Taxing Foreign Source Income:
A Businessman's View

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There is broad agreement that world trade and investment contribute significantly to the economic wellbeing of this country. Economic interdependence has become a reality.

At the same time there is a diversity of opinion as to the appropriate U.S. policy with respect to taxation of foreign source income. In the past 15 years or so U.S. tax policies have increased the burden on income earned abroad—both corporate and individual—on a unilateral basis. In recent years these policies have been under almost continuous public discussion and debate by Congress, labor, and the business community.

In this Brief, B. Kenneth Sanden, C.P.A. and Partner, Price Waterhouse & Co., sets forth a candid "businessman's view" of U.S. policy with respect to the taxation of foreign source income. Mr. Sanden holds that primary emphasis in international tax policy should be on economic neutrality. He sets forth and explains the basic concepts which he believes must be maintained to preserve that neutrality. This Brief constitutes the text of a paper presented by Mr. Sanden at the Tax Foundation's annual tax conference in New York on November 30, 1977.

The Tax Foundation is a publicly supported, non-profit organization founded in 1937 to engage in non-partisan research and public education on the fiscal and management aspects of government. Its purpose, characterized by the motto "Toward Better Government Through Citizen Understanding," is to aid in the development of more efficient and economical government. It also serves as a national information agency for individuals and organizations concerned with problems of government expenditures, taxation, and debt.
Taxing Foreign Source Income:
A Businessman's View

By B. Kenneth Sanden*

Mr. Gilbert Jones, former Vice Chairman of IBM and President of its World Trade Corporation, in his capacity as Expert Adviser to the United Nations Commission on Transnational Corporations recently stated:

There is no denying that the world's technical resources are unevenly distributed. The most important role played by the Transnational Corporation is probably that of a great equalizer among nations. The TNC is a carrier of technology which is injected into national economies at the discretion of the host country. The TNC helps to equalize management methods, wages and, ultimately, living standards. As a result, it serves now and will continue to serve in the future, as a dynamic catalyst of progress in both home and host countries. In short, in the course of their normal day-to-day business activities, TNCs are contributing to common development and spreading know-how and wealth worldwide.

Mr. Jones could well have pointed out that this act of "spreading know-how and wealth worldwide" has caused Congress, labor and the business community to debate almost continuously for the last several years the appropriate United States policy with respect to taxation of foreign source income and its effects on our balance of payments, consumers, foreign competition, national security, employment, availability of essential materials or even political power.

Hopefully, we have long since passed the point where we should dispute the advantages to us of world trade and in-
vestment. Economic interdependence is a reality. In short, the United States must have access to foreign technological developments and commodities and raw materials located abroad. The United States must finance these foreign purchases through what it produces efficiently—whether soybeans, aircraft, or sophisticated computers. Obviously, it is frequently necessary to invest abroad as part of the complicated system of production and trade. Raw materials may only be found—or only remain in quantity—in countries where capital is short or nonexistent. The worldwide shipment of many items is precluded because of transportation costs or physical impossibility. Protectionist or nationalistic fervor demands local manufacture or imposes punitive tariffs and duties on foreign production. The new economic order currently being debated and implemented will ensure that the developing world will get more and more of total world production.

The studies in this area have been less than conclusive and must be further researched and attuned to changing conditions. It is of no help to suggest, for example, that if punitive taxes were imposed on foreign investments, there would be equivalent investment in the United States. Our productive facilities depend not only on oil but tin, zinc, iron ore, nickel and other materials not available in sufficient quantity in the United States. So long as we drink coffee, tea or

*The views expressed in this report are those of the author and do not necessarily reflect the opinion of the Tax Foundation.
cocoa, eat bananas, read newspapers, use aluminum cans, ride on rubber tires and consume countless other everyday items, we must finance their growth or production directly or indirectly. U.S. companies investing abroad for these and other business purposes are not improperly diverting capital or labor but are generally contributing to the economic well-being of this country.

Accordingly, businessmen have reacted with increasing apprehension as U.S. tax policies for the last 15 years or so have increased the burden on income earned abroad—both corporate and individual—on a unilateral basis. It is believed that economic neutrality must be the primary emphasis in international tax policy and the following basic concepts should be maintained:

1. Foreign income of foreign subsidiaries should be taxed only when remitted to the United States.

2. Credit should be given for foreign taxes imposed on such income.

3. U.S. corporations operating outside the boundaries of the United States should be taxed on the same basis as other U.S. corporations are taxed.

4. U.S. taxation of individuals employed abroad on the basis of citizenship is unique among developed countries and the fiscal problems involved should be recognized in tax policy.

In addition, there is serious concern because U.S. policy with respect to taxation of domestic income has not kept pace with changing world conditions. Many of our trading partners have recently removed impediments in their laws or instituted other reforms to stimulate capital formation and saving. As we move toward consideration of "reform" and "relief" this next year, what others have done in this area should be required reading.

Present U.S. Taxation of Foreign Income

U.S. controlled foreign corporations pay no U.S. tax on income earned outside the United States. Under present law, such foreign earnings are subject to U.S. tax only at the shareholder level, and then, only when such earnings are repatriated. (In certain circumstances, U.S. shareholders are subject to taxation currently under the foreign personal holding company and Subpart F provisions.)

Business has repeatedly gone on record as favoring the continuation of this policy which, in general, taxes the earnings of foreign corporations only as they are paid to U.S. shareholders as dividends. Among the reasons for this view:

1. It is consistent with the legal concept that a corporation is a judicial person, separate and distinct from its shareholders.

2. Subjecting the undistributed earnings of controlled foreign corporations to current taxation would adversely affect our competitive position in world trade vis-a-vis the other principal trading countries.

3. Experience indicates that the existing system has not been subject to abuse; that is, funds surplus to the business needs are repatriated as soon as possible, without regard to U.S. tax considerations.

4. To subject U.S. shareholders to tax on the undistributed earnings of controlled foreign corporations could well be challenged as an in-
The recomputation of earnings for U.S. purposes and immediate tax thereon would effectively deny the offset of the foreign taxes which have been merely deferred. At the least any proposal to impose a punitive tax on undistributed earnings should be accompanied by a provision giving recognition to the ultimate matching of the U.S. and foreign rules for the computation of taxable income in the countries involved.

On the other hand, mature foreign subsidiaries would not generally be affected by proposals to include unremitted earnings in the U.S. tax base. It appears they are already remitting over half of their earnings and the foreign taxes paid would normally be more closely related to foreign tax credits allowable under the U.S. rules. If there are corporations, however, unduly benefitting by present law, it would be a simple matter to bring them in line. The income of foreign corporations could be made subject to immediate taxation where they accumulate funds beyond the reasonable needs of the business. This suggestion was made in 1962 when Congress was considering adoption of the extremely complex provisions of Subchapter F. It was repeated by the President’s Task Force on Business Taxation in its report of September 1970 and is equally valid today. This would ensure that those corporations abusing the retention concept would be challenged without imposing administrative and perhaps even legal difficulties on all U.S. multinationals.

In any event, it should be recognized that the U.S. businessman is not indifferent as to whether an investment is made in the domestic economy or abroad. Given the choice he will obviously attempt to maximize U.S. production, income and tax revenues. The U.S. overall tax burden must be met by its tax-

cursion on the sovereignty of the host nation, and, regardless of the legality of such a tax, would be deeply resented by the host government, employees, suppliers, creditors, and especially minority shareholders. Even if direct legal action could not be taken, the resentment could well cause the host nation to take retaliatory action against United States interests, particularly in view of the General Policies set forth in the OECD Declaration on International Investment and Multinational Enterprises to which the United States has subscribed.

5. Having regard to the relative rates of tax in other industrialized nations (they probably would be higher if it were not for the VAT imposed by many) the immediate taxation of undistributed earnings would result in little additional income tax in the United States after allowance of the foreign tax credit. Forced distributions might only result in greater foreign withholding taxes and lesser amounts invested in the business without U.S. revenue gains.

It has been suggested that if there is little overall tax revenue involved in the “deferral” area no harm would result from imposing a penalty tax on undistributed earnings of foreign subsidiaries. With respect to an individual company, however, taxing unremitted earnings computed on a U.S. basis when there may be little or no current taxable earnings in the foreign country can create extreme inequity and hardship. Thus, for example, a plant may be built with funds borrowed abroad. Special depreciation allowances and other investment incentives are available which postpone the imposition of foreign income taxes although over the life of the project such taxes may exceed the U.S. tax equivalent.
payers whether corporate or individual. Higher local employment reduces the drag on welfare and social security systems and maintains domestic consumer purchasing power. Preference naturally would be given to U.S. investments not subject to political strife, laws favoring labor participation in management, punitive employee termination agreements, exchange controls and currency fluctuations, expropriation probabilities and the like.

**Foreign Tax Credit**

The allowance of the foreign tax credit is an essential factor in avoidance of double taxation in world trade and commerce. It has been universally adopted as a means of “neutralizing” differing tax systems without the need of harmonization. The credit is consistent with the aims of international governmental organizations concerned with elimination of artificial barriers and incentives and has been a basic concept of the U.S. tax law for over half a century.

The retention in full of the foreign tax credit is fundamental to the continued growth of U.S.-international trade and investment. The attacks on the foreign tax credit appear to stem primarily from a misunderstanding of what it is and how it works. It is therefore necessary to dispel what are believed to be four fundamental misconceptions regarding the foreign tax credit. It should be understood that:

1. The foreign tax credit is not unique to the United States.
2. The foreign tax credit does not encourage foreign investment to the exclusion of domestic investment.
3. The foreign tax credit does not reduce the U.S. tax liability on U.S. source income.
4. The foreign tax credit is not a tax preference or loophole.

It is generally accepted that taxes on international business should be “neutral”; that is, they should be imposed in a way that business decisions are made on their own merits, and not because of tax considerations. And it is also generally accepted that the cornerstone of tax neutrality is the elimination of international double taxation.

The major industrial nations of the world eliminate double taxation either by following the “territorial” concept of taxation or by granting a credit for taxes paid by domestic taxpayers to foreign jurisdictions.

Under the “territorial” approach income from commercial activity is taxed only by the country in which it is generated. France and the Netherlands are among those who follow this concept. Under the foreign tax credit system, on the other hand, a country taxes the worldwide income received by citizens and domestic corporations, but allows a credit for taxes paid foreign countries. The United States, Japan and the United Kingdom, among others, use this system. Both systems recognize that the host nation is entitled to priority in taxing domestic commercial activity; for it is the host nation which supplies the financial, social and economic stability which permit profitable commercial activity. The tax credit system, in addition, permits the investor nation to tax foreign profits to the extent its tax rate exceeds that of the host nation.

From a theoretical standpoint, the territorial concept best meets the tests of
non-discrimination and neutrality. It was largely on this basis that the adoption of this system was recommended to President Johnson in 1964 by his Task Force on Programs to Improve the World-Wide Competitive Effectiveness of American Business, which was under the chairmanship of Ray Eppert, head of Burroughs Corporation. Other than being received with thanks nothing further was heard about the report. It must be pointed out, however, that if generally adopted the territorial method could be subject to abuse as encouragement would be given to the establishment of tax-haven operations in countries soliciting business solely on the basis of tax savings. This could well foster the spread of stricter controls on capital and technology flows and limitations on transfer prices for goods and services. It is believed that business would generally support the view that tax holidays, tax sparing and similar incentives to international business should be limited in time and application to recognized economic objectives such as assistance to underdeveloped countries on a temporary basis.

The credit that the United States allows for foreign taxes is confined to income taxes and a limited type of taxes imposed in lieu thereof. In many countries the tax structure is quite different from ours, with greater reliance placed on indirect taxes of one kind or another, such as value-added, sales and transfer taxes, and net worth or other capital taxes, which generally are not creditable. The combination of high indirect taxation abroad and high U.S. income taxation may make the total tax cost of doing business greater than it would be if business were conducted in either country alone.

There have been many proposals before the Congress which would eliminate or restrict the use of the foreign tax credit. The clear aim of these proposals is the discouragement of U.S. foreign investment and/or the forced withdrawal of U.S. interests from abroad by imposing a penalty which would render U.S. owned business unable to compete with foreign owned business. Repeal of the credit for foreign taxes paid on foreign source income would be disastrous to U.S. business interests abroad. As former Assistant Secretary of the Treasury Stanley S. Surrey stated in 1967 during Hearings before the Senate Committee on Foreign Relations:

"American investment would not proceed at all without the foreign tax credit because then...two taxes would be imposed and the overall burden of two taxes would be so great that international investment would practically cease."

It could not be better stated but why then are we still considering the matter 10 years later?

A more recent proposal has been the substitution of a deduction for foreign income taxes as against the credit allowance but this would also result in economic double taxation of international business. Operations in a country having a rate equal to the U.S. rate of 48% would be subject to an effective tax rate of almost 73%. It has been suggested that the treatment of state income taxes as a deduction requires consistent treatment of foreign income taxes. Perhaps the consistency argument is sound but then non-discrimination and equity in U.S. operations would be better served by the allowance of state income taxes as a credit also. It should be recognized, however, that present nominal rates of state taxes might well be raised under this system passing on the full cost to the U.S. Treasury and taxpayers in general.

Largely as a matter of simplification, the President's Task Force on Business Taxation recommended in its September 1970 report that the Internal Revenue
Code be amended so that the Treasury...be authorized to exempt from United States tax income derived from the active conduct of business by United States companies and their foreign subsidiaries in countries where the tax rates are relatively high and produce foreign tax credits that largely offset any United States tax liability.” It was envisioned that the effective foreign rate should at least equal 75% of the U.S. statutory rate on corporations. Dividends received from a subsidiary in a designated country would be exempt and there would be no need to determine the foreign tax credit nor to restate the income on U.S. income tax standards. There was little business support of the proposal at that time and I suppose we were naive in believing we could simplify the determination and reporting of foreign source income and related tax credits.

**Allocation and Apportionment Regulation (Reg. Soc. 1.861-8)**

Had we all been able to foresee, however, the 1977 promulgation of U.S. Treasury Regulations (Reg. Sec. 1.861-8) requiring allocation and apportionment of U.S. expenses to foreign source income, we might have been more strenuous in our recommendations and undoubtedly would have received business support as well. For approximately 20 years the government has issued, held hearings, withdrawn and reissued regulations in this area. The final product is an extra long complex, technical, frequently arbitrary set of rules which often run counter to good business judgment. The net effect is that the U.S. business community will be subject to an increased burden of international double taxation while foreign owned operations in the United States might well have their U.S. taxes reduced.

The problem arises because under the regulations certain expenses incurred in the United States are allocated or apportioned to foreign branch income, dividends, interest, royalties, etc., so that the foreign tax credit is reduced even though the actual tax may in fact equal or exceed the U.S. effective rate. The net effect, of course, is tantamount to the disallowance of a U.S. expense deduction which results in additional U.S. tax and double taxation on the foreign source income. A few examples of what business is presently facing illustrate this point.

The regulations treat money as “fungible” and accordingly U.S. interest expense is allocable to all income and therefore would be apportioned to foreign source income. Thus, if the U.S. parent corporation borrows money for domestic plant expansion, part of the interest expense is apportioned to the dividend income from a foreign subsidiary—even though the subsidiary itself has interest expense related to its own activities. Similarly a U.S. charitable contribution to the Topeka, Kansas Boy Scouts may be offset against the income from a branch in France although the “French Connection” would hardly be apparent to management of either operation.

Research and development expenses have long been encouraged under the tax laws in the United States as a major source of continued economic growth. There is no disagreement that a portion of R&D should be charged against foreign source income based on the use of the outcome of such research and generally in such cases a fee or royalty arrangement
would be instituted. The regulations, however, require that current R&D for which no charge can be made be apportioned to current foreign source income - even though the benefits have not been realized abroad and, in fact, may never be. It is ironic that under this provision it might be advantageous for a U.S. multinational to conduct its R&D abroad in order to avoid the U.S. tax impact. Cost sharing arrangements might also become more common with consequent reductions in U.S. income and tax revenues. The benefit of intangibles developed unfortunately would no longer be under U.S. control. Recent increases in foreign income tax rates might also accelerate movement abroad of certain activities to reduce overall tax expense and it is unfortunate that the 861 regulations give encouragement to this trend.

Conversely, foreign corporations having U.S. branches will be able to use the regulations to reduce U.S. source income. Not only will U.S. revenues fall but increasing attention must then be given to these companies by the Internal Revenue Service.

The new regulations are effective starting with 1977 so that business and the Internal Revenue Service now face a decade or so of confusion and controversy. If, in the meantime, immediate taxation of foreign source income becomes a reality the allocation and apportionment provisions will be applicable to a greatly expanded concept of foreign source income with increased possibilities of loss of credits for taxes paid and resulting double taxation.

Some companies, using computer programs because of the complex calculations, have determined that under their present operations substantial reductions in foreign tax credits may be expected under these regulations which, of course, did not have to be reviewed by Congress.

Transfer Pricing and Disclosure

Prior to the 861 regulations, probably no matter has been more difficult in international fiscal affairs than intercompany transfer pricing. Critics have largely assumed that multinationals have been able to frustrate national policies relating to taxation by transferring goods, services and technology at fictitious prices. On the other hand, organizations such as the International Chamber of Commerce have taken the view that modern business is much too complicated to be run by a back-door tax department. Prices are affected by the market place taking into account such factors as availability of resources, trade barriers and regulations, competition, local customs, nationalism, etc. Accordingly, there should be no set rules relating to intercompany pricing such as markup percentages, return on capital, or other rigid standards. “Arm’s length” pricing should be the general base, and deviations therefrom should be explained or determinations satisfactorily supported where no ready market exists. This presumes that the authorities will have full access to essential data and that cooperation will be maintained between governments, including exchange of information. On this basis business has been cooperating with the Organization for Economic Cooperation and Development (OECD) as it attempts “to produce a manual for use by tax inspectors and private firms relating to transfer prices and thus to introduce greater consistency in practice for fixing the prices for goods and services in intra-firm transfers.”
Up to now the explanations and supplying of data on inter-company pricing have largely been between company representatives and examining agents on a confidential basis. Starting with 1977 this will change—particularly for U.S. multinationals. On June 21, 1976, the member countries of OECD, including the United States, adopted a Declaration on International Investment and Multinational Enterprises which contains guidelines for responsible business practices. These guidelines provide that enterprises should cooperate with taxation authorities and that they refrain from “transfer pricing which does not conform to an arm's length standard.” To assist tax authorities and other interested parties disclosure of “the policies followed in respect of intra-group pricing” should be included with the annual financial statements. Although the guidelines are voluntary many of the governments involved have urged their multinational corporations to comply with the disclosure provisions. However, in view of the timing very few corporations—including U.S. companies—referred to transfer pricing policies in their 1976 annual reports.

While multinationals of other countries are considering whether to even comment on intercompany pricing for 1977, U.S. corporations have no choice. Under the recently adopted Financial Accounting Standards Board Statement No. 14, for reporting for segments of a business enterprise, the basis of accounting for intra-enterprise sales or transfers must be disclosed. The Securities and Exchange Commission is currently engaged in revising its disclosure rules to coordinate with the FASB requirement and is considering expanding the intra-enterprise data to include “the relationship between the per unit dollar amounts at which the intra-enterprise sales/transactions were reflected and the per unit dollar amount of sales to unaffiliated third parties of identical products or services.” Thus, in a few short jumps, U.S. business will move from relatively informal discussions explaining transactions with related companies to mandatory requirements for a full blown treatise on intra-enterprise pricing spread out in its annual report. If the U.N. Group of Experts has its way ultimately international business will be faced with even greater demands in this regard. From a selfish view at least U.S. controlled companies would not then be in a unique position.

Naturally corporate executives are concerned about the expanding disclosure area. It will be extremely difficult to set forth adequate explanations of pricing for many corporations engaged in multi-country production, sales, research, service functions and the like. In addition to the potential tax problems involved in the disclosure provisions, both in the United States and abroad, legal counsel are faced with the thorny issue of how the U.S. antitrust and other laws apply to American companies operating abroad. In any event once more the costs of creating foreign income have been increased for U.S. corporations.

### Anti-Boycott Legislation

At the Tax Foundation meeting two years ago William Simon, then Secretary of the Treasury, deplored the fact that the U.S. Internal Revenue Code and regulations amounted to several thousand pages. “Enough already” was his plea but Congress and the Internal Revenue Service grind on—particularly in the foreign.
income area. In what to most businessmen is a complete aberration, the Tax Reform Act of 1976 introduced a new concept in the form of anti-boycott legislation. In essence, if a taxpayer, or any member of its controlled group, agrees to participate or cooperate with an international boycott (other than good boycotts against Cuba or Rhodesia, for example, sponsored by the United States) the following tax penalties will accrue:

1. Foreign taxes paid with respect to boycott income will not be allowed as a credit.

2. Boycott income earned by a controlled foreign corporation will be taxed to the U.S. shareholders immediately and the foreign taxes paid

Export Incentives (DISC)

Since 1972, the U.S. Tax Code has contained a limited tax incentive to foster the export of U.S. made products, i.e., the Domestic International Sales Corporation (DISC) provisions. It was conceived as a means of enabling U.S. companies to compete in foreign trade with the multinational enterprises of other countries, by partially neutralizing their export incentives, whether given directly or through tax provisions having the same economic effect. To avail itself of the DISC benefits, a U.S. enterprise has to establish a separate corporate entity which, although domestically incorporated, would be treated for U.S. tax purposes more in the nature of a foreign subsidiary not engaged in a U.S. trade or business. Thus, its income would be untaxed, but its parent corporation or shareholders would be subjected to tax on distributions (or deemed distributions) from the DISC. The original legislation provided that one half of the DISC's annual taxable income would be considered distributed, whether or not dividends were in fact paid, in addition to which any distributions in excess of the annual deemed distribution would constitute taxable dividend income to the shareholders.

Key to the DISC concept was the notion of a deferral of tax, rather than an outright exemption from tax. It was believed this principle avoided the DISC concept from being in contravention of the export subsidy prohibition of the General Agreement on Trade and Tariffs (GATT).* Deferred DISC income would only retain its deferral privilege by continuing to be invested in export related

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*In November 1976, a special GATT panel of experts found DISC to be in violation, although many commentators believe the finding to be unsupported by the facts and sound argument of law.
assets, including loans to other domestic companies for the financing of export facilities, export inventories and export related research and development.

Incremental Approach

The 1976 Tax Reform Act substantially eroded the limited incentive for exports. By placing DISC benefits for 1976 and future years on an incremental basis, and using as a base period years for which the DISC provisions were encouraging exports, the benefits for those companies who took advantage of the DISC provisions in the early days of the program have been substantially diminished. Thus, those who contributed most to the U.S. balance of trade in the first half of the 1970's will now be penalized. Only enterprises with little or no export activities to date, those who chose not to utilize the DISC benefits, or those with still expanding export activities, will be in a position to enjoy any substantial DISC benefits in the future. Ironically, taxpayers with firmly established export operations, many of which arose perhaps in response to the original DISC legislation, will in effect be subsidizing their competitors who may just be entering the export field. Ultimately, of course, benefits will be phased out for all taxpayers as increased exports in a current year will enter into the base period calculations for future years, thus offsetting future deferral opportunities.

Evaluation

Throughout its short history, the DISC provision has been controversial to say the least. It has been variously referred to as an undesirable and costly tax gimmick, as an anachronism which is counterproductive in a world of flexible exchange rates, as an important tool in shoring up the competitive position of U.S. exports and as a trading chip for multinational trade negotiations. The principal argument against the DISC is that it is no longer necessary under floating exchange rates which will, the argument goes, automatically maintain equilibrium in our balance of payments without the necessity of tax incentives. This argument, however, generally assumes two premises: first, that the exchange rates are truly free-floating; and second, that our trading partners are generally subject to the same type of taxing system as U.S. companies. One only has to look at the European managed float to question the first assumption, and again to the European taxing systems with their incentives to capital and increasing percentages of total revenues from indirect taxes, to worry about the second assumption.

Another argument against the DISC is that it costs too much in terms of deferred tax. However, to the extent that exports have increased, the revenue cost to the government is offset by the increased tax revenues resulting from the increased export income. Thus, for every $1 billion volume of increased exports resulting from the DISC provision, the additional tax revenue derived from the exporting corporation itself would be $53 million on the $147 million of additional export profit using the 14.7 percent return as expressed in the 1977 Treasury Report; not to mention the additional taxes on the $853 million of costs which would represent, to a great extent, taxable income in the form of compensation paid to employees producing the added exports. It is not possible to calculate, however, what portion of the total U.S. exports would have been replaced by foreign production had there been no DISC legislation. Supplying the Common Market from the Republic of Ireland, for example, provides exemption from Irish Corporation Tax and it is no coincidence that there is a marked increased in such ventures by
U.S. companies since the ill-fated changes of 1976.

In the meantime it appears that business support for the DISC concept will gradually diminish. The incremental basis coupled with the horrendous complexity of the qualifying rules may well result in decreased emphasis on export activities. Regrettfully the export incentive cornerstone has been vandalized. It is hoped that no further chiseling will be performed and that tax policy in this important area be seriously reconsidered under present economic conditions.

U.S. Citizens Abroad

Earned Income Exclusion and Foreign Tax Credit

Early in the history of our tax law, U.S. citizens living and working abroad were not taxed on any of their income earned from services rendered abroad, although they continued to be taxed on all unearned income as well as U.S. source earned income. Even this seemingly liberal treatment was more onerous than that accorded by other nations (both then and now), who do not tax their citizens residing outside their national boundaries except to the extent of local income (i.e., the guiding principle of these other nations is to tax all nonresidents alike, irrespective of nationality). In 1962, the U.S. restricted the tax regime of nonresident citizens by placing ceilings on the amount of foreign earned income which could be excluded from the U.S. tax base—$20,000 per annum, rising to $35,000 after three years of foreign residence. The $35,000 top ceiling was reduced to $25,000 in 1965. In addition to the exclusion, a U.S. citizen abroad was entitled to offset his foreign tax liabilities against the U.S. tax attributable to his foreign source income, under the normal U.S. foreign tax credit rules. Accordingly, it was rare that such an individual would incur additional U.S. tax on his overseas income, both earned and unearned, and thus the U.S. treatment achieved some degree of neutrality and conformity with acceptable international principles while at the same time generally adhering to the principle of taxation on a citizenship basis.

Tax Reform Act of 1976

The Tax Reform Act of 1976 unfortunately abandoned all attempts at neutrality. U.S. citizens abroad were to be taxed more heavily than both their local colleagues and even their counterparts back home.

First of all, the exclusion was reduced to $15,000 (except for employees of certain charitable organizations where the ceiling was fixed at $20,000). This amendment results, for many expatriates, in an increase in taxable income of as much as $10,000, or an additional tax of $5,000 for an employee in the 50 percent tax bracket.

Secondly, the excluded $15,000 is to be included in income for the purpose of determining the tax bracket on the remaining income. Thus, the $15,000 excluded no longer results in a saving at the employee’s top tax rate but at the lower brackets on the first $15,000 of taxable income (which is about $3,000 for a married couple). This change could cost an employee in the 50 percent tax bracket an extra $4,500 ($7,500 less $3,000) which together with the tax cost of the reduction in the exclusion of $5,000 above would result in an additional burden of $9,500.
A third amendment disallows as a foreign tax credit those foreign taxes that are attributable to the $15,000 of excluded income. This provision appears particularly inequitable when coupled with the tax bracket change. In fact, the total extra tax costs could well result in making the expatriate citizen feel like taking Freddy Laker's next plane home and going directly on welfare.

Reimbursement Plans

Today, however, most large U.S. based multinational enterprises defray many excess costs including income taxes which invariably result when a U.S. citizen is stationed in a foreign duty post. Under the normal arrangement the employee, in effect, pays no more tax because of a foreign assignment than he would have paid had he remained at home. Accordingly, allowances designed to cover the various cost-of-living differentials, including housing and educational costs, are reimbursed free of tax. While the employee may be satisfied, the corporation, of course, bears an extra cost only because it retains U.S. citizens on its foreign payroll.

That it is frequently in our economic advantage, however, to have U.S. citizens abroad promoting export sales, directing service functions and controlling technology must be recognized. It is this aspect that has largely resulted in Congress postponing the effective date of these amendments from January 1, 1976 to January 1, 1977 in the 1977 Tax Reduction and Simplification Act. At the moment, preliminary legislative action has commenced to further roll back the effective date of these changes to January 1, 1978, and it is understood that the Carter Administration is sympathetic to this additional one-year postponement.

Current Perspective

In the meantime under the proposal sponsored by Senator Ribicoff the blanket exclusion would be phased out to be replaced with a series of special deductions to reflect employer-reimbursed allowances designed to cover differentials in living costs between the U.S. and the foreign duty post. The underlying premise is to segregate, for tax purposes, what is intended to be compensation to the employee from amounts which are clearly noncompensatory in nature. Ideally, the host country would also exclude from income, or permit deduction for, noncompensatory payments to foreign employees temporarily residing in their jurisdiction, as recommended in a resolution adopted by the 1974 Congress of the International Fiscal Association in Mexico City. Inasmuch as there is little possibility of increasing the current exclusion, it is believed that the business community would be prepared to accept a U.S. tax package which couples the complete repeal of the earned income exclusion with a system whereby the expatriate American is subjected to U.S. taxation only on items received which represent true compensation for services rendered together with appropriate allowance for foreign tax credits.
Conclusion

At the present time, the basic tenets of U.S. taxation of international business are again being seriously questioned. Recent proposals for change range from immediate taxation of all foreign earnings without credit for foreign taxes paid to limiting the foreign earnings of taxpayers investing in “tax-holiday” countries or “runaway plants,” or to, in any event, construing a portion of foreign earnings taxable whether distributed or not. All such proposals would ultimately serve to reduce the competitive position of U.S. businesses abroad to a greater or lesser degree.

U.S. companies located abroad must have similar business climates to their foreign counterparts. If earnings were subject to U.S. tax, whether or not distributed, the cost of doing business would increase to the extent the foreign effective rate is lower than the U.S. rate. The resulting loss in competitive position could well mean a decrease in taxable income in the United States and a need for additional investment abroad. Forced dividend distributions would only enrich foreign treasuries through the premature payment of withholding taxes.

The United States cannot unilaterally curb the practice by foreign countries of granting tax incentives they consider necessary or appropriate. If they distort normal economic decisions by establishing improper inducements, the more appropriate remedy would appear to be through bilateral action under the GATT rules or treaty negotiations. The United States should not give up economic benefits presently available to its investors without attempting to secure other advantages in the bargain.

In the meantime the tax systems of many industrialized countries have responded to the economic pressures of recession and inflation. The enlarged Common Market is relying more heavily on indirect taxation as a result of the value added tax. Their exports, accordingly, bear a smaller proportion of the cost of general government than in the United States and encouragement is given to saving and investment. The capital cost recovery allowances of other developed countries are also generally more favorable—and even then the U.S. allowances are under attack. We generally tax capital gains more harshly and in proposing additional taxes wonder why the securities market reacts unfavorably. France, Germany and England as well as many other countries extend, in whole or in part, the benefits of corporate tax payments to the shareholders, thus substantially encouraging capital accumulation and investment. In the U.S. unfortunately the fire under the elimination of double taxation burning brightly a few months ago appears to be turning into ashes. As Wilbur Mills, former Chairman of the House Ways and Means Committee, stated in the 1970 Trade Hearings, “if the United States does not take action to eliminate the disadvantages facing our producers we might end up selling insurance to each other.”