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# The Anti-Competitive Effect of the Internal Revenue Code on United States-Based Multinational Corporations

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## I. Introduction

Events of the past few years serve as pertinent reminders that the world situation is constantly evolving. These events not only are reforming and redrawing political lines, but are expanding the global marketplace. The creation of the European Community ("EC") has forced the United States to scramble to achieve a similar structure in North America. The reunification of Germany and the fall of communism in general have opened up fledgling markets in Eastern Europe which are already being targeted by multinational corporations ("MNCs") as the next "new" business frontier.[1]

The magnitude and rapidity of these events leave no uncertain question that a strong U.S. presence in the global economy is necessary in order for the country to remain an economic power. U.S. tax policy, however, has failed to keep pace with these changes in the world marketplace. Restrictive tax policies are make it increasingly difficult and costly for U.S.-based MNCs to compete effectively against their major competitors. A failure to correct basic deficiencies in U.S. tax polices will cause the U.S. to fall behind other world economic powers in competing for a larger share of a growing market.[2]

This paper is an attempt to show how provisions in the Internal Revenue Code impose on U.S. MNCs costly choices and disadvantages which are not faced by other competitors in the international marketplace. Initially, this paper examines the globalization of the world marketplace. Next, it provides a brief introduction to international tax concepts which are essential to a U.S. MNC's ability to compete. The paper then analyzes certain provisions of the Internal Revenue Code (I.R.C.), discussing their anti-competitive effects and the simple solutions which would eliminate those effects. Finally, it concludes that Congress and the I.R.S. must enact solutions to these problems immediately in order to maintain the international competitive position of U.S. MNCs.

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1. *See, e.g.*, Alan Friedman, *Coke Leaves No Height Unscaled: Reigning Cola King's Global Sales Assault Aims to Conquer Even Mount Everest*, FIN. POST, Jan. 17, 1992, at 39.
2. *See* PRICE WATERHOUSE, U.S. INTERNATIONAL TAX POLICY FOR A GLOBAL ECONOMY 25 (1991).

## II. THE GLOBAL ECONOMY

In recent years, the removal of cross-border investment controls and foreign exchange controls have provided an environment for increased activity by MNCs.[3] The removal of many non-tax barriers to trade and investment has increased global competition and correspondingly has made differences in the way countries tax corporate profits (one of the few remaining barriers to the efficient allocation of capital).[4]

The competitive problem of the U.S. must be viewed in this context. As tax considerations become more of a burden on U.S. MNCs, but not on their competitors, U.S. businesses will be unable to participate in many of these new markets.[5] Accordingly, the economic problems faced by this country will be exacerbated as its corporations are denied effective access to major new sources of income.

The U.S. is no longer the only dominant player in global markets. In 1960, of the top twenty industrial corporations as measured by sales, eighteen were located in the U.S.[6] These twenty corporations also accounted for over eighty-seven percent of worldwide sales.[7] In 1988, the number of such corporations located in the U.S. was halved.[8] Additionally, the overall market share of these twenty corporations had decreased to fifty-four percent.[9] During this same time period, the Pacific Rim and Western Europe emerged as sleeping giants poised to strip the U.S. of much of its international economic influence.

The markets in which these players compete are also undergoing fundamental changes. In 1987, the EC adopted the Single European Act, which committed the EC to creating a single market beginning in 1992.[10] In 1988, Canada and this government signed the U.S.-Canada Free Trade Agreement.[11] Currently, negotiations are underway with Mexico to create eventually a North American Free Trade Zone.[12] With the former Eastern European countries now asking for membership in the EC, it is not too difficult to envision free trade zones existing soon throughout North America and most of Europe.

The prospect of U.S. companies losing their competitive edge as world markets expand becomes even more alarming in light of the U.S. economy's increasing reliance on foreign income. The value of interna-

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3. *Factors Affecting International Competitiveness: Hearings Before the House Comm. on Ways and Means*, 102d Cong., 1st Sess. (1991) (statement of John G. Wilkins, Director of Tax Policy for Coopers & Lybrand).
4. *Id.*
5. *Id.*
6. PRICE WATERHOUSE, *supra* note 2, at 57.
7. *Id.*
8. *Id.*
9. *Id.*
10. *Id.* at 61.
11. *Id.*
12. *Id.*

tional trade as a percentage of corporate net income has doubled, and the foreign affiliates' share of total U.S. corporate earnings has tripled over the last forty years.[13]

It is therefore clear that the globalization of the world economy and the lifting of restrictions to enter these marketplaces will cause U.S. tax policy to have a direct effect on the ability of the U.S. MNCs to compete against foreign competitors who are not burdened by their home government's foreign income tax system.

## III. THE U.S. FOREIGN INCOME TAX SYSTEM

The present tax system evolved from a set of provisions intended to encourage and accommodate international operations by U.S. corporations.[14] Behind these provisions lay the fundamental concepts of relief from double taxation and tax deferral.[15] The effective operation of these concepts is the key factor in a U.S. MNC's ability to compete in foreign markets. Should a provision fail to advance one of these intentions, as is the case with many current provisions, a company's competitive ability will be correspondingly impaired.[16]

Because the U.S. taxes income on a worldwide basis,[17] double taxation of foreign income prevails.[18] Without relief from this burden, investment in a foreign country can become so unprofitable that an MNC may be forced to withdraw its operations abroad solely for tax and not business considerations.[19] Thus, the government provides relief from double taxation through use of the foreign tax credit.[20] This practice allows income taxes paid to another country to serve as a credit against current U.S. taxes.

However, defects with the foreign tax credit system, such as the in-

13. PRICE WATERHOUSE, *supra* note 2, at E-3. Specifically, the foreign income share of worldwide profits as a percentage of GNP has risen from 5.1% in the 1950's to 15.4% in the 1980's. *Id.* at 34.

14. *See* RICHARD L. DOERNBERG, INTERNATIONAL TAXATION 3 (1989).

15. *See* JOSEPH ISENBERGH, 1 INTERNATIONAL TAXATION 18-20 (1990) [hereinafter ISENBERGH I].

16. *See id.*

17. *See* I.R.C. § T 61(a) (providing that "gross income means all income from whatever source derived").

18. Double taxation occurs when two countries simultaneously have and exercise taxing jurisdiction with respect to the income of a taxpayer. *See* DOERNBERG, *supra* note 14, at 6-7. A nation's tax jurisdiction may be based on one of two principles: territorial or personal. As all countries generally will tax income which is earned by a foreigner within their territorial boundaries, the U.S. taxation of worldwide income will necessarily create double taxation. *See id.* at 102.

19. *Factors Affecting International Competitiveness: Hearings Before the House Comm. on Ways and Means*, 102d Cong., 1st Sess. (1991) (statement of Alan J. Lipner, Tax Council on Tax Policy and International Competitiveness) [hereinafter Tax Council].

20. The foreign tax credit, first enacted in 1918, is set forth in I.R.C. §§ 901-908. For an extended discussion of the mechanics of the credit see ISENBERGH I, *supra* note 15, at 472-81.

come sourcing rules, prevent the system from providing relief. For example, when faults with credit computation prevent an MNC from offsetting its U.S. liability with taxes paid to France, the MNC will be double taxed and thus will face a disadvantage with other foreign competitors who are effectively assessed only by the French.

The sourcing rules of the I.R.C.[21] therefore are arguably some of the most important provisions affecting foreign income taxation. These rules identify items of income and expense as derived from either domestic or foreign sources. The distinction between sources of income is crucial, as the U.S. will defer to the taxing jurisdiction of a foreign government and provide relief from double payments only for income recognized as foreign sourced.[22] The sourcing rules directly determine not only whether relief will be available but also the amount of that relief, because the foreign tax credit is limited in proportion to the amount of foreign sourced net income.[23]

The second major policy which enables U.S. MNCs to compete abroad is tax deferral. Deferral refers to the general rule that income earned through a foreign subsidiary will not be subject to U.S. taxation until that income is repatriated here in the form of dividends, royalties, or interest.[24] Deferral therefore results in the postponement of U.S. taxes.

Deferral of income is extremely important to most MNCs, since it is one of the primary mechanisms which put U.S. corporations on an equal footing with competitors from other nations who do not tax foreign earnings at all or who maintain strict deferral regimes.[25] Deferral enables a U.S. corporation to compete by providing the opportunity to reinvest 100% of a subsidiary's earnings in current and/or expansion operations. For many MNCs which cannot make continuous capital contributions to a subsidiary, the ability to utilize untaxed unrepatriated earnings is the only economical way operations can be conducted in foreign markets.[26]

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21. The sourcing rules are set forth in I.R.C. §§ 861-865. *See generally* DOERNBERG, *supra* note 14, at 29-55.

22. *See* ISENBERGH I, *supra* note 15, at 18.

23. An overly simplified foreign tax credit limitation would be computed as follows: Foreign taxes paid times (foreign sourced income/world wide income). I.R.C. § T 904(a). Thus, as the numerator is adjusted upward for an allocation of income, a greater credit against taxes will be allowed. Conversely, allocations of expenses decrease the numerator and the limitation amount.

24. *See* ISENBERGH I, *supra* note 15, at 20.

25. *See* ROBERT A. RAGLAND, TAXATION OF FOREIGN SOURCE INCOME 19-20 (1990); *Factors Affecting International Competitiveness: Hearings Before the House Comm. on Ways and Means*, 102d Cong., 1st Sess. (1991) (statement of Allen C. Holmes, American Petroleum Institute) [hereinafter API Statement].

26. Letter from Louis J. Williams, Vice President EG&G, to Kenneth H. Gideon, Assistant Secretary Department of the Treasury (Feb. 27, 1990), available on LEXIS, Tax Notes Int'l, File No. 90 TNI 21-39; *see also Factors Affecting International Competitiveness: Hearings Before the House Comm. on Ways and Means*, 102d Cong., 1st Sess. (1991) (statement of Philip J. Loree, Chairman of the Federation of American Controlled Shipping) [hereinafter FACS Statement].

Because many corporations have used deferral for tax avoidance purposes, and because its advantages may serve as an incentive to shift investment abroad from the U.S., Congress began in 1962 to enact a variety of rules which subjected non-repatriated subsidiary earnings to current U.S. taxation, thereby accelerating the recognition of income to shareholders in foreign corporations and eliminating the benefits of deferral.[27] In general, these rules were needed in order to prevent the loss of governmental revenue caused by corporations operating in tax havens.[28] However, a variety of defects in these provisions have caused a loss of deferral for legitimate foreign operations.

As the availability of deferral is eroded and foreign operations are currently taxed, a U.S. MNC will be at a competitive disadvantage with a similarly situated competitor from another country who benefits from the current use of 100% of its earnings abroad.[29]

## IV. THE ANTI-COMPETITIVE EFFECT OF THE INTERNAL REVENUE CODE ON U.S.-BASED MNCs

The I.R.C. presently contains many provisions which fail either in part or whole to advance the policies of double taxation relief and deferral.[30] As a result of these deficiencies, U.S. MNCs are forced to shoulder a greater tax burden than their rivals, a burden which in turn impairs their competitive ability. The following representative provisions illustrate how simple defects in the code can lead to the erosion of a competitive position in the global marketplace.

### A. *The Allocation of Interest Expense and the Denial of Double Taxation Relief*

As mentioned above, the sourcing rules require the allocation of expenses to income characterized as foreign sourced. When expenses are increasingly allocated to this income, the foreign tax credit limitation, and thus the amount of relief from double taxation, correspondingly decreases.[31] So long as the costs so identified are actually recognized by a foreign country in their determination of a U.S. MNC subsidiary's taxable income, double taxation relief is not affected.

27. *See generally* JOSEPH ISENBERGH, 2 INTERNATIONAL TAXATION 15, 19-21 (1990) [hereinafter ISENBERGH II].

28. *See id.* at 2.

29. FACS Statement, *supra* note 26. If a U.S. MNC is currently taxed on unrepatriated earnings, it will be at a disadvantage as it must compete with only sixty-six percent of its subsidiary's earnings (100% minus 34% U.S. corporate tax rate) against competitors that have available 100% of their subsidiary's earnings for operations and expansion. *Id.*

30. Examples of such provisions include I.R.C. § A4 6411(a) foreign tax credit carryover rules; I.R.C. § A4 904(e) alternative minimum tax foreign tax credit; I.R.C. § T 263A uniform capitalization rules applicable to foreign persons; I.R.C. § T 904(d)(3)(e) foreign corporation look through rules; I.R.C. § T 861 expense allocation rules; I.R.C. § T 989 exchange rates for foreign taxes.

31. *Supra* note 23.

The IRC, however, provides for the significant allocation of many costs to foreign income in such arbitrary ways that an MNC is denied a tax benefit for the expenditures allocated. Of these items, interest provides an appropriate example, as it is one of the largest expenses incurred by virtually all corporations.[32]

Prior to the Tax Reform Act of 1986 (TRA '86), allocation of interest did not cause problems for U.S. MNCs, since the optional gross income method allowed a corporation to determine interest expense on a company-by-company basis.[33] If a subsidiary had interest cost but no foreign assets, one hundred percent of the interest was allocated to U.S. income and the foreign tax credit limitation was not adversely affected.

However, TRA '86 changed the regulations and required that where there is a group of companies eligible to file a consolidated U.S. tax return, interest expense should be spread among the assets of the affiliated group[34] and not on a separate company-by-company basis as previously provided.[35] The effect of this change was to make allocation of such costs to foreign-source income unavoidable.

Thus, under the current fungibility method,[36] a required dispersal of interest expense likely will result in an allocation of expenditures not recognized by a foreign country in their own determination of a U.S. MNC's tax liability. Those corporations therefore will effectively be denied a deduction for such expense in both countries.[37]

To illustrate the problem, consider the following example:[38] A group

32. Tax Division of the American Institute of Certified Public Accountants, Comments on Proposed Regulations Under Section 861 and 864 Regarding the Allocation of Interest Expense 3 (1991)[hereinafter AICPA].

33. *See* Prior Treas. Reg. T 1.861-8(e)(2)(vi).

34. I.R.C. § T 864(e)(5)(A). An affiliated group of companies is a chain of companies connected to a common parent by stock ownership of at least eighty percent. I.R.C. § A4 1504(a). The effect of treating a group of companies as affiliated is to treat the group as if it were one corporation. Temp. Treas. Reg. T 1.861-9T(a).

35. *See* I.R.C. § T 864(e). U.S. taxpayers must now allocate interest expense to foreign and domestic sourced income based on the relative gross value of consolidated foreign and domestic assets. Temp. Treas. Reg. T 1.861-9T(g) The principle of fungibility governs this required method of allocation. Treas. Reg. T 1.861-8T(a) The principle reflects the view that money is fungible and that there is flexibility in both obtaining and utilizing those funds. *Id.* It suggests that when money is borrowed for a specific purpose, those borrowings free up funds for use elsewhere. Thus, it is reasoned that borrowings even for a specific purpose should be allocated among all of the assets of the borrower. *See* ISENBERGH I, *supra* note 15, at 205-206 (1990).

36. *Supra* note 35.

37. The effective non-deductibility of expenses is caused by a reduction in the allowable foreign tax credit limitation. The decrease in the foreign tax credit results in the inability of a corporation to claim a credit for all foreign taxes incurred. This causes U.S. tax liability to increase in the same way as if deductibility was denied for the interest expense allocated. PRICE WATERHOUSE, *supra* note 2, at 79.

38. Example modified from *Factors Affecting International Competitiveness: Hearings Before the House Comm. on Ways and Means*, 102d Cong., 1st Sess. (1991) (statement of Jere D. McGaffey, Chair ABA Section of Taxation) [hereinafter ABA Statement].

of U.S. investors decide to manufacture bicycles both here and in a foreign country. The U.S. parent is incorporated, with assets of $10 million and the subsidiary with assets of $5 million. The two corporations separately borrow $500,000 at ten percent, secured by their respective assets. Yet the interest expense is now allocated pro-rata based on relative gross assets. Of the $50,000 interest incurred in the U.S., $16,667 is assigned to foreign source income. Yet none of the corresponding expenses of the foreign subsidiary is assigned to U.S. source income because the fungibility of interest does not extend to interest incurred by foreign subsidiaries.[39] Of the $100,000 of interest expense incurred equally here and abroad, $66,667 is allocated to foreign source income while only $33,333 is allocated to U.S. income.

The foregoing system results in an understatement of foreign income and an overstatement of U.S. income which, once placed into the foreign tax credit limitation calculation, creates an effective denial in this example of $16,667 of interest expense. This regulation constitutes a competitive disadvantage because an MNC is denied a tax benefit normally accorded to any other entity incurring such an expense.[40] The magnitude of the disadvantage caused by present law becomes clear when it is understood that a U.S. MNC effectively loses a deduction for all interest allocated to foreign source income. This requirement translates into a situation in which a U.S. MNC cannot avoid paying additional current taxes in an amount equal to thirty-four percent[41] times any interest expenses so assigned. The additional tax has been estimated to increase the effective rate of U.S. taxation on its MNCs by six to eleven percentage points.[42]

It is important to note that such an allocation will be required even when the fungibility principle has been complied with. The premise of fungibility insists that interest expense should be allocated among those assets which may conceivably support the borrowing. However, where a subsidiary of a U.S. MNC finances its activities by securing its own assets, without any guarantees or assistance from other members of the affiliated group, affiliation of the associated interest expense to other members of the group is still required.[43] Requiring allocation under these circumstances stands in direct conflict with this basic principle.

A U.S. MNC thus faces a disadvantage with each of its competitors. A purely domestic rival will be able to deduct the entire $50,000 of inter-

39. Temp. Treas. Reg. T 1.861-9T(a) sets forth the fungibility principle as it applies to U.S. corporations. *See* Temp. Treas. Reg. T 1.861-9T(a). Foreign corporations' recognition of interest expense is covered by Reg. T 1.882-5 where the fungibility principle is not recognized. See Treas. Reg. T 1.882-5; Temp. Treas. Reg. T 1.861-9T(a). The non-fungibility of interest incurred by a U.S. owned foreign subsidiary has been severely criticized. *E.g.*, AICPA *supra* note 32, at 1.

40. I.R.C. § T 163(a).

41. Currently the highest corporate tax rate. I.R.C. § T 11.

42. PRICE WATERHOUSE, *supra* note 2, at 79 (increase based on case study examples).

43. *See* Temp. Treas. Reg. 1.861-11T(c).

est and therefore will pay less tax.[44] Similarly, the U.S. subsidiary of a foreign-based MNC can deduct the $50,000 of interest related to its activities here.[45] This is true even though that corporation may have both foreign and U.S. assets, since the fungibility principle does not extend to subsidiaries of foreign MNCs.[46] Because a U.S. MNC cannot deduct 100% of its interest, the allocation rules ironically make the after-tax cost of facilities built in the U.S. with borrowed funds more expensive for a U.S. MNC than for a foreign one.[47]

Further, MNCs based in all six of the other major industrialized nations[48] can benefit fully from interest expense generated by borrowings on the part of their home-country parent or its subsidiaries.[49] As a result, U.S. MNCs must pay additional taxes which are not incurred by their foreign competitors. These excess costs impair a U.S. company's ability to compete on equal footing internationally.

The provisions diminish the U.S. corporation's ability to compete at home as well as in foreign markets. This effect arises not only from the increased direct tax costs previously identified, but also from the adverse effect such additional taxes have on management decision making. In projecting a rate of return, a U.S. MNC wishing to expand U.S. facilities by incurring debt faces a rate of return approximately one to three percent lower[50] than a domestic or foreign competitor. A U.S. MNC is therefore left with a choice, not imposed on its rivals, of commencing a project which will yield an uncompetitive rate of return, or funding the project with equity funds at the expense of its owner's financial objectives[51] and its marketing position.[52]

The basic solution to the problems caused by IRC § 864 is to apply the principle of fungibility uniformly to both U.S. MNCs and their for-

44. I.R.C. § T 163(a).

45. *Id.*

46. Temp. Treas. Reg. T 1.861-9T(a) (regulation applicable only to U.S. based groups).

47. This is a major competitive disadvantage which is viewed with disdain by most commentators. *See, e.g.*, AMERICAN BAR ASSOCIATION SECTION OF TAXATION, COMMENTS ON THE IMPAIRMENT OF THE ABILITY OF U.S.-BASED MULTINATIONAL COMPANIES TO COMPETE IN THE UNITED STATES RESULTING FROM THE INTEREST-EXPENSE ALLOCATION PROVISIONS 7 (1991) [hereinafter INTEREST COMMENTS].

48. The United Kingdom, France, Germany, the Netherlands, Japan, and Canada.

49. PRICE WATERHOUSE, *supra* note 2, at 79-80.

50. *See* INTEREST COMMENTS, *supra* note 47, at 3-6 (lower rate of return is a result of lower projected net earnings due to higher tax costs).

51. Most corporate shareholders prefer debt over equity financing. Among other reasons, owners will have less investment at risk and the subsequent leveraging increases the rate of return on the existing equity investment. *See* ROBERT W. HAMILTON, CORPORATIONS 322-4 (4th ed., 1990).

52. U.S. MNCs are at a disadvantage when they are not free to do exactly as their competitors do. Therefore, when a domestic or foreign owned competitor finances activities with debt, a U.S. MNC facing a loss of deductions associated with that debt is not similarly situated. INTEREST COMMENTS, *supra* note 47, at 6-7.

eign-based competitors.[53]

In a situation where the borrowings of the parent or a U.S. subsidiary are secured by their own assets, without any guarantees by other group members, the interest expense deriving from that debt should be allocated in full to U.S. source income of the borrower and excluded from the allocation process.[54] This adjustment would be in complete compliance with the fungibility principle, with interest assigned to the assets which ultimately support the borrowing. Such a change would result in full deductibility of the interest expense and allow an MNC to compete on equal ground with a purely domestic corporation because all parties will be given the same U.S. tax treatment.

The fungibility principle must also be extended to the borrowings of foreign subsidiaries of U.S. MNCs. When any such subsidiary's loans are not secured by its own assets and assistance has been provided by a U.S. parent or subsidiary, there is no reason for treating the interest expense as non-fungible and unallocable to U.S. source income.[55] Indeed, if the principle of fungibility is to be correctly observed, the interest expense must be dispersed among all assets of the group which support the borrowing. This change will decrease the incidence of double taxation since the assignment of interest expense to U.S. income will correspondingly increase the foreign tax credit limitation and decrease the possibility of an effective denial of interest expense deductions. With such a correction, a U.S. MNC will realize a tax benefit for a majority of its interest expense, pay lower taxes, and thereby stand in a better competitive position. Fungibility of interest must also be extended to U.S. subsidiaries of foreign-based MNCs.[56] As previously discussed, these MNCs are treated in a completely different manner than their U.S. counterparts. In order to correct that disparate treatment and bring taxation of both U.S. and foreign entities into line with the treatment of U.S. MNCs, interest expense associated with borrowings not secured solely by a subsidiary's U.S. assets should be allocated away from U.S. income and a deduction denied for that amount of interest unconnected with U.S. assets. Such a correction is needed because the I.R.C. directly confers a competitive advantage on foreign-based MNCs at the expense of domestic competitors.

### B. *Deferral of Income*

The anti-deferral regimes of the I.R.C. also suffer from defects which erode a U.S. MNCs ability to compete. The disadvantages imposed, however, are more severe than the denial of deductions and double tax relief. In most cases, the loss of deferral will have far-reaching effects on an

53. This position is advanced by virtually all commentators. *E.g.*, INTEREST COMMENTS, *supra* note 47, at 6-7; Tax Council, *supra* note 19.

54. *See* INTEREST COMMENTS, *supra* note 47, at 6.

55. Tax Council, *supra* note 19; PRICE WATERHOUSE, *supra* note 2, at 117.

56. INTEREST COMMENTS, *supra* note 47, at 7; Tax Council, *supra* note 19.

MNC, including not only the imposition of current taxes on income which is not yet in hand, but also the placement of burdens on such fundamental decisions as how and where to conduct foreign business.

Most tax authorities agree that the premise behind the enactment of the various anti-deferral regimes is legitimate.[57] The regulations were intended to impose current taxes on U.S. taxpayers who conduct business abroad primarily to escape U.S. taxation.[58] The provisions denying deferral therefore should extend their penalizing reach only to those corporations which are engaged in tax avoidance practices.[59]

In practice, however, legitimate overseas businesses are subjected to a loss of deferral because of outdated and conflicting provisions. Of all the anti-deferral regimes,[60] the Subpart F rules[61] for Controlled Foreign Corporations (CFCs) and the Passive Foreign Investment Company ("PFIC") rules[62] are most important, because their current defects pose the greatest problems for the competitive position of U.S. MNCs.

1. Subpart F and the European Community

Beginning in 1992, the European Community (EC) will begin to implement a plan designed to create a single market wielding $4 trillion of economic power and a population base of 323 million people from twelve countries.[63] Because of the removal of physical, tax and trade barriers, it is widely anticipated that EC-based companies will reorganize their current corporate structures within the new market in order to produce more efficient operations which are no longer constrained by geographic considerations.[64]

The EC Commission believes that the centralization of operations by European companies will produce savings of between $99-122 billion, primarily from more efficient procedures.[65] This reduction in operating costs will increase competition in the EC by enabling producers to lower prices. Those businesses that are unable to reduce their prices as a result of inefficient corporate structures will therefore be at a serious competitive

57. *See, e.g.*, ISENBERGH I, *supra* note 15, at 20.

58. *See generally* ISENBERGH II, *supra* note 27, at 16, and 19-22.

59. *See* ISENBERGH I, *supra* note 15, at 19-20.

60. There are five regimes in total: Foreign Personal Holding Companies; Subpart F; Passive Foreign Investment Companies; Foreign Investment Companies; and Foreign Sales Companies. *See generally* ISENBERGH II, *supra* note 27, at 1, 21, 124, 130, and 231.

61. The Subpart F rules are set forth in I.R.C. §§ 952-964.

62. The PFIC provisions are set forth in I.R.C. §§ 1291-1297.

63. CLIFFORD CHANCE, THE CCH GUIDE TO 1993 CHANGES IN EEC LAW 1 (1989).

64. *See id.* at 78; and THE INTERNATIONAL COMPETITIVENESS IMPACT OF THE U.S. TAX LAW ON U.S.-BASED MULTINATIONAL COMPANIES WITH RESPECT TO THE EUROPEAN COMMUNITY 1992 PROPOSALS 1 (1991) [hereinafter EC Comments]. Regarding the removal of barriers, *see generally* CHANCE, *supra* note 63, at 2-11.

65. *Id.* at 16. The reduction of costs is one of the three principal reasons for achieving a single market. *Id.* at 13.

disadvantage.[66]

The stake of U.S. MNCs in the European market is high. Sales of durable goods alone to EC countries in 1988 amounted to nearly $40 billion.[67] Until now there were not significant differences in the operating structures of U.S.-based and EC-based competitors; member nations' regulations generally required a different company to sell goods in each of the twelve different countries.[68] The EC proposals, however, have fundamentally changed this picture so that in the future both U.S. and EC competitors may obtain the benefits of efficiency by centralizing their operations.

Significant opportunities therefore exist for U.S. MNCs in Europe, provided that they are not inhibited or prevented from achieving the same efficiencies as their EC counterparts. Unfortunately, U.S. tax law creates severe impediments to the realization of such efficiencies. The Subpart F provisions in particular force an American MNC to choose between consolidating European operations at the risk of losing tax deferral and suffering current taxation on a subsidiary's income, or else maintaining separate subsidiaries in each EC member country in order to avoid Subpart F taxes while suffering the competitive disadvantages caused by this kind of inefficiency.[69]

The Subpart F rules require U.S. shareholders of a CFC[70] to include in current gross income their pro-rata share of Subpart F income.[71] The largest category of Subpart F income, Foreign Base Company Income,[72] is divided further into subcategories of which Foreign Base Company Sales Income (FBCSI) is the most prevalent and important.[73] FBCSI income has three characteristics: (1) a product was bought by a CFC from a related party; (2) the product was manufactured or produced in a country other than the CFC's nation of incorporation; and (3) the product was resold by the CFC for use or consumption outside the CFC's place of incorporation.[74] In other words, when a CFC purchases goods from a U.S. parent or subsidiary and subsequently resells these goods to consumers in

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66. *See* John J. Salmon & Fred R. Gander, *Refining Subpart F to Make U.S. Firms More Competitive After 1992*, TAX NOTES INT'L, Jan. 1, 1990, at 99; CHANCE, *supra* note 63, at 15, 78.

67. Salmon & Gander, *supra* note 66, at 99 (*citing* INTERNATIONAL DIVISION U.S. CHAMBER OF COMMERCE, EUROPE 1992: A PRACTICAL GUIDE FOR AMERICAN BUSINESS 36-7 (1989)).

68. *See id.* at 98.

69. *See* EC Comments, *supra* note 64, at 3; Salmon & Gander, *supra* note 66, at 98.

70. A foreign corporation is a CFC if U.S. shareholders own more than fifty percent of the total combined voting power of its stock or more than half of the stock's total value. I.R.C. § 957(a). A U.S. shareholder is a U.S. "person" who owns ten percent or more of the total combined voting power of all classes of stock of such foreign corporation. I.R.C. § 951(b). A wholly owned foreign subsidiary of a U.S. MNC is a typical example of a CFC.

71. I.R.C. § 951(a).

72. Ernest Larkins, *Commerce Through a Foreign Subsidiary*, 9 INT'L TAX & BUSINESS LAW. 69 (1991).

73. ISENBERGH II, *supra* note 27, at 78; DOERNBERG, *supra* note 14, at 175.

74. I.R.C. § 951(a).

other countries, Subpart F FBCSI income will arise.

Consider our bicycle manufacturer again. Assume that in order to increase brand-name recognition and acceptance in Europe, the parent establishes a sales subsidiary in Germany. Further, not all earnings are repatriated but instead are reinvested in the CFC in order to expand operations. Income from sales within Germany would not come under Subpart F regulation as that money does not fall within the definition of FBCSI.[75] Sales from Germany to France, however, would qualify as Subpart F income and potentially be subject to current taxation. Significantly, if all the EC member nations were considered as one country for purposes of Subpart F, there would be no tax problem.

Because of the potentially harsh consequences of Subpart F taxation,[76] Congress has always provided an exception to non-CFC country sales. Prior to TRA '86, this exception was subjective and was based on a facts-and-circumstances test.[77] If a U.S. MNC could establish that the rerouting of sales was not for purposes of tax avoidance, then any income received by the CFC from consumers in non-CFC countries would remain untaxed until repatriated.

TRA '86 changed this policy to an objective test. Known as the "high tax" exception, income from non-CFC country sales now will not be taxed as FBCSI only so long as that income has been subjected to an effective rate of foreign tax greater than ninety percent of the maximum U.S. corporate rate.[78] Since all EC member nations have statutory tax rates greater than or equal to the domestic rate,[79] one would expect that a U.S. MNC could centralize its operations in one EC country and sell goods to the other eleven members without fear of Subpart F taxation. The reality of the situation, however, is the opposite because of uncertainties regarding the application of the high tax exception.

Consider the following example.[80] Our bicycle sales subsidiary earns French net income of one million dollars each year for three years and

75. *See id.* and accompanying text. The exclusion of income generated by CFC country sales results from the "foreign country" exception. *See infra* note 87 and accompanying text.

76. When Subpart F is triggered, a taxpayer loses the benefit of deferral because taxes are imposed currently on income which has not been repatriated. A U.S. MNC therefore will have to compete against a foreign competitor with only 66% of its subsidiary's earnings rather than 100%. *See supra* note 29 and accompanying text.

77. Under prior I.R.C. § 954 (b), income would not be classified as FBCSI if a taxpayer could establish that neither (1) the creation of the foreign corporation nor (2) the transaction giving rise to the income had tax avoidance as one of its significant purposes. Prior I.R.C. § 954(b).

78. I.R.C. § 954(b).

79. Belgium 39%; Denmark 40%; France 34%; Germany 50%; Greece 46%; Ireland 40%; Italy 36%; Luxembourg 33%; the Netherlands 35%; Portugal 36%; Spain 35%; the United Kingdom 35%. ERNST & YOUNG INTERNATIONAL, WORLDWIDE CORPORATE TAX GUIDE (1991).

80. Example modification based on EC Comments, *supra* note 64, at 4.

pays French taxes at the thirty-four percent statutory rate. Because the rate abroad is greater than ninety percent of the rate here, income from French sales is not currently taxed by the U.S.

Assume that in year four there is a three million dollar loss, which when carried back results in a refund of the taxes paid to France in years one through three. As the income in those years is now "effectively" untaxed and the Subpart F rules require immediate taxation of that income, the U.S. parent now will have to pay over one million dollars[81] in current taxes even though the French loss and the carryback have no current effect on U.S. taxes.[82] In this scenario, the Subpart F problem is caused not because of non-CFC country sales, but because the high tax exception failed to exempt unrepatriated earnings which had already been assessed at a high rate.

The effective tax rate problem illustrated by this example may be caused not only by loss carrybacks but also by any imaginable combination of differences between the timing of income or deduction recognition for foreign and U.S. purposes.[83] Because of the uncertainties inherent in the high tax exception, most U.S. MNCs cannot project with any accuracy whether income will satisfy the exception and thus be exempt from Subpart F taxation. Consequently, to avoid the harsh effects of Subpart F, a corporation must maintain independent subsidiaries in each of the EC countries where it desires to market its products.[84]

Ironically, Subpart F was never intended to yield such results. In 1962, Congress was primarily concerned with the increasing use of foreign subsidiaries in low tax or no tax ("tax haven") countries.[85] Subpart F was designed to be a penalty which would discourage the transfer of income to a subsidiary principally for purposes of avoiding higher U.S. assessments. As all EC member countries are full tax jurisdictions, rather than tax havens, it is contrary to Congressional intent for Subpart F to apply to the European operations of a U.S. MNC.

At the time of enactment, Congress was also aware that Subpart F

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81. $3 million at the 34% U.S. statutory tax rate = $1.02 million.

82. The foreign loss would have no effect on U.S. taxes since it would not be entered into the foreign tax credit limitation computation; therefore there would be no upward adjustment of the credit amount. I.R.C. § 905, however, requires a readjustment of the current year credit in order to impose current U.S. tax on the refund amount. *See* I.R.C. § 905(c); EC Comments, *supra* note 64, at 4.

83. EC Comments, *supra* note 64, at 5. An example of such a "timing difference" would be depreciation. If a foreign country provides for accelerated depreciation which exceeds the conservative Subpart F depreciation schedules, the U.S. may impose a current tax on the difference. *See* Treas. Reg. T 1.964-1(c)(1)(iii)(b).

84. As the high tax exception does not guarantee the exemption of income, a taxpayer who desires to sell products in various EC countries is left only with the "foreign country" exception to ensure that income will not qualify as Subpart F income. Salmon & Gander, *supra* note 66, at 98.

85. S. REP. No. 1881, 87th Cong., 2d Sess. 78-9 (1962); H.R. REP. No. 1447, 87th Cong., 2d Sess. 57-8 (1962). *See generally* ISENBERGH II, *supra* note 27, at 20-21.

might impair the competitive position of companies engaged in legitimate income-producing activities.[86] Thus, the "foreign country" exception was created, providing that FBCSI would not include CFC country sales.[87] It was apparently Congress' belief that a "subsidiary's 'natural business locus' was the subsidiary's country of incorporation, and that transactions occurring outside that country were likely motivated by U.S. tax avoidance purposes."[88]

In the context of the EC, this assumption does not hold true because a subsidiary's transactions with consumers in other EC countries will involve transactions with other full-tax jurisdictions. Furthermore, because the EC will constitute one single market, it would seem obvious that the "natural business locus" of companies that operate in Europe will expand to include the entire EC.[89] Therefore, to be consistent with Congressional intent regarding the "foreign country" exception, a CFC's "country of incorporation" should be considered the entire EC. It is widely believed, however, that the I.R.C. will not adopt such a position.[90] Thus, a U.S. MNC is effectively relegated to use of only the high tax exception.

The present definition of FBCSI presents a difficult and costly choice for a U.S. MNC: reorganize European operations and lose tax deferral on EC source income, or preserve Subpart F deferral and maintain an inefficient European corporate structure. Unfortunately for American MNCs, this is not a choice which their major competitors must face when determining how to reorganize European operations in response to the existence of a single market.[91]

If the choice is made to maintain separate subsidiaries in each EC member country, U.S. MNCs will be operating at a severe disadvantage in comparison to EC-based and Japanese-based MNCs. Precluded from cap-

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86. S. REP. No. 1881, 87th Cong., 2d Sess. 78-9 (1962); *see also* EC Comments, *supra* note 64, at 2-3.

87. This exception is embodied in the definition of FBCSI. *See supra* note 74 and accompanying text.

88. AMERICAN LAW INSTITUTE, FEDERAL INCOME TAX PROJECT: INTERNATIONAL ASPECTS OF U.S. INCOME TAXATION 291 (1987).

89. Salmon & Gander, *supra* note 66, at 101; EC Comments, *supra* note 64, at 3.

90. For an extended discussion of the law regarding the definition of "foreign country," which determines whether the Internal Revenue Service would have a reasonable basis for this conclusion, see EC Comments, *supra* note 64, at 5-7.

91. Japan has an anti-deferral system, yet the denial of deferral extends only to a list of countries officially recognized as tax havens. No EC countries are listed by Japan. PRICE WATERHOUSE, *supra* note 2, at 21; EC Comments, *supra* note 64, at 5. Canada, France, Germany, and the United Kingdom also maintain anti-deferral systems; however, unlike the U.S. system, these countries do not eliminate deferral for active business income. PRICE WATERHOUSE, *supra* note 2, at 21. Other EC countries either exempt foreign earned income from their taxing jurisdiction altogether by unilateral action (e.g., the Netherlands) or by treaty. EC Comments, *supra* note 64, at 5. As their major competitors are not exposed to current taxation on the earnings from foreign subsidiaries, U.S. MNCs will be at a competitive disadvantage whenever the I.R.C. requires current recognition of unrepatriated income. *Supra* note 29 and accompanying text.

italizing on the efficiency related savings the single market will offer, American entities will be unable to cut prices and therefore will be unable to compete effectively, if at all.[92]

The simplest solution to this problem is to amend the definition of FBCSI to include the EC as a single country.[93] That amendment would give U.S. MNCs the same options as in the European corporate reorganizations enjoyed by their European and Japanese rivals. Further, this simple change would leave the high threshold in place to discourage the use of tax havens for avoidance of U.S. taxes.

Such a change would bring the Subpart F rules back into line with original Congressional intent. Congress intended for the rules to discourage the location of subsidiaries in tax havens, yet was careful to include the foreign country exception in order to prevent impairing the effectiveness of a subsidiary in its "natural business locus." When enacted, the "natural business locus," or competitive environment of a subsidiary, was thought to be only a "foreign country."[94] New realities, however, such as creation of a single European market, suggest that redefining a "foreign country" to include the EC would better achieve Congress' aim to protect competitive ability of U.S. MNCs.

2. The All-Inclusive Passive Foreign Investment Company

The PFIC provisions were enacted to close a loophole in the Subpart F rules which had allowed U.S. shareholders of foreign investment corporations to benefit from deferral of taxes on passive income which built up in those businesses.[95]

The provisions were aimed exclusively at companies such as offshore mutual funds whose predominate characteristic was the production of passive income.[96] As enacted, however, the PFIC provisions are so broad that they may ensnare any corporation, from the originally targeted passive income groups to active manufacturing or marketing subsidiaries who inadvertently happen to fail the PFIC test.[97]

Unlike Subpart F, which applies only when certain ownership levels are met, the PFIC rules apply irrespective of the degree of ownership or control by U.S. shareholders. The IRC provides that any foreign corporation is a PFIC if, for any taxable year, either seventy-five percent or more of its gross income is passive, or fifty percent or more of its assets would

92. *See* Salmon & Gander, *supra* note 66, at 100.

93. Such a change has nearly universal support from tax authorities to industry executives. *E.g.* Salmon & Gander, *supra* note 66, at 100; EC Comments, *supra* note 64, at 8; API Statement, *supra* note 25.

94. EC Comments, *supra* note 64, at 8.

95. Tax Council, *supra* note 19. Passive income generally includes interest, rents, and royalties. See I.R.C. §§ 1296(b)(1), 954(c).

96. I.R.C. §§ 1296(b)(1), 954(c); PRICE WATERHOUSE, *supra* note 2, at 161.

97. *See* Tax Council, *supra* note 19; Larkins, *supra* note 72, at 86-7.

produce passive income.[98]

Once the PFIC test is satisfied, a U.S. investor is faced with a costly choice: the shareholder may elect immediate taxation of his share of all of the corporation's income (both passive and ordinary), or, when the shareholder receives an extraordinarily large dividend or sells his interest at a gain, he will have to pay regular tax and an interest penalty for the "privilege" of not being taxed on his share of the income as it was earned.[99] These options are respectively known as the current inclusion and interest charge regimes.

As suggested, any company potentially may qualify as a PFIC, irrespective of the fact that it is primarily engaged in active rather than passive business operations. Under the applicable test, gross income, not gross revenue, is the determinative amount, a figure arrived at by subtracting cost of sales. Obviously, even the most active of subsidiaries may produce no gross income, though substantial gross revenue is generated by active operations. Consider the following:[100] Our bicycle sales subsidiary generates sales revenue of $10 million but has an equal amount of cost of sales. The subsidiary also earns $100 of interest on funds held in its corporate account. Even though passive income is only 0.001% of overall gross revenue, one hundred percent of its income in that year is passive so that our predominantly active subsidiary is a "passive" company for tax purposes.

The relevant test is too easily met, for gross revenue and cost of sales may be equivalent in any given year as a result of a reduction in prices to clear out slow-moving inventory, to attract a greater market share, or to respond to a temporarily unfavorable foreign exchange rate.[101]

An active subsidiary may violate the asset test with similar ease. Two Internal Revenue Service Notices have announced that, for purposes of computing the amount of passive assets, cash and other assets easily convertible into cash, such as inventory, will be considered passive assets even though such holdings are an integral part of active operations.[102]

Assume our subsidiary has a balance sheet as follows: cash ($5 million); trade receivables ($30 million); inventory ($55 million); and property and equipment ($30 million). Based on current IRS positions, our subsidiary will qualify as a PFIC because fifty percent of its assets are passive. Our subsidiary is a PFIC even though all of the assets are used in

98. I.R.C. § 1296(a); *see generally* ISENBERGH II, *supra* note 27, at 129-152.

99. *See* I.R.C. §§ 1295(a), and 1291(c); John S. Karls, *PFIC/PFC Planning for Active Foreign Subsidiaries*, 2 J. INT'L TAXATION 205 (1991).

100. Example adapted from Karls, *supra* note 99, at 206.

101. *Id.*; AMERICAN BAR ASSOCIATION SECTION OF TAXATION, COMMENTS ON THE COMPETITIVE IMPLICATIONS FOR U.S.-BASED MULTINATIONAL COMPANIES OF THE WRITTEN PROPOSALS ON TAX SIMPLIFICATION IN THE HOUSE WAYS AND MEANS STAFF REPORT RELEASED JUNE 18, 1990 6 (1991) [hereinafter PFIC Comments].

102. *See* I.R.S. Notices 88-22, 1988-1 C.B. 489; 89-81, 1989-2 C.B. 399. *See also* Karls, *supra* note 99, at 206.

its active sales operations and none of the assets generate passive income.

As indicated previously, if either test is satisfied, a shareholder has a choice of electing taxation under either a current inclusion or an interest charge regime. Under a current inclusion regime, a shareholder will be taxed currently on his share of all the earnings of the subsidiary, both ordinary and passive.[103] A shareholder who elects current inclusion treatment therefore subjects himself to a particularly harsh system of taxation which results in complete elimination of deferral for all income from a foreign subsidiary.[104] With an MNC which requires all of the subsidiary's earnings to be reinvested in order to maintain or expand operations, this option can be crippling.[105]

The alternative is no less harsh: Under the interest charge regime, a shareholder must pay interest as well as taxes on the deferred tax liability from the date of qualification as a PFIC or the shareholder's purchase date (whichever is earlier) to the date of a distribution or gain.[106] To illustrate the impact of this penalty, assume the following:[107] The parent of our bicycle subsidiary receives a $60 million distribution in 1992 from the sales subsidiary which represents all of the subsidiary's earnings from 1987 through 1992. If the company qualified as a PFIC in 1988, the $60 million would be allocated equally over the years 1988 through 1992, with interest assessed on the deferral years 1988 through 1991. Assuming an interest rate of twelve percent, the interest liability alone would be $6.1 million.[108]

Basically, the interest charge regime is designed to impose the maximum amount of interest and taxes on the electing shareholder.[109] Because the penalty imposed by this option is so severe, it might not be an option at all and might prevent a U.S. MNC from investing in a foreign subsidi-

103. I.R.C. § 193(a)(1)

104. *See* Larkins, *supra* note 72, at 90; ISENBERGH II, *supra* note 27, at 145.

105. *Supra* note 29 and accompanying text.

106. I.R.C. § 1291 (a)(1), (c)(2)-(3).

107. Example modified from PFIC Comments, *supra* note 101, at 4-5.

108. *Id.*

109. Several requirements should be noted regarding the calculation of the interest penalty. First, the amount of the distribution is allocated equally to each deferral year, while interest and taxes are assessed for each year irrespective of whether there was an offsetting tax loss in any year. Karls, *supra* note 99, at 207-8. Second, total tax and interest are payable even though the U.S. shareholder may have had excess tax credits in a particular year which would have offset the amount due. *Id.* at 209. Third, prior distributions do not affect the allocation period. *Id.* at 208. Therefore, if a second distribution was made five years later in 1997, interest and taxes would be calculated based on a 1988 through 1996 allocation period, ignoring the fact that all of the 1987 through 1992 earnings had been distributed and taxes and interest paid. Because of longer allocation period, a higher amount of interest and taxes is then assessed. Fourth, the required tax rate is the highest individual or corporate rate for each year. I.R.C. § 1291(c)(2). The bottom line is that interest and taxes easily may exceed one hundred percent of the dividend or gain, thereby eliminating any benefit from the investment. Karls, *supra* note 99, at 209 (extensive computations provided); PFIC Comments, *supra* note 101, at 2.

ary altogether.

Another harsh aspect of the PFIC provisions is that they retain their pre-acquisition status even though they are not held to be a PFIC at the time of purchase.[110] Thus, if a subsidiary desired by an MNC has ever qualified as a PFIC, even if solely in foreign hands at the time, that subsidiary will be a PFIC in the hands of the new purchaser.[111]

A U.S. MNC wanting to enter a market therefore must decide to create a new corporation to purchase a less desirable non-qualifying corporation, or to purchase the desired corporation and bear the burden of proving that it is not a PFIC. As many foreign companies do not retain the necessary information, the latter choice may present a formidable obstacle.[112] Any of the foregoing options, however, represents an uneconomical barrier for a U.S. MNC to enter a new market.[113]

Once the PFIC test has been met, its consequences will continue forever, as a qualifying corporation permanently becomes a PFIC.[114] The classification continues irrespective of the fact that such a status never occurs again.

However, a U.S. shareholder does have the option of cleansing PFIC status once the test is no longer met. Under IRC § 1297(b)(1), a shareholder may elect to recognize all of his unrealized gain with respect to stock investment.[115] Because the calculation of unrealized gain will likely result in a large current tax liability for the shareholder which would require an equal distribution of earnings from the subsidiary, most US investors do not make the election and are saddled with an uneconomical investment.[116]

Further, the election may be made only by those shareholders who were shareholders when PFIC status terminated.[117] Thus, an MNC which desires to purchase a qualifying subsidiary is denied the right to discontinue its status. Should the MNC be unable to secure the election from the prior owners, it will be unprofitable to purchase the subsidiary, and it will be forced to enter the market by purchasing another, possibly less desirable corporation.

The overly broad sweep of the PFIC provisions therefore presents severe disadvantages to U.S. MNCs that desire to conduct active business

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110. I.R.C. § 1297(b)(1). *See* PFIC Comments, *supra* note 101, at 3; AICPA, *supra* note 32, at 9.

111. PFIC Comments, *supra* note 101, at 3.

112. *Id.* at 5-6.

113. *See id.*

114. I.R.C. § 1291(a)(1)(B)(ii) (popularly known as the "once a PFIC always a PFIC" rule).

115. Temp. Treas. Reg. T 1297-3T(a), (b)(3); Larkins, *supra* note 72, at 88.

116. *See* Letter from Thomas M. Nee, International President, Tax Executives Institute, Inc., to Donaldson Chapoton, Acting Assistant Secretary for Tax Policy (Aug. 28, 1987), *available in* LEXIS, Tax Notes Int'l, File No. 87 TNI 36-30.

117. Temp. Treas. Reg. T 1.1297-3T(a)(1).

operations abroad. From the outset, a corporation's decision is burdened by problems associated with pre-acquisition PFIC status. Further, an MNC establishing new operations or maintaining existing operations potentially may suffer a complete denial of deferral which may be necessary to sustain ongoing activity or expansion, or may lose most of the benefit of a subsidiary's earnings when distributed.[118] These disadvantages by themselves impair the ability of a U.S. MNC to compete internationally. Additionally, since these disadvantages are not imposed on major foreign rivals, the PFIC provisions can deal a devastating blow to a U.S. MNC.[119]

With CFCs, the anti-competitive effects are magnified. Such corporations are already subject to an anti-deferral regime under Subpart F.[120] However, by violating the gross income or asset test, a CFC may also qualify as a PFIC. The effect is that all of the CFC's income is effectively treated as Subpart F income and denied deferral even though Subpart F would otherwise deny deferral only for a portion of that income.[121]

Subpart F, which applies exclusively to the deferral of CFC income, is therefore rendered inoperative by the PFIC definition. As a result, a CFC is denied the benefit of the high tax and foreign country exception and is taxed in a way totally unintended by Subpart F.[122] In order to correct this defect, the PFIC provisions should be amended to exclude CFCs.[123] This action would merely bring the PFIC provisions to the condition intended when enacted — as a catchall for non-CFCs that escaped Subpart F.[124]

U.S. MNCs do not exclusively conduct business abroad through use of a majority or wholly owned subsidiary.[125] Often new markets are penetrated through a joint venture or other arrangement whereby U.S. ownership is less than that necessary to qualify as a CFC.[126] When a foreign subsidiary with active business operations is not a CFC, a change in the provisions only as to CFCs will not totally remove the disadvantages im-

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118. *See supra* note 99 and accompanying text.

119. *See supra* note 91; PFIC Comments, *supra* note 101, at 2.

120. *Supra* note 70 and accompanying text.

121. *See* PFIC Comments, supra note 101, at 9 (*quoting* Letter from Ronald A. Pearlman, Esq., Chief of Staff of the Joint Committee on Taxation, to House Ways and Means Committee (June 18, 1990)).

122. Because all income of the subsidiary, both ordinary and passive, is denied deferral without exception under the PFIC provisions, the high tax and foreign country exceptions of Subpart F are meaningless.

123. Such a change has been called for by tax authorities and industry representatives. *See e.g.* Tax Council, *supra* note 19; API Statement, *supra* note 25; Letter from Robert J. Patrick, Jr., CEO Tax Study Group, to Kenneth W. Gideon, Assistant Secretary of Tax Policy (April 23, 1990), *available in* LEXIS, Tax Notes Int'l, File No. 90 TNI 21-38.

124. *Supra* notes 95-96 and accompanying text.

125. Among the various reasons why a U.S. MNC would not utilize a wholly or majority owned subsidiary are host country restrictions, lack of available capital, or uncertainty regarding the host country and its market. *See* DONALD T. WILSON, INTERNATIONAL BUSINESS TRANSACTIONS 2-3 (2d ed. 1984).

126. *See id.*. CFC (Controlled Foreign Corporation) is defined at *supra* note 70.

posed by the PFIC rules.[127] Therefore, in order to remove the penalties on subsidiaries, specific changes must be made to the PFIC provisions.

The fundamental defect with the provisions is the PFIC definition.[128] As demonstrated previously, the test is too simple to meet. In particular, the asset test is flawed. By including both cash and inventory in the definition of "passive assets," a business such as a sales subsidiary, which generally has only inventory and cash, is especially vulnerable even though none of its assets produce passive income.[129] The test also inherently impairs a company's competitive ability because it encourages such unsound business practices as delaying the collection of accounts receivable to avoid having an excess amount of cash on hand and thereby meeting the test for "passive assets."[130]

The solution to this problem is to exclude from the definition of passive assets cash and inventory which are necessary for active operations.[131] This change would better measure whether assets held by a subsidiary are predominantly for the production of passive income.

The gross income test is similarly flawed. Foreign subsidiaries actively engaged in businesses that happen to incur an operating loss in a particular year should not be classified as a PFIC simply because a small amount of passive income causes the seventy-five percent limit to be exceeded. Because a comparison between gross revenue from operations and passive income would more accurately reflect the predominant characteristic of the business, the test should be changed and based on gross revenue instead of gross income.[132]

Finally, the pre-acquisition status of a foreign subsidiary should be irrelevant.[133] It makes no sense to distort an MNC's investment choice when, at the time of purchase, the subsidiary does not qualify as a PFIC. This change would put the burden on the purchasing MNC to avoid PFIC classification instead of erecting barriers to an investment decision which the MNC has had no role in creating.

## V. CONCLUSION

The foregoing examples demonstrate the significant impact the Internal Revenue Code has on the ability of a U.S. corporation to compete internationally. Considering that these few items are only representative of the total number of foreign tax provisions which potentially can have

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127. This is because a change only as to CFCs would not solve the problems associated with taxation of non-CFC's active business operations which occur as a result of defects in the PFIC provisions.

128. *E.g.* PFIC Comments, *supra* note 101, at 6-7.

129. Typically, since a sales subsidiary has only inventory to be sold, cash, and accounts receivable, the test is particularly easy to meet for such operations.

130. *See* Karls, *supra* note 99, at 212.

131. PFIC Comments, *supra* note 101, at 7.

132. *Id.* at 6.

133. *Id.*

adverse effects on a U.S. MNC,[134] it becomes clear that the U.S. tax system is a great threat to U.S. corporations that desire to operate abroad.

Tax writers advance various reasons to justify their treatment of MNCs, ranging from the need to treat U.S and foreign operations of an MNC equally to the need to prevent the export of U.S. capital and jobs.[135] However, when the rhetoric is stripped away, the real reason for the manner in which MNCs are taxed is solely revenue related.[136] Income from international activities represents a lucrative source for taxes which politicians can easily target without fear of popular criticism. As foreign income becomes a larger component of U.S. MNCs' overall earnings, the temptation to overtax this major source of revenue will increase as well.

Throughout the fifties and sixties, when Congress enacted a large portion of the foreign tax provisions, discrimination against MNCs and their foreign sourced income was not a significant issue.[137] The economic dominance of the U.S. in world markets led policy makers to believe that domestic tax policy could not possibly have an effect on the country's overall competitive ability. It was also believed that if foreign countries had inconsistent tax policies, they would follow the U.S. lead and make similar changes.[138]

The realities of the nineties, however, are drastically different from those thirty years ago. Not only has the U.S. lost its dominant economic position but the world itself has dramatically changed. The emergence of common markets such as the EC and the dissolution of the Soviet empire are only the beginning of events which will reshape the global stage on which international competition will occur. Nonetheless, tax writers are engaged in a dangerous mode of thinking. They have continued to enact discriminatory and conflicting laws that subject U.S. MNCs to higher rates of taxation than their competitors, operating on past beliefs rather than present realities. All concerned must realize that such action is a formula for future economic disaster. Even though world income is becoming a larger share of U.S. wealth,[139] the country's share of international markets is decreasing.[140] Thus the establishment of impediments to competition abroad will affect U.S. growth and prosperity.[141]

The U.S. system of taxing the foreign income of MNCs therefore needs to be critically reexamined, an examination that must involve a

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134. *Supra* note 30.

135. *E.g.* PRICE WATERHOUSE, *supra* note 2, at E4-5; ISENBERGH II, *supra* note 27, at 20.

136. *See, e.g.*, AICPA *supra* note 32; *Factors Affecting International Competitiveness: Hearings Before the House Comm. on Ways and Means*, 102d Cong., 1st Sess. (1991) (statement of Chemical Manufacturers Association).

137. *See* PRICE WATERHOUSE, *supra* note 2, at 92.

138. *Id.*

139. *Id.* at 33.

140. *Id.* at 90.

141. *See* RAGLAND, *supra* note 25, at 26.

fundamental change of thought. The focus should shift to enhancing the competitive ability of MNCs rather than compromising that ability solely to maximize present federal revenue, concentrating on harmonizing U.S. tax rules with those of our major competitors.[142] The goal here should be to establish a level playing field so that a U.S. MNC does not pay more tax than a foreign MNC with respect to income earned in the same market. Should harmonization be impossible, U.S. provisions should be restructured with the goals of competitiveness and simplicity in mind.[143]

The economic future of the U.S. is being decided by today's policies. It will surely be tragic if, as the markets of the world become more accessible due to the removal of external barriers, our own country's tax policies become the ball and chain preventing U.S. MNC participation. If the I.R.C. is not reexamined and restructured now, our future prosperity may be disappear in the wake of the competitive advantage of foreign corporations who do not have onerous burdens placed upon them by their governments.

*James Leonard*

142. The days are gone when other nations could be expected adopt U.S. tax policies. Thus, many significant differences now exist between the way U.S. MNCs are taxed compared to their foreign competitors. This lack of harmonization is one of the key factors causing U.S. MNCs to pay higher effective income taxes than MNCs chartered in other industrialized nations. PRICE WATERHOUSE, *supra* note 2, at 94. A tax policy of harmonization is necessary to the establishment and retention of the competitive position of U.S. MNCs. Otherwise, U.S. MNCs must struggle on an unequal playing field, contending against foreign corporations as well as our own tax code. See API Statement, *supra* note 25. *See generally* PRICE WATERHOUSE, *supra* note 2, at 92-96.

143. *See* RAGLAND, *supra* note 25, at 26.