countries, and one operation generated foreign source income but the other a loss, the loss could effectively wipe out any utilizable foreign tax credit in the profitable operation because the numerator of the limitation could be reduced to zero. Basically, the overall limitation was repealed in order to encourage foreign investment.[24]

Soon after this change, Congress changed the law *again* in 1960 to allow taxpayers an election between the two methods.[25] Congress reasoned that the overall limitation would encourage investment, and was more consistent with the way United States companies viewed their operations. In most cases, United States firms operating abroad think of their foreign businesses as a single operation and set up their organizations on this basis.

Finally, in 1976, the per country limitation was repealed altogether and taxpayers were required to use the overall limitation. Congress felt that the use of the per country limitation prevented losses in one foreign country from reducing the amount of credit allowed for foreign taxes paid in other foreign countries from which other income was derived. Again, the reason given for the change was that most United States companies viewed their foreign operations on an overall basis, not on a country by country basis.[26] The overall limitation remained in effect from 1976 to 1986. While specific changes, such as the separate interest limitation, were made to the foreign tax credit between these years, the overall limitation itself basically remained intact until 1986.[27]

Beneath the significant changes in the foreign tax credit limitation over the years, several basic principles have materialized. First, double taxation is countercompetitive and the foreign tax credit is necessary to afford relief in situations where the same income is taxed by more than one country. Second, United States businesses engaged in foreign operations do not generally recognize geographical boundaries. From a business standpoint, income taxes paid to the various foreign countries in which operations are conducted, represent an aggregate charge against all foreign business. Finally, the policy of the United States tax laws

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24 *See* H.R. REP. No. 1337, 83rd Cong., 2d Sess. (1954); S. REP. No. 1622, 83rd Cong., 2d Sess. (1954).

25 *See* H.R. REP. No. 1358, 86th Cong., 2d Sess. 3 (1960); S. REP. No. 1393, 86th Cong., 2d Sess. 4 (1960).

26 *See* H.R. REP. No. 658, 94th Cong., 1st Sess. 225 (1975).

27 One significant change in the overall limitation was the addition of the separate interest income limitation in 1984. The separate interest income limitation was designed to prevent averaging of foreign taxes on passive interest income. Passive interest income is often exempt from foreign tax under foreign law or treaties or subject only to withholding tax at modest rates, with foreign taxes on other foreign income. In addition to some modifications to the overall limitation, other safeguards were in effect at this time to prevent perceived abuses of the foreign tax credit. For example, Code Section 861 regulations, requiring an allocation of expenses between U.S. and foreign source income, operate to reduce foreign source income and thus reduce the numerator of the limitation fraction.

should be to encourage, not discourage, United States companies from investing abroad. United States companies should not be put at a competitive disadvantage with respect to foreign companies.

According to the President's Tax Proposals to Congress of May 1985 ("President's Proposals"), a return to the per country limitation was needed to prevent the foreign tax credit from reducing the U.S. tax on domestic income. The recommendation was made in light of the proposed reduction in the country's corporate tax rates. The lower the tax rate, it was argued, the greater the benefits of homogenization (the overall credit allowing averaging of income from both high tax and low tax jurisdictions) and the stronger its incentive effects. In other words, the lower the rate in the United States the more likely it would be that a United States corporation would pay a foreign rate higher than the United States rate, and, therefore, seek to generate low taxed foreign income as a balance. In addition, the President's Proposals further maintained that "[f]or a taxpayer with excess foreign tax credits, low tax country investments may be more attractive than investments in the United States . . . because of the possibility of using the excess credits to affect a portion of the U.S. tax otherwise due." While these contentions may or may not have been true, the outcry from the interested lobbying groups, primarily the multinational corporations, was sufficient to drop the per country proposal from the 1986 Act.

As an apparent compromise measure, the 1986 Act retained the overall limitation, but created nine separate limitation categories with respect to certain types of foreign source income that allegedly can give rise to abuse of the foreign tax credit. Three reasons lie behind the creation of the separate limitations: 1) the source, foreign or domestic, of the income can be manipulated; 2) the income bears little or no foreign tax; or 3) the income bears a rate of foreign tax that is abnormally high or in excess of rates on other types of income.

The new law, in Code Section 904,[28] creates nine such separate categories, often referred to as "baskets" of income, that are subject to a separate limitations calculation. In general, the more significant separate limitation categories are as follows: (1) passive income; (2) financial services income; (3) certain shipping income; (4) highly taxed interest income; and (5) certain dividends from noncontrolled foreign corporations. There is also a residual basket which contains all income not included in the other baskets.[29] Furthermore, the new passive income basket replaces the old separate limitation for passive interest income and in-

[28] 26 U.S.C. § 904 (Supp. 1988).

[29] Code section 904(d)(1)(E) may actually contain many baskets since it mandates a separate

cludes, generally, dividends, interest, annuities, rents, royalties, and gains from the sales of noninventory assets.

The new basket rules are exceedingly complex, certainly more so than either the overall limitation or the per country limitation. In practice and effect they operate much closer to the per country limitation. The overall limitation of the prior law was largely a product of compromise designed to achieve some degree of equity without undue complexity. It was designed to allow for averaging among high and low tax foreign income. The system was consistent with business reality, but, at the same time, it restricted the benefits of foreign losses. Prior to the 1986 changes, many multinational corporations could not use all their foreign tax against the United States tax on an annual basis. The fact that they were in an excess credit position indicated that the mechanism was working. The basket limitation approach reduces the possibility of multinational companies averaging worldwide tax rates, but it adds significantly to the complexities of compliance and enforcement in this area. It also requires tracing income from controlled foreign corporations which makes compliance and administration in the international area uncertain and difficult.[30]

In summary, although the overall limitation with "baskets" now approximates the perceived benefits or detriments of the per country limitation, it leaves us with complexity and administrative burdens not inherent in the per country limitation system. Ad hoc legislative adjustment may be leading to a more theoretically perfect foreign tax credit mechanism. Unfortunately, this "perfect" mechanism may be impossible for either the taxpayer or the Service to administer. At what price victory?[31]

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basket for the dividends of each uncontrolled corporation that pays dividends to a taxpayer. 26 U.S.C. § 904(d)(1)(E)(Supp. 1988).

30 On the other hand, perhaps we are lucky. We could have ended with a worse fate. Six possible limitation rules were identified by the recent Proposals of the American Law Institute on United States Taxation of Foreign Persons and of the Foreign Income of United States Persons, which are: 1) the overall limitation; 2) the per country limitation; 3) the line of business rule; 4) the overall limitation with "baskets;" 5) the per country limitation with "baskets;" and 6) the "high tax" and "low tax" baskets. Although it is impossible to go into great detail in this paper, a per country limitation with separate income "baskets" (requiring a separation based on both the character and geographical source of income involved) and the "high tax" and "low tax" "basket" limitation (requiring a separation based not on the character or geographical source of the income involved but rather on the effective rate of foreign-tax income) approaches would both entail much more complexity than the overall limitation with "baskets."

31 In all fairness, the President's Proposal did state that "[i]t is impossible as a practical matter to eliminate all tax rate averaging by calculating the foreign tax credit on a transactional basis. Taxes are not ordinarily levied on such a basis and the technical complexity of such a system would make it unworkable. The question therefore becomes how much tax rate averaging to permit in the

B. Income Source Rules

The changes in the income sourcing rules bring to mind the old adage, "if it ain't broke, don't fix it." Sourcing rules determine whether an item of income is United States source income or foreign source income. They are important for both United States citizens and foreigners. While a citizen or resident of the United States is taxed on worldwide income, regardless of its source, the sourcing rules allow these taxpayers to compute the overall limitation of the foreign tax credit as previously discussed. Nonresident foreign persons find these rules of utmost importance because the United States generally taxes their United States source income, and does not generally tax their foreign source income.

United States multinationals particularly rely on the rules for determining whether the income from the sale of personal property, *e.g.*, inventory, depreciable assets, and intangibles, is domestic source income or foreign source income. Prior law applied a "passage of title" rule and generally sourced income from the sale of tangible or intangible personal property in the country where title to that property passed to the purchaser. Courts have consistently followed and allowed the passage of title test. New Code Section 865 substantially revises the rules for determining whether income from the sale of personal property is United States source income or foreign source income. The new general rule makes income from the sale of personal property by a United States resident United States source income. Income from such sales by nonresidents, however, are foreign source income. One important exception is that income from the sale of inventory property continues to be sourced under the passage of title rule. This rule was left unchanged because of its importance to the competitiveness of United States multinationals.

Critics challenged the title passage rule for being arbitrary and subject to manipulation. Nevertheless, the rule having been in place for a significant period of time, was understood relatively well, and easily applied. For twenty-five years, the shortcomings of the title passage rule have been recognized. Safeguards in the form of Code Section 482 and subpart F provisions were built into the Code to prevent abuse. In addition to these safeguards, Treas. Reg. § 1.861 7(c) added the "substance of sale" rule to the present income tax regulations. This regulation provides that when tax avoidance is involved "all factors of the transaction, such as negotiations, the execution of the agreement, the location of the property and the place of payment will be considered, and the sale will be

system and at what cost in terms of the complexities of compliance and enforcement." Apparently the draftsmen of the Proposal and ultimate legislation felt international business could bear a high degree of complexity in this regard.

treated as having been consummated at the place where the substance of the sale occurred." This rule has not been used by the Service to any substantial extent, although it would appear that the Regulation could be applied by the Service in a sham transaction situation.

Why then change an existing law to merely change it? Perhaps the new sourcing provision is easily administered, but its many exceptions, particularly for inventory, still allow for the abusive manipulation the drafters sought to cure. In addition, the change is arguably more artificial in its application than the previous rule. The new rule does not coincide any more often with the economic realities of the underlying transaction than previous laws. The evidence is not convincing that existing law needed any change on this point, particularly a piecemeal change that does not approximate economic reality any closer than the prior rule.

V. THE 1987 PROPOSALS

The year 1987, so close to the extensive 1986 changes, brought new proposals to the international area, proposals as lacking in clearly reasoned policy goals as the changes brought about by the 1986 Act. Among the proposals discussed was the addition of yet another category to Subpart F income. The category would cover the income to a controlled foreign corporation from goods manufactured in a foreign country and sold back to the United States. This new category of Subpart F income could also constitute a separate basket income for foreign tax credit limitation purposes. Once again, it appears that the international competitiveness of the United States would be adversely affected without any apparent benefit. Although these provisions were not enacted, the very thought that they were proposed causes concern.

In comparison, nothing was done to coordinate the new passive foreign investment company ("PFIC") provisions[32] added by the 1986 Act with the Subpart F provisions. These rules basically provide that a United States person must pay United States tax and an interest charge based on the value of tax deferral when the shareholder disposes of his or her PFIC stock or receives an excess distribution. The PFIC provisions have forced sophisticated taxpayers to restructure completely appropriate international operations because of tax consequences. Once again, it appears that little comprehensive thought is being given to the international tax area with any regard to reality.

32 26 U.S.C. §§ 1291, 1293-1297 (Supp. 1988) A PFIC is generally a foreign corporation that derives 75% or more of its gross income from passive sources or has at least 50% of the average value of its assets in assets producing passive income.

VI. RECOMMENDATIONS

Where do we go from here? How do we escape from this Alice in Wonderland set of rules? Some practitioners and commentators have given up and have decided that, perhaps realistically, nothing can be done. In that regard, I have followed Schuyler Moore's recent proposals concerning tax reform, in general with some amusement, but also some concern that we may only be left with the creative, albeit outrageous, measures he suggested. Among Mr. Moore's proposals are to impose a tax of $1,000 on each congressman for every tax bill introduced and a requirement that for every new tax section that is added, two existing sections should be repealed.[33] In fact, I only take issue with his recommendation that professors should be prohibited from testifying on tax legislation.

On a more serious note, however, what can be suggested? First, a comprehensive evaluation of the international tax area should be done paying particular regard to the balancing of current policy goals with reality. Perhaps the starting point should be a clear articulation of goals with the knowledge that a "perfect" taxing system is not feasible either as a practical matter or as a desirable one. I would make the recently released Federal Income Tax Project of The American Law Institute, "International Aspects of United States Income Taxation"[34] required reading on the part of all members of the staff of the Ways and Means Committee.

Second, a five-year moratorium on new legislation in the international tax area needs to be imposed to see if existing legislation is working with respect to the articulated goals and, if it is not working, why not? Certainly, administrative impractibility should be a reason why existing legislation is not working. Comments from practitioners and businessmen should be encouraged. If it is working, even though a small amount of abuse is still possible, then let us leave the existing rules in place.

Third, a new emphasis should be placed on using existing safeguards built into the system under, for example, Code Section 482. Similarly, the Internal Revenue Service could apply, in the sourcing area, the existing safeguard of Treas. Reg. § 1.861-7(c) which up to now has been little used.

Fourth, study the effects of existing law on the United States trade deficit, balance of payments, and on the competitiveness of United States

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[33] *See* Moore, *A Proposal to Reduce the Complexity of Tax Regulations*, TAX NOTES 1167 (Dec. 14, 1987); Letter to the Editor from Schuyler Moore, *Creative Suggestions to Simplify the Tax Code*, 38 TAX NOTES 861 (Feb. 22, 1988).

[34] INTERNATIONAL ASPECTS, *supra* note 6.

business in the international area. An independent unbiased party, such as an accounting firm, should be commissioned to do the study.[35] If we follow these rather obvious and sound recommendations the taxpayer will benefit competitively, and the United States government will gain added revenue from an expanded tax base. Furthermore, neither will be subjected to an impossible administrative burden. We may all stand to gain in the long run from such a far sighted approach. If you know where you are going you will probably end up there, or at least close, and not just "in Wonderland."[36]

[35] For a start in the right direction, see ARTHUR YOUNG & COMPANY, *supra* note 2.

[36] On March 15, 1988 House Ways and Means Committee Chairman Dan Rostenkowski, Democrat from Illinois, announced that the staff of the House Ways and Means Committee will begin a "thorough review of selected areas of the tax code with a view toward making them more rational." The "driving force" behind the review, he said, will be sound tax policy rather than revenue raising consideration. In comments the previous day, Assistant Treasury Secretary O. Donaldson Chapoton said the Treasury also is looking at ways to make the Code simpler. *Rostenskowski and Chapoton Speak of Tax Simplification*, 38 TAX NOTES 1288 (March 21, 1988). Perhaps we will have a happy ending after all.