Thinking About Subpart F: The Domestic Base Company

By
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Present law effectively declares that the income of a controlled foreign corporation having no foreign ownership will eventually be subject to U.S. tax. The tax, however, is "deferred" in most cases until the income is brought back to the United States. Such deferral is generally the rule when the income of the controlled foreign corporation (CFC) derives from an active business, and there are various other circumstances (high foreign taxes, certain prior year or affiliate losses, *de minimis* tainted earnings) where current taxation is inapplicable. Thus, it can reasonably be maintained that deferral, not current taxation, is the norm for CFCs.

When CFC income does become subject to U.S. tax, a foreign tax credit is granted in order to mitigate or eliminate international double taxation. If the credit is in excess of U.S. tax on CFC income, it can be used (with various limitations) to offset U.S. tax on other income. In practice, the statutory rules make deferral tantamount to exemption—or what is doubtless better from the standpoint of taxpayers, a periodic choice between exemption and taxation *cum* foreign tax credit.

It is true that subpart F is intricate and that some taxpayers may fall within its provisions inadvertently. But the tax base here is income from foreign investment, and most persons who make such investment are well aware of the rules, or at least capable of finding and taking advice from persons who are well aware of the rules. Inadvertent taxation, though possible, is probably rare.

Subpart F affects a limited number of taxpayers. Statistics of Income published by the IRS show that, as of 1998, the known universe of controlled foreign corporations consisted of about 46,000 entities owned by approximately 1,750 domestic corporations. Doubtless there were other CFCs owned by individuals as well as a group that did not bother to register with the IRS, but these numbers nevertheless stand in contrast to the 4.85 million domestic corporations that filed tax returns for 1998.

The statistics suggest that the United States collects less than $1 billion in tax each year on non-passive subpart F income, and perhaps another $1 billion in tax on subpart F income that is passive. These are hardly large sums in the overall scheme of things. It is difficult to understand, on the basis of such numbers, why reform of subpart F is so frequently and earnestly discussed.[1]

The answer must be that the statute, without actually resulting in substantial taxation, constrains

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certain activity that taxpayers would like to engage in. What is that activity? Almost certainly it is activity with a purpose to reduce all taxation, U.S. and foreign, by deflecting income into jurisdictions that impose no or little tax. The present statute really does leave untouched a vast amount of income production, both actual and planned. But it reflects a position that certain activity in low-tax and no-tax jurisdictions that cannot be shown to have an economic nexus to those jurisdictions through local sales, manufacturing or services should be subject to U.S. tax on a current basis. Since there is little of that activity today, the gist of the debate must be that taxpayers want to have more of it in the future and that subpart F stands in their way.

Within the contours just outlined, a principal focus—I would say "the" principal focus—is sales activity. A prime target of those who would "reform" subpart F is the foreign base company sales rules of section 954(d) of the Internal Revenue Code. Whether doing away with those rules is an appropriate tax policy choice for the United States in 2004 is a difficult question but, reflecting on it, I am struck by two impressions from the current debate:

- Many of the debaters do not really address the question.
- There appears to be no reason why the discussion of subpart F should be confined to subpart F.

On the first point, call it the narrowness of my professional training but I cannot overcome the notion that taxation requires rules. It simply is not sufficient to propound concepts and theories and leave the rules to write themselves. Thus, I believe the subpart F debate should focus on whether to retain or discard the foreign base company sales rules, why any proposed new rules are the right rules, and what behavioral consequences would follow if those right rules were adopted. Since it cannot reasonably be argued—in any event, I have yet to hear anyone so arguing—that subpart F "reform" is about something other than tax havens, I think the "reformers" of subpart F should address, frankly and directly, why it is desirable for the United States to exempt tax haven income.

On the second point identified above, I wonder whether, and why, there is any reason for U.S. policymakers to favor foreign activities over activities in the United States. The proposed "reform" of subpart F entails exemption for certain specific types of income when that income is earned by a foreign corporation and attributable to activities taking place abroad. This seems odd. Those who would amend subpart F commonly point to the enactment of the statute more than 40 years ago and the myriad of ways in which the world has changed since that time. Surely they are equally aware that communications today permit the more or less instantaneous formation of foreign entities and that substantial elements of value no longer require bricks, mortar or human beings. An eyeblink is all it takes to lodge substantial intangible values in a foreign corporation. In these circumstances, why should the United States embrace exemption only for income earned in tax havens—in Hamilton, Nassau, Singapore, Hong Kong? Not altogether facetiously, I have asked: why not Des Moines?[2] If we find it appropriate to provide exemption for a slice of income when the income is earned outside the United States, why should precisely the same income be taxable when it is earned inside the United States? Why is it not necessary, perhaps even preferable, to provide exemption in the latter case?

When I posed questions of this sort at the University of Chicago Tax Conference in November, there were two immediate objections of substance. First, I was proposing "a race to the bottom" or, as I interpreted the objection, a *reductio ad absurdum*. And second, I was effectively proposing abolition of the corporate income tax in favor of some kind of consumption tax.

But neither of these objections is valid. In fact, each is reflective of deeper perceptions and beliefs that are at work in the subpart F debate. I was not trying to propose an absurdity. My suggestion was simply that if a slice of income assigned to an economic function in Bermuda merits exemption, the same slice of income assigned to the same economic function in the United States should, at least presumptively, also merit exemption. That is not an absurd point of view, nor does it proceed so radically beyond proposals to eliminate the foreign base company sales rules as to represent a quantum leap toward a ridiculous result. In fact, when one thinks about a domestic base company concept, the suggestion that it verges on the absurd has interesting implications: that some persons perceive a qualitative difference in economic functions that take place across the waves (water, not amber grain). Why is that? In a "globalized" world, is it not now all one and the same? There is nothing inherently unique about an economic function that purports to be conducted abroad by a foreign corporation. If the income from that function merits its exemption, the burden should be on proponents to explain why the exemption should apply only in such limited circumstances.

A base company exemption, domestic as well as foreign—or, perhaps, domestic instead of foreign—might be a viable substitute for the goofy extraterritorial income (ETI) provisions that have been found unacceptable by the World Trade Organization.

The base company idea can surely be structured so that it is not focused on exports, as indeed it should not be, since the competitiveness argument that allegedly justifies exemption for foreign base companies presumably applies equally in the United States. True, a base company proposal can be challenged as a benefit to only certain sectors of the economy—those in a position to benefit from a base company—but that is hardly different from recent proposals to apply a different (and lower) tax rate only to manufacturing income. And while it may be observed that exemption for all base companies approaches an across-the-board reduction in the corporate tax rate, that hardly amounts to an indictment. Assuming (as policymakers and politicians seem to assume) that the ETI regime must be replaced with some kind of tax reduction, a straightforward rate reduction might be simpler, fairer, more efficient, and generally better than identifying a particular slice of income to exempt. None of these observations, in my view, even begins to defend an exemption for foreign base company income and only for such income.

The second objection made at the Chicago conference, that a domestic base company exemption would represent a step toward abolition of the corporate income tax, is true, but only in the limited sense that elimination of any income tax burden on corporations can be so characterized. One of the grand fallacies in tax analysis is that a step pointing in a given direction necessarily implies acceptance of all next steps in the same direction. Imposing a normal tax on income from exports equates to deterring exports. Limiting the deduction for mortgage interest represents opposition to home ownership. What nonsense. In a rational world, the United States should be capable, if it chooses, of adopting policies that take a midway position between extremes. Exempting the domestic base company does not necessarily imply abolition of the corporate income tax any more than reducing the corporate tax rate bears such an implication. An exemption of base company income, foreign and domestic, could arguably be justified on the narrow ground that it would redress a competitive disadvantage presently suffered by U.S. taxpayers. There is no implicit need, in the proposal, to go further, and certainly not so far as abolition of the corporate income tax.

So what is the problem with the idea of exempting income of domestic base companies either in addition to the income of foreign base companies or, conceivably, instead of the income of foreign base companies? There is, of course, the revenue cost. It may be asked, however, whether revenue cost represents an adequate justification for a distortive provision—one that favors certain economic functions only when they are carried on offshore. Such a provision would seem to benefit only taxpayers having the means and knowledge to form a CFC while leaving identical income, from functions performed in the United States, fully taxed. Something other than income is being taxed here—perhaps ignorance?

The other problem with the domestic base company idea is definitional. Base company sales income, under subpart F, is income from either buying from or selling to a related party when the property bought or sold is not manufactured by the CFC and neither manufactured nor sold in the country where the CFC is incorporated. Subpart F thus does not reach (1) income from selling property manufactured by the CFC; (2) income from sales of property in the country where the CFC is incorporated; and (3) income from sales of property manufactured in that country. Should the domestic base company concept extend to such income as well as the income that, if earned by a controlled foreign corporation, would presently be reached by subpart F?

The beacon here should be competitiveness, since it is competitiveness on which any "reform" of subpart F must rest. Other countries allow *their* multinationals to situate a slice of income in tax havens without currently taxing that income. This gives those companies an advantage over U.S. companies in the marketplaces for goods and capital.

The advantage, if it exists, should not logically be limited to marketplaces outside the United States. If Japan tolerates exemption for a slice of income when property is sold in Australia, presumably it tolerates exemption for the same slice of income when property is sold in Chicago. The U.S. competitor, fully taxed when it remains in the United States and subject to subpart F when it would emulate the Japanese company, stands in a worse position.

It follows, I think, that a domestic base company concept must apply to a U.S. company that buys from or sells to a related party with either manufacture of the property in question or its sale in the country of incorporation—that is, the United States.

But what about the situation where *both* manufacture and sale take place in the United States? This presents a harder question because it is not clear that there is a realistic competitive threat in this case. One can imagine a U.S. affiliate of a Japanese company manufacturing in the United States and selling to a sister company in the Bahamas for eventual resale back into the United States. The question, however, is whether transfer pricing rules—U.S., not Japanese, rules—would be up to the task of rendering this exercise insufficiently profitable to be worth the effort. Notwithstanding an abiding skepticism about the effectiveness of our much touted transfer pricing regime, I think the present rules should be able to neutralize the contortions described above, even if real processes of some kind take place in Nassau. Given the additional revenue cost of extending the domestic base company concept to a manufacture-and-sell case, I would be inclined to take a chance here. But developments could, I acknowledge, prove that to be an overly optimistic choice.

The case involving manufacture by the seller should also be excluded from the domestic base company regime. Subpart F does not reach sales of property manufactured by a CFC, for two reasons: (1) the statute does not apply to property manufactured in the CFC's country of incorporation; and (2) the statute applies only to a purchase of property and "its" resale. When a CFC purchases property, manufactures it, and resells it, the statute will not apply on either or both of these grounds.

Here again, the guiding principle in the domestic base company context should be competitiveness. A prototypical base company is a distributor, buying product and reselling the same product, with a related party on one side or the other. The domestic base company would, in the first instance, mirror that description. But should the exemption also apply to a domestic company engaged in manufacture? My sense is that it need not. Under present law, manufacture is something CFCs engage in (barely), whether through their own efforts or those of a contract manufacturer, in order to remove themselves from subpart F. But that is because they are endeavoring to fit into a recognized statutory exception to current taxation. In a regime for exemption, not current taxation, any company could easily avoid manufacture and lodge in a domestic distributor elements of value not including a return to manufacturing. Another way of putting the point is that I suspect that the manufacturing function does not lie at the heart of the competitiveness issue.

The proposal of a domestic base company would, of course, place enormous pressure on the rules governing transfer pricing. But that cannot be an adequate response to the proposal because eliminating the foreign base company sales rules would do the same thing. If the fragility of the transfer pricing rules is a concern, "reform" of the foreign base company sales rules presents the same concern—perhaps even a greater concern, because it is surely easier to police activity within U.S. borders for transfer pricing issues then to pursue those issues abroad. In fact, the transfer pricing concern might justify an exemption for domestic base companies as a replacement for, rather than a complement to, an exemption for foreign base companies.

The foregoing thoughts and observations should provide at least some useful additional grist for the subpart F mill. Whatever the course of the debate, it is hard to understand how the prospect of exemption for tax haven income and the concept of a domestic base company can be ignored by those who would "reform" the present statutory rules.

ENDNOTES

[1] For example, the 56th Annual Federal Tax Conference of the University of Chicago Law School devoted a substantial portion of its first morning to this specific topic.

[2] *"Why Not Des Moines? A Fresh Entry in the Subpart F Debate,"* TAX NOTES INT'L, Dec. 8, 2003, at 895.