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THE CASE FOR TAX SPARING ALONG WITH EXPANDING AND LIMITING THE SUBPART F REGIME

SAMUEL C. THOMPSON, JR.*

I. INTRODUCTION

I am particularly happy to participate in this important conference at The George Washington University School of Law. I feel as though I am caught in the middle of bipolar, policy approaches to international tax, championed by two outstanding George Washington Law School professors of international tax, Professor Robert Peroni and Professor Karen Brown. Professor Peroni has argued persuasively that the United States should end deferral, a policy under which U.S.-controlled foreign corporations (CFCs) are generally not subject to U.S. taxation until the earnings are distributed, essentially by adopting the partnership model for taxing the foreign source income of CFCs.[1]

On the other hand, Professor Brown has made compelling arguments for the adoption of an exemption system for investment in developing countries (DCs), particularly those in Africa.[2] Under an exemption system, CFCs would not be subject to taxation in the United States, either at the time that foreign income is earned or at the time that such income is repatriated. Professor Brown's proposed exemption system would have an effect similar to that of a tax sparing policy. Under a tax sparing policy, pursuant to a treaty, for foreign tax credit purposes, the United States would treat CFCs as having paid the full foreign tax on foreign income, even though the income is subject to a lower tax pursuant to a tax holiday.

The George Washington University School of Law is, indeed, privileged to have these two outstanding international tax scholars on its faculty. This Symposium is also privileged to host Professor Paul McDaniel, the author of an important and excellent paper

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1. *See, e.g.*, Robert J. Peroni, *Deferral of U.S. Tax on International Income: End It, Don't Mend It—Why Should We Be Stuck in the Middle with Subpart F?*, 79 TEXAS L. REV. 1609 (2001).

2. *See, e.g.*, Karen B. Brown, *Missing Africa: Should U.S. International Tax Rules Accommodate Investment in Developing Countries?*, 23 U. PA. J. INT'L. ECON. L. 45 (2002).

entitled *The U.S. Tax Treatment of Foreign Source Income Earned in Developing Countries.*[3] I am, indeed, honored to have the opportunity to offer the following comments on Professor McDaniel's Article and to set forth my views on both the need for reform of the Subpart F regime and on the advisability of the adoption by the U.S. Treasury of a tax sparing policy.

This Article proceeds as follows: Part II provides a brief comment on the current deferral system; Part III addresses the economic case for a tax sparing policy; Part IV provides a brief examination of Professor McDaniel's policy options; and Part V sets out the author's policy prescription.

II. Comment on the Current Deferral System

I would like to start with a comment on the economic effect of the current system of deferral. Professor McDaniel claims that the current U.S. system prevents DCs from offering tax incentives, like tax holidays, to attract foreign direct investment (FDI).[4] I have a small quibble with this statement, a quibble that goes to the heart of the deferral concept. I believe that his characterization is a bit too broad because, under the current deferral system for active income, tax incentives will provide an advantage as long as the income is not repatriated. As Professor McDaniel points out, long-term deferral approximates the benefits of exemption because of the lack of an interest charge on the deferral benefit.

I believe that it is fair to say that the current deferral system is not, in and of itself, enough to encourage investment in DCs, even with substantial tax incentives. Subject to the Subpart F inclusion rules, the current deferral regime is available for CFCs wherever the foreign investment exists; therefore, the current deferral regime does not offer a greater incentive for investment in DCs than does investment in developed countries that offer tax incentives. Finally, it is important to remember that the deferral regime applies not just to tax holidays; it also applies to any situation in which the foreign corporate tax rate is lower than the U.S. corporate tax rate, such as with Ireland's 10% corporate tax rate.

3. Paul R. McDaniel, *The U.S. Tax Treatment of Foreign Source Income Earned in Developing Countries: A Policy Analysis*, 35 Geo. Wash. Int'l L. Rev. 265 (2003).

4. *Id.*

III. The Effectiveness of Tax Sparing for the Attraction of FDI in DCs

In addressing the question of whether tax sparing benefits or other incentives should be made available to DCs, it seems that the first issue is whether it is important for a DC to be concerned about the level of its inbound FDI. I believe that the answer is a resounding "Yes." For example, the 1998 article, *How Does Foreign Investment Affect Economic Growth,* cited by Professor McDaniel, firmly establishes that FDI contributes to economic growth. The authors, Borensztein, Gregorio and Lee, point out that:

> [o]ur results suggest that FDI is in fact an important vehicle for the transfer of technology, contributing to growth in larger measure than domestic investment. . . .[T]here is a strong complimentary effect between FDI and human capital. . . .Our results are supportive of a crowding-in effect, that is, a one-dollar increase in the net inflow of FDI is associated with an increase in total investment in the host country of more than one dollar.[5]

This is a logical conclusion and it would appear that any rational finance minister, especially a finance minister in a DC, must be concerned with attracting FDI. Indeed, this was my personal experience while working, on behalf of the U.S. Treasury Department, as the Tax Policy Advisor to the Ministry of Finance in South Africa from 1999 to 2000. Thus, I think that it is crystal clear that FDI is an important element in the economic growth strategies of many DCs. The next question is whether either tax sparing benefits or a selective exemption system for DCs, like the one proposed by Professor Brown, could be effective in attracting FDI. Professor McDaniel cites the 1998 article by Hines, *Tax Sparing and Direct Investment in Developing Countries,* finding that tax sparing benefits are effective in stimulating FDI.[6] For example, Hines writes:

> [t]he results indicate that "tax sparing" is effective in stimulating FDI. Japanese firms locate a much higher fraction of their foreign investment in countries with whom Japan has tax sparing agreements than do American firms. Furthermore, host governments appear to grant Japanese firms significant tax reductions that are not available to their American counterparts. All other things equal, tax sparing agreements are associated with 140% to 240% higher FDI levels and 23% lower tax rates on FDI.[7]

Further, it seems logical to conclude that the significant reductions in tax that can result from tax sparing would be effective in

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5. *Id.* at 117-18.

6. James R. Hines, Jr., *"Tax Sparing" and Direct Investment in Developing Countries,* 1998 NBER Working Paper Series 1, *available at* http://www.nber.org/papers/w6728.

7. *Id.* at 3.

attracting FDI. I believe that the previously mentioned economic studies of the effectiveness of FDI and tax sparing lead to some important conclusions. First, the adoption by the United States of a tax sparing policy, or similar selective exemption policy, as proposed by Professor Brown, would likely increase the amount of U.S. source FDI flowing to a host DC that received the benefits of such a policy. Second, this increased FDI would likely increase the rate of domestic investment and economic growth in the host DC.

IV. An Examination of Professor McDaniel's Policy Options

Given this background, let me turn to an examination of the various policy options analyzed by Professor McDaniel in his Article.[8] I will begin by noting those points as to which Professor McDaniel and I reasonably agree at certain levels. Specifically, I will address the reduction of U.S. corporate tax on income earned in DCs, the relaxation of Subpart F rules, and the modification of Section 482. First, Professor McDaniel concludes that reducing the U.S. corporate tax on income earned in DCs is unlikely to be more effective than an exemption system. Although I do not support this type of policy approach, it would appear that such an approach could be designed to reach the same or similar result to that provided by tax sparing or an exemption system. Second, I agree with Professor McDaniel's finding that a relaxation of the Subpart F rules for investment in DCs would not likely be effective. This type of policy would unlikely increase economic growth in DCs and would permit DCs to be used as mere tax havens for economic activity occurring in other countries. Third, I agree with Professor McDaniel's conclusion that modifying the Section 482 transfer pricing rules for investment in DCs is not an appropriate policy. In addition to violating the WTO, such an approach would unlikely increase economic growth in DCs.

Below, I will address those of Professor McDaniel's contentions with which I take issue, including the exemption system, tax sparing, and the suggestion of increased official development aid (ODA).

A. *Exemption System*

Professor McDaniel argues that an exemption system for investment in DCs is unlikely to increase FDI flowing into DCs, so long as the current, U.S.-modified worldwide system (i.e., the CFC regime)

8. McDaniel, *supra* note 3, at 285-94.

is in effect. I think that his conclusion is inconsistent with findings in the Borensztein, Gregorio and Lee study discussed in Part IV on the effect of tax sparing on FDI.[9] Although I am not aware of any studies on the effect of a selective exemption system on FDI, Hines' *Tax Sparing* study seems to logically apply to a selective exemption system. It is noteworthy, however, that if the United States were to adopt a generalized exemption system for all FDI, as has been proposed recently by some international tax professionals, so that the exemption applied without respect to the location of the investment, then I would agree that such a system would unlikely be effective in attracting FDI to DCs. Although, as indicated below, I recommend the adoption of a selective tax sparing system, I do not support a generalized exemption system for investment in DCs.

B. *Tax Sparing Approach*

Professor McDaniel opposes a tax sparing approach. He argues that there are many obstacles to this approach, including the following: (1) general ineffectiveness; (2) the inability of DCs to implement exchange of information agreements and source rules; (3) the limited resources in the Treasury's International Tax Counsel's (ITC) office; and (4) the complexity associated with such a system. I will address each of these concerns in turn.

First, I think Professor McDaniel's conclusion regarding the effectiveness of tax sparing is inconsistent with the previously discussed findings concerning the relationship between FDI and tax sparing. Second, as I will propose below, tax sparing should only be available to those DCs that can properly implement information exchange agreements and otherwise provide proper administration of the tax system. Based on my experience serving as the Tax Policy Advisor to the Ministry of Finance in South Africa, I also believe that the United States could help these DCs dramatically improve their tax systems. If the United States were to adopt a tax sparing policy for DCs that adhere to principles of good government, the DCs would both be able to and have an incentive to comply with their information exchange obligations. My experience in South Africa leads me to conclude that many DCs would welcome our assistance in this regard.

Third, regarding Professor McDaniel's point on a lack of resources, certainly, if the U.S. decided to adopt a tax sparing policy, it could find the resources to enhance the ITC office so that we

9. *Id.* at 283.

could implement an effective tax sparing policy. The same is true of a selective exemption system. Fourth, I believe that Professor McDaniel's position on the complexity of a tax sparing regime is one that essentially ignores the finding of the Hines study regarding the Japanese system. Clearly, if the Japanese can adopt an effective tax sparing policy, the United States can do the same. Finally, although the Organization for Economic Co-operation and Development (OECD) is opposed to what it refers to as "Harmful Tax Competition,"[10] a recent study by the OECD is quite balanced in its assessment of tax sparing.[11] For example, the report concludes: "The analysis of this report does not suggest that OECD and other countries which have traditionally granted tax sparing should necessarily cease to do so."[12] The report goes on to urge countries that employ tax sparing to "achieve a better targeting of the provisions and to reduce the potential for abuse."[13]

C. *Suggestion for More ODA*

As an alternative to providing tax incentives for investment in DCs, Professor McDaniel suggests increasing ODA. This suggestion is consistent with United Nations proposals that each developed country devote 0.7 percent of its GNP to ODA.[14] I agree that there should be more ODA, and the United States' current contribution is much too low, at 0.2 percent of GNP, or $4 per taxpayer.

But the political scene in the U.S. makes a substantial increase in ODA unlikely. Although ODA clearly should be increased, it is also true that U.S. companies may earn substantial benefits by investing, through properly targeted and focused tax sparing agreements, in active business operations in DCs. As indicated above, there is economic evidence that an increase in FDI increases economic growth. Accordingly, I do not think that an obvious need for an increase in ODA can be used as a basis for not supporting a properly structured tax sparing policy.

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10. Organization for Economic Co-operation and Development, Harmful Tax Competition: An Emerging Global Issue 7 (1998).

11. Organization for Economic Co-operation and Development, Tax Sparing: A Reconsideration (1998).

12. *Id.* at 42.

13. *Id.*

14. *See generally* McDaniel, *supra* note 3, at 278-79.

V. My Policy Prescriptions

In this section, I begin by outlining the reasons why I think we should retain the current deferral system and not adopt Professor Peroni's anti-deferral regime, which is fundamentally inconsistent with providing any type of tax incentives for investment in DCs. Second, I address changes in the current Subpart F regime for CFCs that I think are needed, even if a tax sparing approach is adopted. Finally, I provide the general structure of a targeted and focused tax sparing program that could be implemented through the Treasury's treaty policy. This tax sparing program would not apply to income otherwise subject to taxation under the Subpart F regime, as proposed to be modified here.

A. *Continuation of the Present Deferral System*

Although I see the logic in ending deferral along the lines proposed by Professor Peroni, I believe that such a policy may run the risk of hurting competitiveness of U.S. firms. For example, assume that a U.S. firm is competing for an industrial project in a foreign country that has a corporate tax rate below the U.S. rate or in a foreign country that is offering a tax holiday for the project. Also assume that the foreign competitors for the project are located in countries that have exemption systems. Under the anti-deferral regime proposed by Professor Peroni, the U.S. firm is at a tax disadvantage. Under the current deferral system, the U.S. firm is on the same footing as the foreign competitors at the time the income is earned and as long as the income is reinvested and not repatriated. If the income is reinvested for a significant period, the deferral facilitates an effect like that of exemption, thus reducing the competitive advantage of the foreign competitor.

With proper planning, repatriation of the income may be done at a time when other high taxed foreign income is repatriated, thereby using cross-crediting, under the foreign tax credit rules, that generates the same effect as an exemption system. This demonstrates that the current deferral system already addresses many of the concerns that the Nation Foreign Trade Council (NFTC) and others have expressed with competitiveness.[15] I would thus retain our current deferral system with the modifications suggested below.

15. Basically, the argument is that the current CFC regime puts U.S. firms doing business in foreign markets at a competitive disadvantage relative to their foreign competitors that are located in countries without CFC regimes. *See also* National Foreign Trade Council, International Tax Policy for the 21st Century (Dec. 15, 2001).

B. *Expansion of and Limitation on the Subpart F Regime*

I would both expand and limit the current Subpart F regime, pursuant to which the Subpart income of CFCs is currently imputed to certain controlling U.S. shareholders, thus denying the benefits of deferral. In order to take pressure off of the Section 482 transfer pricing rules, which are complex and difficult to administer, I would offer two suggestions. First, I would expand the definition of Subpart F income for outbound sales from U.S. parents to their CFCs. Second, I would consider limiting the definition of Subpart F income for foreign to foreign sales transactions, pursuant to which such income arises on sales by one CFC to a sister CFC where the sister sells the product outside of the country in which the sister is incorporated.[16]

First, with respect to outbound sales, the Subpart F regime should be expanded to include within foreign base company sales income (FBCSI)[17] and, therefore, Subpart F Income, all outbound sales by U.S. parent corporations (and their controlled U.S. subsidiaries) to their CFCs. This rule should apply without respect to where the product is resold by the CFC. Under the current definition of FBCSI, such transactions produce FBCSI only if the sale takes place outside of the country in which the CFC is incorporated. Under this proposal, for example, FBCSI would include income realized on the CFC's purchase of property from its U.S. parent and from the sale by the CFC of the property in the country of its incorporation. Presently, such income is not included in FBCSI because of the requirement that the sale take place outside of the country of incorporation of the CFC. This proposed extension of the FBCSI rules would take pressure off of Section 482 in the outbound context, while preserving deferral for real business activity in foreign countries, thus addressing the basic concern with competitiveness.

Second, with respect to the foreign to foreign Subpart F provisions, consideration should be given to relaxing these rules to the extent that there is no Section 482 issue. This would address the essential competitiveness concerns set out in the NFTC Study.

16. Samuel C. Thompson Jr., *A Critical Perspective on the Thomas Bill*, 96 TAX NOTES 581 (2002) (presenting similar suggestions for expanding and limiting the Subpart F regime); *see also* Samuel C. Thompson Jr., *Inversion Hearings Focus on Wrong Issues*, 27 TAX NOTES INT'L 193 (2002).

17. I.R.C. § 954(a)(2) (2000).

C. *Adoption of a Focused Tax Sparing Regime*

I would adopt a focused tax sparing program for investment in certain DCs. The Treasury treaty program would implement the system with benefits that would apply only to active income earned in the applicable DC. The system would not apply to income earned from sales of property between the U.S. parent and the foreign subsidiary, i.e., income that would give rise to FBCSI under the proposed modification discussed above or to any other type of Subpart F income. Therefore, tax sparing would not apply to sales of property that would otherwise be subject to Section 482.

The U.S. Treasury would also limit tax sparing benefits to those countries that meet certain minimum standards, including: (1) a commitment to basic democratic principles; (2) a commitment to basic human rights protections; (3) an effective tax system and information exchange program; (4) an adoption of good corporate governance principles; (5) compliance with environmental best practices; (6) compliance with basic labor law principles; (7) an adoption of anti-corruption policies, and (8) the satisfaction of other good government principles. The Treasury would consult with other branches of government in determining if the relevant parties satisfied all eight conditions. Thus, that benefits of this provision would only be available for those DCs that practiced good government principles, and it would be a carrot attracting commitments to good government.

The following example illustrates the basic operation of this type of system. Assume that tax sparing benefits are extended by treaty to country DCX and that GM, a U.S. corporation, sets up, in DCX, an auto-manufacturing subsidiary, GMX. GMX makes no purchases of products from GM that would generate FBCSI under the rules suggested above, and GMX has no other Subpart F income. GMX manufactures the automobiles that are sold in DCX. The corporate tax rate in DCX is generally 35%; however, pursuant to a tax holiday for a period of ten years, DCX imposes a tax rate of only 10% on the income earned by GMX. For the current year, GMX has $100M of taxable income and pays $10M of income tax to DCX. When GM repatriates the $90M of after tax income from GMX, GM would not be subject to taxation on the $90M because, under the tax sparing principle, the income is deemed to have incurred a 35% corporate tax rate in DCX. Thus, the economic effect of conferring tax sparing benefits is the same as an exemption for the income earned by GMX in DCX. Without this system, assuming that GM's only foreign income was the amount repatriated, under the indirect foreign tax credit provisions in Section 902, GM would then be subject to a tax of $25M on the repatriated amount, i.e., the difference between the 10% rate in DCX and the 35% U.S. rate.[18]

This approach is consistent with the competitiveness concept, because it would offer U.S. firms doing business in such countries the same or similar benefits as those received by competing foreign firms that also benefit from tax sparing. Further, this concept can be justified on efficiency grounds. By promoting economic growth in DCs, this concept is likely to enhance long-term economic efficiency. Concededly, the distortion in investment decisions that this type of policy would encourage through its reduction in short-term worldwide welfare, might hurt economic efficiency. The policy is, however, likely to promote long tern economic efficiency, because it helps DCs in growing their economies more effectively. The accelerating economic growth of DCs will make worldwide welfare greater in the long run.

VI. Conclusion

The events of September 11, 2001 demonstrate that we cannot expect to live in prosperity while others live in abject poverty. Just as after World War II, when the United States wisely adopted policies to help rebuild the economies of Germany and Japan, it would be prudent for the United States to adopt policies to help build the economies of DCs. A focused tax sparing program could be a powerful tool in this economic building process, and it is clearly worth the effort to pursue this policy option on the basis outlined in this Comment. The tax sparing program proposed here should not be viewed, however, as a substitute for other forms of foreign assistance, such as ODA.

My proposal for a focused tax sparing program is not inconsistent with my support for anti-inversion legislation, which would prevent companies from unilaterally adopting a de facto territorial or exemption system of taxation through inversion transactions.[19]

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18. *See, e.g.*, Damian Laurey, *Reexamining U.S. Tax Sparing Policy with Developing Countries: The Merits of Falling in Line with International Norms*, 30 Va. Tax Rev. 467, 473-75 (2000).

19. Samuel C. Thompson Jr., Section 367: A 'Wimp' For Inversions and a 'Bully' For Real Cross- Border Acquisitions, 94 Tax Notes 1505 (2002); Samuel C. Thompson Jr., IRC Section 367: A 'Wimp' for Inversions and a 'Bully' for Real Cross-Border Acquisitions, 26 Tax Notes Int'l 587 (2002); Samuel C. Thompson, Jr., Analysis of the Non-Wimpy Grassley-Baucus Inversion Bill, 26 Tax Notes Int'l 741 (2002); Samuel C. Thompson Jr., The Non-Wimpy Grassley/Baucus Inversion Bill, 95 Tax Notes 1515 (2002); Samuel C.

While inversions undermine the current CFC regime on an ad hoc and arbitrary basis, the focused tax sparing program proposed here would be a judicious and carefully focused exception to the current system.

Thompson, Jr., Treasury's *Inversion* Study Misses The Mark: Congress Should Shut Down *Inversions* Immediately, 26 TAX NOTES INT'L 969 (2002); Samuel C. Thompson Jr., Treasury's Inversion Study Misses the Mark, 95 TAX NOTES 1673 (2002); Samuel C. Thompson Jr., U.S. Treasury Official Gives Unconvincing Reason for Not 'Blockading' Inversions, 26 TAX NOTES INT'L 1321 (2002); Samuel C. Thompson Jr., Inversion Hearings Focus on Wrong Issues, 96 TAX NOTES 154 (2002); Samuel C. Thompson Jr., Inversion Hearings Focus on Wrong Issues, 27 TAX NOTES INT'L 193 (2002); Samuel C. Thompson Jr., A Critical Perspective on the Thomas Bill, 96 TAX NOTES 581 (2002).