International Tax Grows Up: The Tax Section at 75, Subpart F at 53, and the Foreign Tax Credit at 97

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As the Tax Section celebrates its 75th anniversary, I was asked to reflect on the Section's contribution in the international tax arena and on how the Section's international community has grown. I started by recognizing the number years that such reflection needs to cover: In 2015 the foreign tax credit will be 97 years old, and Subpart F of the Code will be 53 years old; I am celebrating the 39th anniversary of my first cross border tax project, and I've been involved in the international committees of the Tax Section for more than half of that time. Although reflecting on the changes wrought over so many years is daunting, it has also been quite interesting.

Ruminating on the changes in the Section's involvement in international tax caused me to think about the changes in the practice of international tax overall. My first cross border project gave me a very visceral feel for the foreign tax credit. It was 1976, and the issue was the amount of credit that the taxpayer could claim. But, it wasn't an esoteric question of whether the tax had been separated from the income, the correct identity of the taxpayer, or even if it was a creditable tax. Rather, the taxpayer had collected receipts from customers who had withheld tax on interest payments on loans and had kept them in cardboard boxes. The receipts were frequently beautiful, with bows, ribbons, and wax seals. But they weren't in English, and the agents required that each receipt be matched, physically, to the specific underlying loan in order to claim the credit. Given the status of IT systems in 1976 that was certainly a challenge, but it was hardly sophisticated tax planning. Fast forward to foreign tax credit planning in the 1990s and 2000s and nobody was looking at matching paper to paper. The planning involved the sophisticated use of structured financial and business arrangements that required the involvement of multiple parties.

Similar changes have occurred in the area of deferral. Having lost the bid to end deferral altogether, the Kennedy administration accepted the introduction of Subpart F, sections 951-959,[1] to try to capture some of the offshore income that was subject to low tax. In my view, the early years of Subpart F were not terribly impactful because much of foreign income was being subject to non-U.S. taxes that were higher than the U.S. corporate tax rates,

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[1] All references to a section are to the Internal Revenue Code of 1986, as amended.

and we had a number of foreign tax credit planning tools, including what was referred to as the "rhythm" method of calculating the foreign tax credit (annual determinations of income and earnings and profits, with the ability to defer one or the other) and the overall (as opposed to country by country) foreign tax credit. Both facilitated tax planning.

But the world changed in the 1980s.[2] The discussion on the principles of international tax moved from capital export neutrality to competitiveness of U.S. companies in the global market place—capital import neutrality. The 1986 Act[3] gave us the expansion of the Subpart F regime, the "basketing" of income for foreign tax credit purposes, the PFIC regime, and the "super-royalty" provisions of Section 482. More taxpayers had to pay more attention to the global taxation of their businesses, and more advisors were needed to navigate the very new world.

The 1980s also brought considerable changes to the "inbound" taxes—the taxation of non-U.S. persons. Prior to 1984 U.S. multinationals borrowed money by issuing "Eurobonds," so called because they were issued to non-U.S. investors through an issuance in Europe. But there was a problem—if the bonds were issued directly by a U.S. corporation, the interest paid would have been subject to the 30% tax imposed by sections 871 and 881, and that would have made the bonds too expensive to issue as the purchasers would have wanted the interest to be grossed up for the taxes. To manage the issue, the U.S. corporation would set up a Netherlands Antilles subsidiary, which would actually issue the bonds, and the Netherlands Antilles subsidiary would lend the proceeds to the U.S. corporation. Under the U.S.–Netherlands Antilles treaty, the interest paid by the U.S. company to the Netherlands Antilles company was free from U.S. tax, and the interest paid by the Netherlands Antilles company to the investors was foreign source and therefore not subject to tax under sections 871 or 881. So long as the Netherlands Antilles company was properly capitalized and the operations were run correctly, the structure worked.

The fact that the structure worked made Congress and Treasury start to look at the use of treaties to eliminate statutory taxes, but there was also a realization that there was a need to support foreign investment in the United States, so section 871(h) was introduced, giving us the portfolio interest exemption.[4] Once there was an exception to the 30% tax, much planning was needed to use it. International tax practice and the number of practitioners continued to grow.

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[2] For a review of the history of the changes in U.S. international tax rules, see Reuven S. Avi-Yonah, *All of a Piece Throughout: The Four Ages of U.S. International Taxation*, 25 Va. Tax Rev. 313, 313-18 (2005), *available at* http://repository.law.umich.edu/articles.

[3] Tax Reform Act of 1986, Pub. L. No. 99-514, 100 Stat. 2058.

[4] As an aside, I have always found it curious that portfolio interest was tied to the termination of the Netherlands Antilles treaty, when it appeared to me in 1984 that the exception was really needed to allow the U.S. government to facilitate its issuance of debt to non-U.S. persons. The treaty issues seemed to be a convenient excuse for the change in the law.

During the 1980s and 1990s, source taxation became more important as the financial markets became global, and we learned to deal with the cross border products that our banking brethren were creating. This led to an increasing emphasis on the use of tax treaties. Then in 1997, we had what to my thinking was the most significant change in the international area in my years of practice—the introduction of the check-the-box rules.[5] Adding this election to the tool box of a tax professional was like opening Pandora's Box. And it required, as in 1986, rethinking historic means of doing business to manage the global tax position of a company.

As the international tax area grew, twisted, and exploded, advisors needed a forum in which to discuss the issues not only with other practitioners but also with governmental personnel. The Tax Section provided that forum. Today, there are four committees that are focused on international tax:

- Foreign Activities of U.S. Taxpayers (FAUST)
- Foreign Lawyers Forum (FLF)
- Transfer Pricing (TP)
- U.S. Activities of Foreigners and Tax Treaties. (USAFTT)

The growth of the committees has paralleled the explosion of growth in the practice area. Until 1978, there was one international committee called simply Foreign Tax Problems. In 1978 that committee was divided into FAUST and USAFTT—outbound and inbound. In 1980 FAUST had about 90 members and USAFTT had about 125. In 2010 FAUST had 522 and USAFTT had 472. The biggest jump in membership came in the early 2000s, not surprisingly (to me) corresponding with the adoption of the check-the-box rules and the significant changes in the foreign tax credit area.

In 1997, principally through the efforts of Elinore Richardson, a Canadian tax lawyer who was very active in the Tax Section, FLF was formed. This gave non-U.S. tax professionals an official place at the table, recognizing that cross border tax planning really required an integration of U.S. and non-U.S. laws. The Tax Section was at the forefront of that integration. And in recognition that transfer pricing is at the heart of all international tax matters, in 2001 the TP committee was formed, moving the topic from the Affiliated and Related Corporations Committee. This gave the Section the four corners of the practice—inbound, outbound, foreign law, and transfer pricing.

I had the pleasure of being introduced to the USAFTT committee in the 1990s, and through the outreach of N. Susan Stone, who was then the chair of the committee, was welcomed as an active member. It was quite the time to join the committee—Treasury and the Service were in the throes of the overhaul of the withholding tax systems of sections 1441 and 1442, and there was a meaningful opportunity to work with government personnel as we prepared

[5] The entity classification regulations, Regulation section 301.7701-3.

panels for Section meetings. To this day I hear John Staples'[6] voice in my head when I think through a section 1441 question.

The consistent interaction of private practitioners and the government personnel is the hallmark of the committee CLE sessions. There are often spirited discussions, and the government's view of issues is crucial to practitioners. For as long as I can remember we have had the active input of the office of the Associate Chief Counsel International and Treasury on panels and as speakers at our lunch sessions.

The Section outreach goes beyond the three annual Section meetings and beyond the shores of the United States. In 2001, through the efforts and vision of Elinore Richardson and the late Christine Brunswick, then Executive Director of the Tax Section, the Section, together with the Taxes Committee of the International Bar Association (IBA), hosted the first international tax conference in Amsterdam, the Netherlands. Now entitled *Tax Planning Strategies – U.S. and Europe*, that conference has moved to a different European city each year, and this year will be held in Munich, Germany. In addition to the IBA, cosponsors of the conference now include the USA branch of the International Fiscal Association (IFA) and the Tax Executives Institute, Inc. (TEI).

The conference provides for the examination and discussion of current tax topics that are crucial to the tax planning of companies that operate on a multinational basis. Authorities of the tax administration of various countries and the OECD are frequent speakers, and the conference has gained a reputation for being an excellent resource for those involved with tax planning for multinational companies.

In addition to the European focused conference, in 2008 the Section presented the first annual *U.S. – Latin America Tax Planning Strategies Conference* in recognition of the need to focus on the growing area of Latin America. Held annually in Miami, the eighth LATAM conference will take place in June 2015. This conference is also cosponsored by the Taxes Committee of the IBA, the USA Branch of IFA, and TEI. TEI also plays a significant role in planning this conference, particularly in the half-day workshop for in-house tax advisors that precedes it. While the Tax Section members bring the U.S. view to the conference, for many of us the draw is the ability to gain insight into the laws and practices in Latin American jurisdictions. The conference therefore fulfills a need for Tax Section members.

In both the European and LATAM conferences, networking plays a large role. It is impossible to practice "international" tax in a vacuum, and the conferences provide a community within which to work. For those of us who work in firms that do not have a global reach, participation in that community is crucial to being excellent practitioners.

The most recent addition to the international conferences is the International Tax Enforcement Conference. It was developed at the urging of Scott Michel,

[6]Former Assistant Chief Counsel International.

as he saw the need to examine how taxpayers are treated on a global basis when it comes to enforcement, and benefitted from the significant input of Michael Danilack, the then Deputy Commissioner-International of LB&I. For practitioners in the international area, that conference provided an opportunity to gain firsthand knowledge of the changes at LB&I that would impact their clients. I think of it as the "conference that could."[7] The first conference was in 2012 in Manhattan, right after Hurricane Sandy and in the midst of a snow storm, but it made it over the hill. The second conference was scheduled for 2013 but was postponed in part by the government shut down; it was successfully held in March 2014. The 2015 ITEC is being scheduled as this is being written.

In addition to the strong focus on practitioner and government interaction, the Section takes seriously its obligation to provide the government input on the development of tax law and tax policy. The international committees have made significant contributions to that goal. Recounting all of the submissions is beyond the scope of this writing, but there are a few that need to be mentioned. The submissions are in two buckets (or "baskets" for foreign tax credit fans)—submissions on proposed regulations or IRS pronouncements and submissions on policy matters.

In the first bucket, I think of the recent comments on section 987, the foreign currency regulations, which were principally drafted by Paul Crispino and David Golden,[8] and the comments on section 871, which were principally drafted by Matthew Stevens.[9] I had the privilege of reviewing those comments, and it was an incredible learning experience. Both were praised by the Service and Treasury for their thoughtful, balanced, and in-depth explication of the issues.

In the second bucket, recognizing the increasing intensity of the debate on international tax reform, the Section formed a task force to evaluate reform proposals for taxing income of U.S. persons from direct investment abroad and considered a series of modifications to current U.S. outbound tax rules. The task force report that was submitted in 2006[10] discussed the policy objectives of fairness, efficiency, and administrability and the application of those objectives in the international tax context. The task force report then provided separate chapters discussing: (1) U.S. taxation of a U.S. person's foreign business income; (2) alternatives for reform of the international tax rules,

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[7] For those who haven't had the opportunity to read to a child lately, the reference is to the book, *The Little Engine That Could* by Watty Piper.

[8] Section of Taxation, Comments on Proposed Regulations Under Section 987 (2010), *available at* http://www.americanbar.org/content/dam/aba/migrated/tax/pubpolicy/2010/Comments_Concerning_Proposed_Regulations_Under_Section_987.authcheckdam.pdf.

[9] Section of Taxation, Comments on the Taxation of a Dividend Equivalent (2010), *available at* http://www.americanbar.org/content/dam/aba/migrated/tax/pubpolicy/2010/102210comments.authcheckdam.pdf.

[10] Task Force on International Tax Reform, Section of Taxation, *Report of the Task Force on International Tax Reform*, 59 Tax Law. 649 (2006).

specifically exempting foreign income or curtailing deferral of foreign income; (3) entity classification and corporate residence; (4) the foreign tax credit; and (5) reform of Subpart F. Each of the chapters provided background on current law, described policy implications of those rules, and analyzed various proposals for change in law (without making any specific recommendations).

Tax reform in the international area continued to be of acute interest to Congress, and to assist in the conversation, the 2006 task force report was followed in 2009 with an update, reflecting additional analysis, prepared principally by Steve Shay.[11]

In 2014, the Section took a look at the inbound side of the issues and developed a report outlining the options that could be considered to effectuate positive changes in the area, again without making recommendations; the goal was to assist in the education of the policy makers, not to advance the goals of a particular group of taxpayers.[12]

The future for the Tax Section and the international committees won't involve any slowing down. We are now working with transparency in international taxation through the global implementation of FATCA. We see a concerted, coordinated approach to avoiding double nontaxation through the OECD Base Erosion and Profit Shifting project that will have a significant impact on worldwide tax planning. And until we have more serious tax reform, we will continue to have corporate self-help in international planning—the inversions of U.S. companies into foreign parented entities. Then we hope for some form of international tax reform.

As it has done over the past 75 years, I expect the Tax Section to continue to be a significant contributor to the debates that arise in the international tax arena and to provide a community in which members can learn, contribute, and grow as professionals.

[11] Section of Taxation, Statement Regarding Policy of U.S. International Taxation 2 (2009), *available at* http://www.americanbar.org/content/dam/aba/migrated/tax/pubpolicy/2009/090609policyintltax.authcheckdam.pdf. At the time Steve Shay was a Council Director, overseeing the international committees.

[12] Section of Taxation, *Options for Tax Reform in the Inbound International Tax Provisions of the Internal Revenue Code*, 67 Tax Law. 331, 331 (2014).