Brooklyn Journal of International Law

Volume 26 | Issue 4 Article 18

5-1-2001

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I. INTRODUCTION

Leonardo, it is said, was the last to understand all human knowledge. Now the rate of change threatens our ability just to keep up. People must constantly teach others to use everyday machines, and the instant availability of information gives rise to financial instruments unheard of a few years ago. To evaluate how, or even what, new goods and services are being offered becomes bewildering, as does whether they are goods *or* services.[1] What is certain is that a growing proportion of wealth is represented by intangibles, and what is uncertain is whether and where to tax it.

This sets a background for my comments on David Rosenbloom's excellent and well thought out paper.[2] Based on the sometimes competing goals of efficiency, equity, and simplicity, the paper makes several proposals about the way in which the United States (and perhaps other countries) should tax foreign income earned by its residents.[3]

More specifically, it proposes that the United States should:

a. treat income of any controlled foreign subsidiary as income of its United States parent;
b. classify jurisdictions as either high-tax (like France) or low-tax (like the Cayman Islands);
c. exempt from United States tax all active business income

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1. Alan Greenspan once joked that no one should be allowed to buy stock in a company unless he could explain what it did.

2. H. David Rosenbloom, *From the Bottom Up: Taxing the Income of Foreign Controlled Corporations*, 26 BROOK. J. INT'L L. 1525 (2001).

3. This comment assumes familiarity with the paper, and this summary describes only some proposals. It omits, for example, the proposal to grant only deductions in respect of foreign taxes on non-exempt income.

attributable to a permanent establishment in a high-tax jurisdiction (unless such income is not likely to be taxed at regular rates); and

d. tax the gain on any assets transferred to a high-tax permanent establishment (a section 367 issue).

The comments, like the proposals, become intertwined:[4] Exemption, current inclusion of income, simplicity, and the section 367 issue. Let me start with exemption.

Many years ago, a member of the Ways and Means Committee—when confronted with what he thought were intemperate requests for real estate income tax incentives—threatened to exempt the entire industry from tax. Similarly, even without limiting its application to high-tax jurisdictions, exempting foreign active business income from tax might increase revenue. United States tax on foreign source income that consists of royalties, interest from related parties, and exports no longer could be offset by credits for foreign tax on active business income; and losses of foreign branches no longer would be deductible, by reason of section 265.

Combining exemption with the current inclusion of all controlled foreign subsidiary income and limiting the exemption to high-tax countries, would increase substantially the revenue gain. Since the paper asks what kind of system we should start with, most practical objections (including treaty obligations) seem beside the point. But there are some significant differences between Professor Rosenbloom's exemption-cum-inclusion proposal and current exemption systems.

II. THE PROPOSAL COMPARED TO CURRENT EXEMPTION SYSTEMS

The obvious disadvantage to taxpayers under an exemption system—as compared with the current United States credit system—is the inability to reduce tax on royalties, interest, exports, and low-taxed active business income by excess credits in respect of other business income. The obvious disadvantage to taxpayers under Professor Rosenbloom's proposal—as compared with current exemption systems—is the in-

4. Professor Rosenbloom disarmingly points out some of the pressure points of his own proposals, such as the need to allocate deductions under either a credit or exemption system.

ability to defer residence tax on low-taxed business income. In part, the acceptability of foreign exemption systems may rest both on:

a. deferral of residence tax as well as some *equivalence* of a credit in respect of low-taxed business income; and
b. the indirect exemption of other income by the lack of 861 regulations.

A. Deferral

As for deferral, exemption countries generally do not tax unremitted low-taxed active business income.[5] As for the equivalence of a credit, they sometimes have exempted such income from tax even when remitted. This has been done through tax-sparing treaties with developing countries, treaties to which the United States will not agree.[6]

Exempting low-taxed business income reduces the disadvantage to taxpayers in exemption countries of being unable to use excess credits against residence tax on royalties, interest, or export sales. The reason is that, in the United States, credits also must be used against the low-taxed business income system that other countries exempt. As a result, only excess credit as to *all* business income is available to reduce residence tax on the other items.[7]

B. Indirect Exemption

To my knowledge, countries other than the United States do not have meaningful section 861 regulations.[8] In exemption

5. In this discussion, active business income necessarily does not include what the United States would consider foreign base company income.

6. Because of what the OECD has labeled harmful tax competition, high-tax exemption countries may now be less willing to conclude tax-sparing treaties. But those treaties long have allowed the equivalent of cross-crediting between high-taxed and low-taxed foreign business income.

7. Moreover, exemption countries use a tax credit system to reduce residence tax on foreign royalties and interest. In some cases, tax-sparing treaties allow reduction of such tax by hypothetical taxes of the source country. *See* Article 24 of the tax treaty between Germany and Brazil.

8. Japan, a credit country whose international tax system was based partly on that of the United States (United States' constitutional cases are precedent in Japan), does not seem to have meaningful 861 regulations. A Japanese lawyer once explained his firm's expertise in Japanese-U.S. section 482 transfer pricing

systems, this allows deductions attributable to exempt foreign income to reduce residence tax on non-exempt income. By contrast, deductions attributable to the United States equivalent of exempt foreign income—foreign income of taxpayers in an excess credit position—do not reduce residence tax on any income at all. This requires a bit of explanation.

As an economic rather than technical matter, under the United States' credit system, any foreign general limitation income of companies in an excess credit position is exempt from United States tax. To illustrate, assume that a company has $100 of Canadian business income on which it has paid $70 of tax. The excess $35 of tax credit can offset United States tax an additional $100 of foreign source-royalty, subsidiary interest, or export income, making $200 economically exempt from tax.

As a corollary, any research or interest deduction allocated to foreign source income by the section 861 regulations will decrease foreign income below $200; and that decrease, reducing income that already is economically exempt from United States tax, makes the deduction useless. In effect, section 861 acts like section 265—it disallows deductions allocable to exempt income. Thus, when a foreign country does not allocate deductions against exempt foreign business income, it allows deductions that the United States economically would disallow. Those deductions reduce residence tax on non-exempt income—including foreign royalties, interest, or exports—which the United States economically would exempt by tax credits.

To use the above example, suppose that the United States would allocate $60 of deductions to the $200 of foreign income, of which $40 would be allocable to the Canadian business income: the foreign country would allocate no deductions to the active business income. In effect, the United States credit system has exempted $140 of foreign net income from residence country tax (the $200 economically exempted by credits, less the $60 of effectively disallowed deductions). But the exemption system also has exempted $140 of net income from residence country tax (the $100 explicitly exempted, plus the $40 of deductions used, thereby eliminating residence tax non-ex-

matters. I asked him what Japan did about the corollary of allocating income to a residence jurisdiction and allocating deductions to a source jurisdiction. He had not heard of the issue.

empt income).[9]

III. SIMPLICITY

A. *Whether the Need Exists*

To begin with, in the foreign income area specificity may be better than simplicity. To a large extent, law and accounting firms, as well as the sophisticated in-house advisers to the few thousand large American multinational corporations, administer the foreign tax credit. This is an area where the players *do* study the rules.

Subpart F may not have kept up with information technology, but neither have the source rules—the determination of where income is earned. In fact, the source rules really have never resolved the places where Pierre Boulez or Paul Karrer or the Bank of America or Quill Corporation primarily should be taxed.

The widespread criticism of subpart F—including certain income of controlled foreign corporations in income of the parent (but treating the income as that of the subsidiary)—has not distinguished sufficiently among its different functions. Two of the functions seem relatively uncontroversial: (1) the current taxation of interest, dividends, and capital gains from portfolio investments; and, (2) income from sales or services transactions with related United States companies. The former prevents the use of income from mobile capital for the purpose of avoiding United States tax. The latter deters erosion of the United States tax base by siphoning profits from United States companies through artificial intragroup transfer pricing.

By contrast, the two controversial aspects are the current taxation of interest, royalties, dividends, and capital gains from *non*-portfolio investments, and the taxation of income from sales or services transactions between related *foreign* companies. The former has nothing to do with mobile capital: it consists of income from active businesses conducted by foreign subsidiaries and frequently (as in the payment of intragroup interest and royalties) reduces foreign rather than United States tax. Similarly, income from sales or services transac-

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9. Thus, income could consist of income for foreign royalties, interest, or exports; but it equally could eliminate residence tax on domestic income.

tions between related foreign companies has nothing to do with the United States tax base—it deters erosion of a foreign country's tax base by siphoning profits through artificial intragroup transfer pricing.

The two controversial aspects stem from the idea that subpart F acts as a sort of world tax policeman. It taxes, as foreign personal holding company income payments, by one foreign subsidiary to another, and the sales of the stock of one foreign subsidiary by another, because they might not incur substantial foreign tax; not because they represent income from mobile capital or reduce United States tax.

Similarly, siphoning profits from foreign companies by artificial intragroup transfer pricing saves foreign rather than United States taxes. The check-the-box regulations, which have to a great extent repealed the two controversial aspects of subpart F, have highlighted this tax policeman role. The Treasury has tried to treat, what for United States purposes are: (a) *intra*-company payments; and, (b) sales of assets rather than stock of subsidiaries: as (a) *inter*-company payments; and, (b) sales of stock of subsidiaries. As the latter two, they would constitute subpart F income unless they incurred sufficient foreign tax.[10]

B. Whether the Proposal Would Create It

Exemption may not involve simplicity, but instead, it may just raise old issues in an unfamiliar context.

1. Classification

The matter of classifying countries as high-or low-tax must take into account not only their rate, but their base. This involves judging the allowances, exemptions, and credits—as

10. *See* I.C.C. Code § 954(b)(4) (2000); I.R.S. Notice 98-35; I.R.B. 1998-27, 35 (1998); Prop. Treas. Reg. §§ 301.7701(a)-3(h) (1996). A similar attitude surfaces in section 864(c)(4), which taxes foreign corporations on foreign source income. This was motivated by the fact that their residence countries did not tax them, so that they could use the United States as a tax haven. But the motivation did not appear to arise from damage to the competitiveness of United States' banks in making loans to Brazil. (In the 1960's, the United States had little reason to fear competition in lending to Brazil.) Rather, it seemed to derive from a notion of tax equity that the United States should enforce. *See* Post-Script, *infra* Part VII, for a more recent manifestation of this attitude under Code section 367.

applied by the foreign country—by the United States' standards of reasonableness. This is an extraordinarily difficult task, as indicated by recent cases involving Ontario's mining tax[11] and by base erosion tests in the branch profits tax and in treaties. Much time has been spent—some by this commentator—looking into whether deductions allowed by Luxembourg were the equivalent of exemption under a 1929 decree.[12]

Professor Rosenbloom knows, as well as anyone, the resources available to the U.S. Department of Treasury to classify the tax systems of the world as to base, provisions for special industries, arrangements for financing branches, and incentives for Alsace.[13] Moreover, countries change their tax systems and might not be eager to disclose an attempt to attract investment, and yet preserve the United States exemption. The fact that a country, in general, has a high tax rate means that it will not compete—as localities do with industrial revenue bonds—for new industrial investment. To alleviate this, the United States might grant an exemption by treaty, so that only certain regimes within high-tax countries would qualify.

2. Section 861 (to become Section 265) Regulations

As Professor Rosenbloom acknowledges, the issues of looking through to classify income and of applying the section 861 regulations to allocate deductions would remain. In addition to the allocation of research expense to foreign branches, an allocation of worldwide interest expense among taxable income and exempt foreign income probably would supersede the current allocation of only domestic corporation interest.

3. Undeveloped Treaty Law

There arises the question of substituting an embryonic OECD law—even as interpreted by the United States—for the existing history of interpretation under our credit system. The key terms for determining exempt income would be "business

11. *See, e.g.*, Texasgulf, Inc. v. Comm'r, 172 F.3d 209 (2d Cir. 1999).
12. If the deductions were equivalent, the old Luxembourg treaty did not apply to United States income.
13. The European Union recently has identified sixty-six preferential tax regimes within its jurisdiction that it suggests be eliminated.

profits" and "attributable to a permanent establishment." In deciding whether a permanent establishment existed, a 1995 Tax Court case went back to commentary by the League of Nations as well as the OECD.[14] The question of what income is attributable to a permanent establishment has been contested sharply in two subsequent cases; one involving the intracompany attribution of assets and the other of intra-company assets *and* liabilities.[15] Both relied on the 1977 Commentary to the OECD Model Convention, although one overlooked the fact that—during some of the years before the court—the United States had changed its position as to that commentary.[16]

C. *Intra-company Payments*

With respect to intra-company payments of interest and royalties, the questions resemble those created under subpart F by the check-the-box regulations. First, do intracompany payments reduce business profits of a permanent establishment? Under a treaty, the United States has taken the position that they do not. Under an exemption system, the United States probably would *want* the payments to reduce business profits attributable to the permanent establishment if the foreign country allowed them to be deducted. A second question is, if the recipient country taxed the interest or royalties at a sufficiently high rate, would the interest or royalties constitute business profits of the recipient?[17] This is not to say that the issue cannot be resolved, but only that many of the look-through, classification, and apportionment of deduction issues, under a credit and deferral system, do not disappear under an exemption and current inclusion system.

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14. Taisei Fire & Marine Ins. Co. v. Comm'r, 104 T.C. 535 (1995).

15. Northwest Life Assurance Co. of Canada v. Comm'r, 107 T.C. 363 (1996) (which had a concurrence and dissent); National Westminster Bank, PLC v. United States, 44 Fed.CL. 120 (1999).

16. *See Transfer Pricing and Multinational Enterprises: Three Taxation Studies* (OECD 1984) (raising the question of whether interpretation of a treaty is static or ambulatory).

17. *See* I.R.S. Notice 98-35; I.R.B. 1998-27, 35 (1998).

D. Section 367 and Intangibles

With respect to the proposal on the section 367 issue, the non-recognition of gain for the transfer of an active business conducted abroad has been allowed under section 367 under a deferral system. There seems no compelling reason to retract it under the less favorable exemption regime.

The real section 367 and 861 issue under an exemption system relates to the transfer of intangibles—whether the United States would impute royalties to what is, for United States tax purposes, the same entity. The United States has perhaps the world's most valuable intangibles. Under the "commensurate with income" standard, the United States reserves the right to impute income from that value, to itself, as the residence country. The concomitant of exemption, as proposed by the paper, is the treatment of income earned by foreign subsidiaries as the exempt income of branches. Under that construct, domestic owners of those intangibles or the countries of their use might believe that taxation of royalties (the yearly value of the intangible) no longer should belong exclusively to the United States.

From the point of view of the owners, the sourcing of income from United States—developed intangibles in the country of use—has allowed them to reduce foreign tax by deducting the royalties paid by subsidiaries and to reduce United States tax by excess credits attributable to other income. If the royalties would be taxed by the United States at a rate higher than that of the foreign country, they plausibly might argue that one cannot impute royalty income *within* a corporation; from one person to himself.[18]

The foreign country might make the same argument: that the entire profit from the intangible was attributable to the country of use. Under current law, if the foreign subsidiary actually were a branch, there would not be any imputation. Instead, research expenses of the home office would be allocated to the branch under the section 861 regulations (and under Article 9 of the OECD Model Treaty).[19]

18. *See* Treas. Reg. § 1.863-7(a)(1) (2000).

19. Under a treaty, in *Cudd Pressure Control, Inc. v. Her Majesty the Queen*, [1998] 98 D.T.C. 6630 (Can.), the Supreme Court of Canada refused to allow imputed rent on a machine to reduce the profits of a United States corporation's

The foreign country could take either of two positions. One, that if the United States regarded the subsidiary as a branch which could not, by definition, pay royalties, the income of the subsidiary should be reduced only by the research expenses, not by any royalties. The other would be to not disallow the deduction for royalties, but to disallow benefits under Article 12 of its treaty with the United States, which limits tax only on *inter*-company royalties. This raises for a foreign country the section 894(c) treaty issues created by the check-the-box regulations, so that there would be another existing issue under a new system. If the foreign country did not apply the treaty and withheld substantial tax on the royalty, the United States would either have to give a credit for such tax or allow substantial double taxation on some of its most valuable assets.

IV. THE BIG PICTURE AND THE DETAILS

Let me conclude by going back to the beginning of this comment, regarding the pace of change and the increasing value of intangibles. The United States has not had a consistent or successful international tax position as to intangibles. It first let intangibles be transferred to foreign or possessions corporations, litigated the results under section 482 with mixed success, and then insisted on the residence country's right to tax an amount of income commensurate with their value. The "commensurate with income" standard is not one to which other countries accede.

Thus, under domestic law and traditional ways of doing business, the current system has not solved fully the problem of taxing intangibles. The question of who should tax the value of intangibles—the country that produced them, the country where there are consumed, or both—has not been decided. When licensed, they currently are sourced in the country of consumption but by treaty often taxed only in the residence country. When their value is realized in the form of transferring tangible goods or performing services, different source and treaty rules apply. An exemption system would raise anew two of the most controversial issues that have been tentatively

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branch in Canada. A concurrence would have allowed a national rent expense payable to the head office in other factual circumstances. *See id.*

resolved under the credit system: (1) the source of income attributable to United States-developed intangibles used abroad; and, (2) the allocation of research expense deductions to those intangibles.

With respect to taxing the value of intangibles attributable to new types of doing business—both financial and especially technological—the proposal would go to treaty law. But there is no particular agreement within the OECD as to the character of such transactions (transfer of technology, of goods, or of services), its source, or how it should be taxed. For instance, the distinctions as to character in the recent United States section 861 computer software regulations[20] have not received wide OECD acceptance. Further, the concept of what, if any, profits are attributable to a permanent establishment consisting of a Web site is in its draft stages. Grafting this issue onto the OECD concept of profits attributable to a permanent establishment, when the value of intangibles has been given very little consideration in that context, would seem to not foster simplicity.

Moreover, as companies do business by sending and receiving signals, treaties might begin to permit the country of consumption to tax their profits without requiring the existence of a permanent establishment. As intangibles play a more and more prominent role, the concept of permanent establishment becomes less and less relevant to taxation.

V. EXEMPTION SEPARATED FROM DEFERRAL

The issue of exemption might be separated from ending deferral. If profits are exempt when included currently, it does not matter if their exemption is postponed until they are repatriated. This would alleviate the problem of having the section 861 regulations, rather than 367(d), apply to the intra-group transfer of intangibles, and the source country would be likely to allow the royalties to be deducted from the payor corporation's income.

To grant deferral to exempt profits, and include currently in income only non-exempt profits, brings back the tainted "subpart F" nomenclature, which Professor Rosenbloom is clearly trying to avoid. But apart from financial institutions,

20. Treas. Reg. § 1.861-18 (2000).

multinationals generally have avoided the use of foreign branches in treaty countries. The resulting lack of precedent as to intra-company transactions may make it less wrenching to retain an expanded subpart F (with respect to high-tax jurisdictions) rather than to essay mandatory branches.

VI. CONCLUSION

Leonardo did not study the application of the 861 regulations to intangibles. Had he known about it, he might not have considered it necessary to master all human knowledge. Professor Rosenbloom's paper takes a Leonardo-type overview, and this comment goes into the details. But the U.S. system really has never mastered the details—and they may not be just details. There should be kudos on a paper that makes people think seriously about how a theoretical proposal should be implemented.

VII. POST-SCRIPT

At the symposium, two attendees who worked at the U.S. Department of Treasury on the original subpart F regime denied that it was intended to (or did) act as a world tax policeman. One said that in the 1960's European countries just could not cope with American manipulation of inter-company pricing. But of course, that is just what a policeman does—come to the aid of third parties.[21]

More to the point, the government is still acting as a policeman. Not only are Notice 98-35 and Proposed Regulations section 1.7701(a)-3(h) directed at situations in which foreign tax is avoided[22] (by paying interest or selling stock rather than assets): the recently enacted section 367(a) regulations adopt the same position. Under those regulations, if a United

21. The U.S. Treasury's Policy Study on Deferral referred to 1962 arguments that "avoidance of foreign tax should not be of concern to the United States." U.S. DEP'T OF THE TREASURY, THE DEFERRAL OF INCOME EARNED THROUGH U.S. CONTROLLED FOREIGN CORPORATIONS: A POLICY STUDY, Appendix A, text at note 111, (2000), *available at* http://www.ustreas.gov/taxpolicy/library/subpartf.pdf.

22. In Notice 98-35, foreign tax is avoided by deducting interest payments, which for United States' purposes are just intra-company transfers of funds. *See* I.R.S. Notice 98-35; I.R.B. 1998-27, 35 (1998). *See* Prop. Treas. Reg. §§ 301.7701(a)-3(h) (1996) (foreign tax is avoided by selling what, for foreign purposes, is stock of a subsidiary, but for United States' purposes, is a branch of the parent corporation).

States corporation transfers assets to a foreign parent corporation in a non-recognition transaction, there is no further consequence if the foreign parent sells the transferred assets. But if the United States corporation transfers assets to a subsidiary of the foreign parent corporation, gain will be recognized (as if the transfer were taxable) if the subsidiary is sold within five years.[23] The question of whether to impose United States tax in respect of the resale apparently depends on whether foreign tax might be imposed on that sale. It is assumed that the foreign parent can sell the assets without incurring foreign tax[24] if they are owned by a subsidiary, but not if they are owned directly.

Pointing out when the United States is acting as tax policeman does not imply disagreement with that role. It can be said to reinforce capital export neutrality and to prevent harmful tax competition. But it should be recognized that deterring the avoidance of foreign tax—thus protecting the tax systems of other countries—is police work.

23. *See* Treas. Reg. §§ 1.367(a)-3(a)(3) (2000) as to asset reorganizations. *See also* Treas. Reg. §§ 1.367(a)-3(d)(1) (2000) with respect to indirect stock transfers and applicability of a gain recognition agreement.

24. The Netherlands, for example, does not tax income from the sale of a foreign subsidiary, which owns the assets received from the United States transferor.