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Whether, When and How to Tax the Profits of Controlled Foreign Corporations

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WHETHER, WHEN, AND HOW TO TAX THE PROFITS OF CONTROLLED FOREIGN CORPORATIONS

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I. INTRODUCTION

Among the choices of how the United States could tax the earnings of controlled foreign corporations (CFCs) are these: (1) exempt the income from tax permanently; (2) accrue the income currently and grant either a credit or deduction for foreign taxes; or, (3) defer taxation until repatriation and allow a credit or deduction for foreign taxes at that time. The present system reflects aspects of all three approaches, but mainly accords deferral with a foreign tax credit upon repatriation, except for income taxed currently (actually or effectively) under anti-deferral regimes such as subpart F and the passive foreign investment company (PFIC) rules. The essential premise which the present system rests upon, and variously compromises, is that residence-based, export-neutral taxation is fair and efficient, provided that it alleviates international double taxation and prohibits deferral in appropriate cases.

David Rosenbloom's paper[1] examines the U.S. system in light of the traditional criteria—fairness, efficiency, and simplicity—and, with an emphasis on simplicity and a refreshingly congenial approach to fairness and efficiency, concludes that a significant portion of CFC profits should be exempt from U.S. taxation and that much of the balance should be taxed currently, with only a deduction for foreign taxes. Before addressing the paper, I would like to begin with a thoroughly unrealistic situation and then build upon it the complications that have resulted in the inordinately intricate complex of rules in place

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

today. The purpose is to suggest that, while present rules are unforgivably complicated and proposals like Mr. Rosenbloom's deserve serious consideration, there may not be room for much improvement short of retreating from income taxation in favor of wage, consumption, or wealth-based tax systems.[2] Unless such a bold direction is taken, and I am not suggesting that it should be, the best prescription may be for modest, incremental change.

II. BALANCING RESIDENCE AND SOURCE CLAIMS

A. An Unrealistic Situation

Imagine an unreal world of two states, R and S. R is a bedroom state with personal residences, schools, hospitals, cultural institutions, and civic facilities to support them, but very little business activity. S is across the river and houses the businesses where the citizens of R work and invest capital and ideas. S has its necessary civic support facilities, but relatively few people reside in S. Given the small population in S, most of the market for the products of S business is in R. There are no corporations in R or S; they do not allow them. Both R and S need tax revenue to support their functions, but most of the income generated by their economy would be sourced in S, according to L, a lawyer living in R who has read a futuristic novel about international taxation. A pure residence-based system would jeopardize S's existence, whereas a pure source-based system would jeopardize R's.

Compromise of principles is imperative if R and S are to co-exist. R and S have not heard of formulary taxation and agree that certain items (*e.g.*, wages) will be taxable only in S and other items (*e.g.*, interest and royalties on loans and ideas provided to S business) will be taxable only in R. R and S agree that enterprise profits of S business should be split evenly since production takes place in S but the market is in R. In light of the income allocation they have agreed to, R and S set their respective tax rates at levels sufficient to enable them to provide desired government services.

R and S reach enlightenment and introduce corporations,

2. *See* David Bradford, *Blueprints for International Tax Reform*, 26 BROOK. J. INT'L L. 1449 (2001).

taxable as separate entities. Many of the businesses in S incorporate, some under the law of R, where most of the shareholders live, but many under the law of S. Some of the S corporations are controlled by R residents, some by R corporations, and some by residents of S with minority ownership by R residents. Subsequently, S amends its corporate tax law to provide for integration of corporate and shareholder taxation for some of its corporations. Later, electronic commerce and derivative financial instruments appear on the scene. L talks the R legislature into allowing corporations to elect to be treated as transparent for tax purposes. Planning to avoid taxes, something relatively rare in the past, becomes common. The citizens of R and S multiply, relocate, and form several new states where they replicate their experiences in R and S, except that most of these new states have a mixed economy, resembling an amalgam of R and S rather than one or the other. Some of these states hold themselves out as low-tax jurisdictions where businesses can incorporate and minimize worldwide tax.

The once simple resolution worked out by R and S seems hopelessly confused. Over time the states respond to these developments in deliberate fashion by unilaterally and selectively adopting and refining sundry versions of source rules, expense allocation rules, foreign tax credit rules, exemption rules, transfer pricing rules, anti-expatriation rules, anti-deferral rules, and elective transparency rules—each complicated and none without flaws—and by entering into treaties to coordinate their systems. Tax planning becomes more aggressive, facilitated by technological and financial innovation. The states suspect that their systems are not working fairly and efficiently and that tax is being improperly avoided. However, they are not sure what changes to make first, recognizing that each part of the system depends on another.

B. How to React?

This illustration captures a large part of the challenge presently besetting makers of international tax policy. It began with a simple tussle between residence and source taxation, and showed, I think, that there is no such thing as pure residence taxation. There are numerous legitimate questions about where to source certain types of income, particularly those arising in electronic commerce and financial innovation, and whether corporations should be deemed resident where they are organized or managed without regard to the nationality of their shareholders or locations of their business.[3] But once those questions are answered, and regardless of how mechanically they are answered,[4] some balancing of residence and source claims is essential in order to avoid double taxation. Where the residence country claims a secondary right to tax, the question remains whether it should be exercised on a current or deferred basis, and what level of double tax relief (credit or deduction[5] of foreign tax) should be afforded. So, without getting bogged down in residence versus source semantics, the questions are whether the United States should exercise its right to impose residual tax on the income of CFC's (to exempt or not to exempt), and if so then when (to defer or not to defer) and how (choice of accrual model and whether to credit or not to credit foreign tax).

C. The Appropriate Role of Efficiency

At this juncture, it seems appropriate to comment on the role of efficiency in this endeavor. Much of the debate on deferral is dominated by abstract considerations of global efficiency in the allocation of savings and investment. Advocates of capital export neutrality (CEN) argue that, due to empirical evidence indicating that direct investment decisions are more elastic than savings decisions—that investment decisions are more responsive to tax burdens than are savings decisions, or,

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3. Some argue for absolute irrelevance of a corporation's residence, at least insofar as residence is determined by place of organization, and that a corporation, including a U.S. corporation, should be taxed by a country only with respect to income earned in that country—a strict territorial approach. *See* Herman Bouma, *Two Arguments Against an Alternative View of Deferral*, 20 TAX NOTES INT'L 875 (2000).

4. Many "source" rules reflect a default concession that the residence country has the primary right to tax the item in question, often because no other country exercises taxation of the item, rather than a principled judgment that the item is attributable to activity in the residence jurisdiction. *See, e.g.*, I.R.C. § 865(a) (1994). The same can be said of consensual treaty-relaxed or eliminated withholding rates applicable to portfolio flows that are attributable to activity in the payor's jurisdiction.

5. Where double tax relief is provided in the form of a deduction for foreign tax, it is somewhat misleading to speak of a "secondary" right and "double tax relief," because the residence country cedes no primacy to the source country and double tax is avoided only on pre-tax income dedicated to foreign tax.

in other words, that the demand for capital is more elastic than the supply of capital—worldwide efficiency is best served by a tax system that neutralizes the investor's decision to make direct investment at home or abroad, notwithstanding that such a system may distort savings decisions. In its purest form, CEN implies no taxation at source coupled with current residence taxation, or taxation at source coupled with current residence taxation and an unlimited foreign tax credit. Advocates of capital import neutrality (CIN), which is believed to distort investment decisions but to result in an efficient allocation of savings as between present and future consumption, argue that companies investing in a given location are not on competitively equal ground unless they bear equal tax burdens on the investment, regardless of where they reside. CIN implies a territorial system. CEN and CIN converge only when tax rates in all countries are equal. Given the belief that investment is more elastic than savings, theory holds that CEN is more efficient than CIN because its resulting efficiency gains from investment exceed its resulting distortion of savings, whereas the investment distortions of CIN exceed its savings efficiency gains. The U.S. system of limited deferral is a compromise between CEN and CIN, as are most tax systems.

Two observations about efficiency are pertinent. First, the point made by Michael Graetz in another paper presented at the symposium,[6] that global efficiency is not necessarily a proper objective of U.S. tax policy. Why shouldn't U.S. policy serve national economic interests instead of global economic interests? This provocative point is part of a mosaic that national welfare and other national goals and policies should not be subjugated to pursuit of global efficiency in making U.S. international tax policy. Second, and this is a narrower point, economic analysis simply does not seem to have reached a level of sophistication that captures actual circumstances to the degree necessary to accord it primacy in making international tax policy. To be fair, it attempts to know what may be demonstrated theoretically in a confined atmosphere, but which may not be accurately quantifiable when theoretical constraints are lifted, by reason of the insuperable difficulty of incorporating

6. Michael J. Graetz, *Taxing International Income: Inadequate Principles, Outdated Concepts and Unsatisfactory Policies*, 26 BROOK. J. INT'L L. 1357 (2001).

into the models all of the numerous cross currents and biases inherent in tax rules that depend on a taxpayer's particular legal and financial structure and position at a given point in time.[7]

Thus, emancipated at least somewhat from the stricture of pursuing global economic efficiency, analysis of the question of whether to exempt, accrue, or defer CFC earnings can proceed in light of balanced sensitivity to the traditional criteria of fairness, efficiency in a more general sense, and simplicity. Before continuing, it is worth noting that, despite the *ad hoc* manner in which the rules have responded to perceived threats and the unnecessary complexity of them, the possibility cannot be excluded that they stack up decently against reform proposals on a cost/benefit analysis. Reform proposals should be scrutinized for claims of simplification, lest promised simplification result in more complexity. Any major reform will require time and scarce government resources to understand, implement, and enforce, not to mention the cost of taxpayer understanding and compliance and the risk of unforeseen economic and revenue effects. The benefits should be rather clear before the venture is undertaken.

III. THE PROPOSAL: EXEMPTION VERSUS ACCRUAL WITH DEDUCTION OF FOREIGN TAX

Writing on a clean slate, David Rosenbloom begins with the proposition that residence-based taxation easily is justifiable on straightforward notions of fairness and efficiency, but that such finding implies nothing for respecting the separate identity of a CFC. He regards use of a CFC structure by controlling resident shareholders essentially as a tax election without significant nontax consequences—an election that need not be respected for tax purposes, Section 902's indirect credit being an indication of such disregard in current law. He does not extend this reasoning to non-controlling shareholders because, for them, the corporate form is likely to entail a delegation or sharing of authority different from what would obtain

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7. In an informative paper reviewing the economics literature on the effects of deferral, the author was admirably candid in pointing out factors excluded from the models and in emphasizing the tentative nature of the conclusion to be drawn from them. *See* Robert Altshuler, *Recent Developments in the Debate on Deferral*, 20 TAX NOTES INT'L 1579 (2000).

in a non-corporate investment. Nor does he believe that disregarding a CFC requires, in the name of consistency, shareholder integration of taxes paid by U.S. corporations. CFC's and U.S. corporations, in his judgment, raise different issues and may be treated differently.

At this point, he gets to the heart of the matter by raising the necessity of alleviating international double taxation, either through an exemption or credit system. In a credit system, the theoretically correct approach is to allow credits on an item-by-item basis with no cross-crediting, but it would be hopelessly impractical for taxpayers and the government. The next best solution, cross-crediting within boundaries delineated by geography or income categories, with taxpayers inevitably seeking the widest boundaries in order to maximize cross-crediting, is complicated. Respecting the separate identity of CFC's aggravates the complexity by requiring look-through rules and intricate applications of loss-tracing and expense allocation rules. This is especially true when credits arise upon repatriation after an interim period during which the CFC and its foreign affiliates have had an opportunity to manipulate categories through self-dealing. The problem, as Mr. Rosenbloom sees it, is not that the rules are irrational, but that they are so complicated as virtually to guarantee inconsistent and, therefore, unfair application. Unconvinced that abolishing deferral meaningfully would alleviate the complexity of cross-crediting rules, he concludes that the beast to be slain is not just the separateness of CFC's, but the foreign tax credit itself.

He suggests exemption as a better alternative. Specifically, with respect to controlling shareholders, the proposal is for exemption of business income earned by a CFC (and by branch investment as well), when earned and when repatriated, that is attributable to a permanent establishment maintained in a country designated on a list confined to those countries that have mature tax systems—countries that would be likely to tax the income at a substantial rate.[8] The list would be compiled

8. The paper speaks of granting exemption to "resident taxpayers" on direct foreign investment and on direct investment by the taxpayer's controlled CFC. It is not clear whether this reference to resident taxpayers includes resident individuals. If a resident individual can make a foreign direct investment and enjoy exemption, then it might seem necessary to pass the benefit of exemption to that same individual when he makes the same investment through a U.S. corporation

primarily through the treaty process, subject to legislative oversight, and regularly updated to take account of changes in practice in the listed countries.

CFC business income earned in other countries (or in listed countries to the extent not attributable to a permanent establishment there) would be subject to current taxation in the United States and there would be a deduction, not a credit, for foreign taxes. The same treatment would apply to passive income. In special cases, a direct foreign tax credit would be available, but only by treaty.

As to non-controlling shareholders, which is not the focus of the paper, passive income earned through a foreign corporation could be subject to rules akin to the PFIC rules. As to business income earned through non-controlled foreign corporations in a listed country, the suggestion is to exempt from U.S. taxation dividends received by a U.S. corporate shareholder, or, at worst, to tax the dividend but allow a deduction or perhaps a direct credit for withholding tax.

IV. OBSERVATIONS ON THE PROPOSAL

A. *Exemption*

Focusing first on exemption of business income earned in listed countries, the economic and revenue effects would not seem great if the assumption is that there would be little residual U.S. tax. However, if there were taxes in excess of the U.S. rate in such countries, the ability to cross-credit such taxes against low-taxed business income from non-listed countries would be lost. In this situation, the proposal loses some of its claim to efficiency and fairness. Despite Mr. Rosenbloom's expressed dislike of elections, this may be an argument for allowing an election to stay on the credit system, which of course would detract significantly from the simplicity gains of the proposal.

The list approach itself resembles the high-tax exception to

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that owns the comparable branch or CFC. Otherwise, the individual can avoid U.S. tax if he invests directly, but not if he does so through a U.S. corporation. Passing the benefit of exemption on to individual shareholders of a U.S. corporation has implications for operation of the classical system in the United States. *See* William Burke, *Deferral and Subpart F Revisited*, 536 TAX F. 23, 23-24 (1999).

subpart F,[9] in that income bearing a substantial tax is exempt altogether (as opposed to being immune to accrual under subpart F). In practice, the list probably would turn out to be a proxy for a minimum foreign tax rate, with the important difference that substantiality of a country's tax apparently would be determined on a system-wide basis (as opposed to an item-by-item or taxpayer-by-taxpayer basis). An unattractive feature of the list approach is that, like the rules governing creditability of foreign tax,[10] to some degree it forces conformance by countries who wish to attract U.S. investment by getting on the list.

As to simplicity gains, the proposal as applied to business income from listed countries, has the potential for significant, but not dramatic, progress. Virtually no rules would need to be more complicated than they are today, although their emphasis would be redirected and some could be simpler and smaller in scope.[11] The greatest obvious benefit would be removal of listed country operations from the morass of foreign tax credit rules and consequent elimination of the incentive to engage in credit-seeking transactions of the type described in Notice 98-5.[12] However, there would be a need for ordering rules, similar to those in Section 959, to cover situations where exempt income is intermingled with nonexempt income as it is distributed up a chain of subsidiaries.

More generally, unless the United States were to relax its base-protecting vigilance, some might say neurosis, or taxpayers were to abandon efforts to shift income to where the tax is

9. *See* I.R.C. § 954(b)(4) (1994).

10. Treas. Reg. § 1.901-2 (as amended in 1996).

11. Presumably, subpart F could be eliminated, but it would have to be replaced with an accrual system for non-exempt income. *See infra* Part IV.C and text accompanying note 20. Expense allocation rules would have to be retained in order to disallow deductions attributable to exempt income, as opposed to their primary function under current law of policing allocation of costs to foreign-source income in order to monitor the foreign tax credit limitation. *See, e.g.*, I.R.C. § 265 (1994). Transfer pricing rules still would be necessary, even if, as Mr. Rosenbloom observes, they would be of reduced importance. Section 367 could be narrowed and simplified in that inbound transfers from exempt or non-exempt jurisdictions presumably would not result in U.S. tax (the foreign income is either exempt or already has been taxed in the U.S.) and outbound transfers to non-exempt jurisdictions would not facilitate avoidance of U.S. tax. However, there would be a continuing need to police outbound transfers to exempt jurisdictions and to retain § 367(d) for that purpose. *See, e.g.*, I.R.C. § 367(d) (1994).

12. I.R.S. Notice 98-5, 1998-1 C.B. 334.

lowest, it is not hard to imagine the proposal lurching toward nearly the same level of complexity that exists today, minus the foreign tax credit. Only the pressure points would differ. Instead of taxpayers searching for low-taxed income not subject to subpart F, they would search for low-taxed income attributable to a permanent establishment in a listed country. If the listed country is doing its job, which presumably is why it would be listed in the first place, such income should be hard to find. But taxpayers would try, and the United States might feel compelled to step in where the listed country exercises less vigilance, possibly presaging another saga similar to Notice 98-11[13] and its aftermath. Nevertheless, the proposal does eliminate the foreign tax credit for operations in listed countries without increasing, if not meaningfully reducing, complexity in other respects. For that reason alone it merits consideration.

B. Accrual with Deduction Versus Credit

The troubling aspect of the proposal concerns treatment of business income from non-listed countries. Such income would be accrued currently for U.S. tax purposes and associated foreign taxes would be deductible (a rule often associated with "national neutrality"), not creditable. It is not clear why business income taxes should be deductible just because they are generated in low-tax jurisdictions, nor why accrual and non-creditability with respect to income from non-listed countries is a necessary complement to the proposal on income from listed countries. I suppose the response is that that is the price of simplicity, but the price seems quite high,[14] and is likely to be regarded as offensive by non-listed countries whom we have no wish to offend.

Whatever might be said about the efficiency and anti-competitive effects, ending deferral for low-taxed income does enhance fairness. But denying a foreign tax credit seems unduly

13. I.R.S. Notice 98-11, 1998-1 C.B. 433. *See also* I.R.S. Notice 98-35, 1998-2 C.B. 34; Prop. Treas. Reg. 113909-98, 64 Fed. Reg. 37727 (July 13, 1998).

14. A non-creditable 10% foreign tax in a non-listed country translates into a 41.5% overall rate, as compared with the rate in effect in another country, say 25%, which is substantial enough to get that country on the list. A minimum tax approach, with a credit instead of a deduction, would equate the current tax burdens on investment in the two countries. *See infra* Part IV.C, text accompanying note 19.

to elevate simplicity over fairness for those who operate in non-listed countries. Moreover, the simplicity gains of replacing a credit with a deduction must be weighed against the complexity cost of implementing an accrual model.

In the same vein, the core proposal to exempt income from listed countries presents an opportunity to simplify the foreign tax credit itself. If income bearing a substantial foreign tax is exempt, it follows that other income would be low-taxed relative to U.S. rates. In other words, virtually all taxpayers with non-exempt income would be in an excess limitation posture. Leaving aside transactions engineered to generate excess credits at little or no economic cost, the type aimed at by Notice 98-5,[15] cross-crediting opportunities virtually would be nonexistent. Such a condition would permit a limitation system consisting of only two baskets: One for transactions of the Notice 98-5 ilk, and a residual basket for all other activity. In addition, although a simplified credit system could be enacted alone or in combination with this extra step, further simplification could be achieved by allowing a credit for all foreign taxes, not just *income* taxes. The *income* tax requirement dates back to the early period (1918-21) when there was no limitation on foreign tax credits. So long as the United States employs its own income tax accounting principles to determine the foreign tax credit limitation,[16] confining a credit to *income* taxes is unnecessary.[17]

Admittedly, permitting cross-crediting for whatever high taxes on non-exempt income which might exist (*e.g.*, taxes on natural resource extraction in non-listed countries) and allowing credits for non-income taxes raises the specter of runaway credits, which resulted in the rules defining creditable taxes and disallowing credits for "taxes" that are subsidized or that pay for specific economic benefits.[18] These concerns could be alleviated by adding a third basket for passive income, and by postponing removal of the *income* tax requirement of creditability until the Notice 98-5 issue is resolved and the effects of a two- or three-basket system are clearer. The main point is

15. I.R.S. Notice 98-5, 1998-1 C.B. 334.

16. *See* United States v. Goodyear Tire & Rubber Co., 493 U.S. 132 (1992).

17. *See* Joseph Isenbergh, *The Foreign Tax Credit: Royalties, Subsidies, and Creditable Taxes*, 39 TAX L. REV. 227, 285-95 (1984).

18. *See* Treas. Reg. § 1.901-2 - §1.901-2A (as amended in 1996).

that exemption of income in listed countries, with a simplified credit for other income, is a realistic and more attractive package than accompanying exemption with accrual of other income with only a deduction for foreign tax.

C. Accrual Model

An alternative to accrual as a means of dealing with low-taxed business income would be to impose an overall minimum tax on CFC profits,[19] either as part of, or in place of, existing subpart F, with the United States collecting from controlling shareholders their share of the excess of the minimum tax over the foreign taxes actually paid by the CFC. Upon repatriation, the shareholders would receive a credit for the foreign taxes and for the minimum taxes previously paid. Such a system would be complicated, but less complicated than implementing a full accrual model and, as argued above, fairer than allowing only a deduction for foreign tax.

The proposal ends deferral for non-listed business operations without specifying precisely how the accrual model would work. More than one type of model is available.[20] Where the CFC is wholly owned, it could be disregarded entirely, in the same manner as single-owner foreign entities may be disregarded under current law by "checking the box."[21] But, where the CFC has multiple shareholders, disregarding the entity is problematic. In such a case, the CFC's earnings and profits could be treated as a constructive dividend. If the CFC generated capital gains, such an approach would have the disadvantage of failing to pass through capital gains to non-corporate members of the control group, contrary to treatment under the PFIC rules where an election to be taxed currently is in effect. Flow-through of capital gains should be preserved in order to maintain parity with domestic investment.

Another suggestion is to use a modified subchapter K (the

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19. Several other countries employ a minimum tax approach in their anti-deferral rules. *See* Reuven Avi-Yonah, *The Logic of Subpart F: A Comparative Approach*, 79 TAX NOTES 1775 (1998).

20. A group discussion indicating general agreement that full accrual is impractical and problematic for other reasons appears in *Transcript From the Symposium, Globalizàtion and the Taxation of Foreign Investment*, 20 TAX NOTES INT'L 1268, 1277-82 (2000).

21. Treas. Reg. § 301.7701-3(b)(2) - § 301.7701-3(c) (1999).

partnership rules) as an accrual model for foreign corporations, regardless of whether the corporation qualified as a CFC under Section 957 and regardless of the U.S. shareholder's percentage ownership.[22] This would make life very difficult for U.S. shareholders of a foreign joint venture corporation which also has foreign shareholders unless the modified subchapter K is very different from the one I know.

Subchapter K, in addition to policing allocations for substantial economic effect, contains numerous complicated rules dealing with built-in gains,[23] transfers of property into and out of the entity,[24] basis adjustments,[25] and the ability of members to amortize contributed intangibles.[26] Sometimes, there is also the issue of whether contributed intangibles are "property" within the meaning of Section 721, and, if not, whether a "profits" interest in the partnership is necessary to preclude current taxation.[27] Under current law, if a CFC forms a non-corporate joint venture with a foreign partner, the CFC, for purposes of managing its earnings and profits, presumably has to apply subchapter K in order to determine its share of profits from the joint venture entity, which can embroil the CFC in arcane, contentious discussions with its foreign partner over why certain allocations must be provided for in their agreement. The foreign partner owes no U.S. tax, but is concerned that provisions beyond its advisor's understanding

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22. *See* Robert Peroni, J. Clifton Fleming & Stephen Shay, *Getting Serious About Curtailing Deferral of U.S. Tax on Foreign Source Income*, 52 SMU L. REV. 455, 508-16 (1999). This proposal would permit less-than-10% shareholders to defer tax until a liquidity event, with an interest charge, along the lines of the PFIC rules.

23. *See* I.R.C. § 704(c) (1994); Treas. Reg. § 1.704-3 (as amended in 1997).

24. *See* I.R.C. §§ 704(c)(1)(B), 707(a), 731(c), 737, 751(b) (1994).

25. *See* I.R.C. §§ 734(b), 743(b) (1994).

26. *See* Treas. Reg. § 1.704-3, § 1.197-2(g)(4), and § 1.197-2(h)(12) (as amended in 2000).

27. *See, e.g.*, E.I. DuPont de Nemours & Co. v. United States, 471 F.2d 1211 (Ct. Cl. 1973); Rev. Rul. 69-156, 1969-1 C.B. 101. A "profits" interest, well recognized as precluding current income in the context of partnership interests issued for services, has no claim in a current liquidation at book value and, therefore, precludes income even if the intangibles are not considered property for purposes of § 721. *See* Rev. Proc. 93-27, 1993-2 C.B. 343. The Clinton Administration proposed to resolve this issue by treating intangibles as property even where less than all substantial rights therein have been transferred to the partnership. DEP'T OF THE TREASURY, GENERAL EXPLANATION OF THE ADMINISTRATION'S FISCAL YEAR 2001 REVENUE PROPOSALS, 150 (2000).

might adversely affect its economic share of what seemed to it a straightforward deal. The foreign partner doesn't understand why it's an "anti-churning partner" and what "remedial allocations" and "capital shifts" are, and rightfully wants no part of them without exacting concessions. The same problem will occur, but with immediate tax stakes, where the CFC must apply subchapter K, not to manage earnings and profits, but rather to determine the currently taxable distributive shares of its U.S. shareholders. Subchapter K is not the right accrual model; it is too encrusted with operational detail to export to "partners" abroad.

Another aspect of importance in selecting an accrual model is whether transactions between the foreign corporation and its owners would be respected and given effect, or disregarded.[28] Constructive dividend or partnership treatment would seem to call for recognizing such transactions, if consistency with domestic rules is desired, whereas such transactions would be ignored if the foreign corporation is disregarded. One commentator recommends treating both actual branch operations and foreign corporations as subsidiaries (with constructive dividend treatment) in order to have harmonious treatment of intercompany dealings, regardless of how foreign operations are structured.[29]

V. CONCLUSION

Mr. Rosenbloom's paper is an extremely valuable reminder that it is never too late to think anew about old problems. Having said that, I end where I began: There may be little room to improve the system significantly without retreating from an income tax. Standing alone, the proposal to exempt business income from listed countries has much to commend it on equity, efficiency, and simplicity grounds. But the proposed treatment of business income from non-listed countries surren-

28. A related question is whether § 367(d) would impute royalties from a disregarded CFC, and, if not, whether the host country might be inclined to impose withholding tax on outbound royalties in contravention of normal treaty practice. *See* Charles Kingson, *Leonardo da Vinci and the 861 Regulations,* 26 BROOK. J. INT'L L. 1565 (2001) (commenting on H. David Rosenbloom, *From the Bottom Up: Taxing the Income of Controlled Foreign Corporations,* 26 BROOK. J. INT'L L. 1525 (2001)).

29. Burke, *supra* note 8, at 25-28.

ders too much equity for the simplicity gain of getting rid of the foreign tax credit, and imposes too much complexity for the equity gain of full accrual.

Perhaps I am proving Mr. Rosenbloom's point that it is hard to "unlearn" prior experience. Nevertheless, I would prefer a reform which takes the proposal on exemption for listed countries, but which retains deferral (other than for passive income) with a simplified foreign tax credit for other income, shored up by a minimum tax approach in addition to, or ideally in place of, existing subpart F.