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Rethinking U.S. Taxation of Overseas Operations

Subpart F, Territoriality, and the Exception for Active Royalties

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Introduction

The United States produces a third of the world's wealth but contains less than 5 percent of the world's population. This disparity pushes many U.S. businesses and entrepreneurs to embrace globalization to improve productivity and expand market reach. Large and small businesses alike are increasingly

using the tools of faster information, cheaper transportation, and overseas workforces that blur the traditional notions of taxes and services based on geographic lines.

The U.S. government can effectively promote this dynamism and growth with a tax system that taxes profits earned in the

Key Findings

- *A conflict between those who seek to discourage tax sheltering by requiring U.S. firms to pay taxes on all their activity ("worldwide" system), and those who seek to only tax corporate activity in the U.S. and leave overseas activity to other countries ("territorial" system), led to the enactment of the poorly designed compromise IRS Code Subpart F in 1962.*
- *Under Subpart F, "active" income can be deferred from U.S. tax until repatriated home, while "passive" income (royalties, interest, dividends) is generally subject to immediate U.S. taxation.*
- *Since 1996, "check the box" regulations have mitigated many of the harmful effects of Subpart F but political pressure to expand U.S. taxation of overseas activity continues.*
- *As one example of the complexity of Subpart F, royalty income from active business operations involving related firms cannot be deferred even though it by definition cannot be tax-haven activity.*
- *The U.S. should consider moving toward a territorial system, and in the meantime should review Subpart F for policies that discourage legitimate overseas business activity.*

United States but leaves taxation on activity occurring in other countries to those other countries. Instead of pursuing this economic concept of **neutrality**, however, the U.S. government seeks to tax the profits of U.S. corporations wherever in the world they are earned. This **worldwide** tax system differs from most other countries, where only activity within the country's borders is taxed (**territoriality**).

The U.S. government can effectively promote dynamism and growth with a tax system that taxes profits earned in the United States but leaves taxation on activity occurring in other countries to those other countries.

U.S. corporations operating overseas therefore face a unique combination of burdens not borne by their international competitors: taxes owed to the United States, taxes owed to the country where the operating activity takes place, and a complex tax system that attempts to reduce the resultant economic harm but involves an array of credits and definitions (primarily the Internal Revenue Code's **Subpart F**).

One illustrative example is the taxation of royalty income earned overseas by U.S. companies. Generally, U.S. taxes are deferred, or not immediately owed on profits earned overseas (a practice known as **deferral**) if the activity meets a stringent "active trade or business test" requiring active engagement

by the U.S. corporation in the actual development, creation, or production activities. **Passive income** (royalties, interest, dividends, and other investment income that does not meet this test) is thus excluded from the protections of deferral and subject to immediate U.S. taxation. This practice is justified by the belief that mobile and liquid income earned overseas by U.S. companies is undertaken purely for tax avoidance reasons.

These quirks should be remedied, but they only highlight the necessity of reforming our entire tax system into one that is competitive and compatible with the rest of the world.

Whether or not that belief has any merit, a strange quirk in the system is that royalty income that meets this "active" test is nonetheless subject to immediate U.S. taxation if there is involvement by a **related party** (an individual, corporation, partnership, estate, or trust that controls the company or is controlled by the company¹). This limitation is redundant to the "active" test and sweeps legitimate overseas business operations (those involving active income between related parties) into a prohibition not intended for them. These quirks should be remedied, but they only highlight the necessity of reforming our entire tax system into one that is competitive and compatible with the rest of the world.

1 See 26 U.S.C. § 958 (defining related person).

2 26 U.S.C. § 61 (defining adjusted gross income). See also 26 U.S.C. § 1 (imposing tax on taxable income); 26 U.S.C. § 63 (defining taxable income as adjusted gross income less qualified deductions).

The Rise of Subpart F: The Desire to Encourage and Discourage Overseas Investment by U.S. Corporations

The Internal Revenue Code imposes on Americans a tax on “all income from whatever source derived....”² The U.S. government does not geographically restrict this assertion of taxing power, and thus income earned outside U.S. borders by U.S. residents and corporations is taxable by the U.S. government (although taxpayers are permitted to take certain credits for taxes paid to foreign governments). This “worldwide” taxation has not always been the case: while “worldwide” in name before 1962, U.S. corporations operating overseas were generally free from U.S. taxes on overseas operations aside from an “exit tax” on property transferred overseas.³

Rising overseas investment by U.S. corporations precipitated a policy change in 1961 and 1962. “The Kennedy Administration...sought to curb further erosion of the U.S. tax base through a *worldwide* taxation system that would tax *all* foreign-source income. The Republican-led Congress and multinational business community...sought to encourage U.S. foreign investment and corporate profit generation through the continuance of a *territorial* taxation system that taxed *only* domestic-source income.”⁴

Rejecting a territorial system, the U.S. House of Representatives passed a bill to impose immediate tax on all “passive” income earned overseas.⁵ The Senate was reluctant to take

the same action, so the Treasury Department stepped in to broker a compromise.

A key criticism of the worldwide system is that it does not value neutrality, the economic principle that tax systems should not reward or punish based on investment location but rather should apply the tax code neutrally to all activity.

The resultant Subpart F (named for its section of the U.S. tax code) immediately taxes so-called “passive” income but permits “active” income to be deferred from U.S. taxes until it is brought back to the U.S. (**repatriation**).⁶ It aims to equalize taxes on investments in U.S. corporations whether here or overseas while attempting to mitigate the obvious result: U.S. corporations operating overseas paying higher total tax rates than their international competitors. “The system does not function as easily, however, as [its] purpose may suggest. Wriggled with numerous revisions, additions, and exceptions, Subpart F is the most extensive and complicated of the international antideferral regimes.”⁷

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3 See M. Carr Ferguson, *How to Save the Corporate Income Tax*, XX Tax Notes 951, 957 (Aug. 29, 2011). The exit tax was enacted in 1932. See also U.S. Department of the Treasury Office of Tax Policy, *The Deferral of Income Through U.S. Controlled Foreign Corporations* at 1-11 (Dec. 2000), <http://www.treasury.gov/resource-center/tax-policy/Documents/subpartf.pdf> (describing the “worldwide” standard applying to U.S. persons as dating from 1913 but generally avoidable for income earned overseas until the 1962 enactment of Subpart F); Keith Engel, *Tax Neutrality to the Left, International Competitiveness to the Right, Stuck in the Middle with Subpart F*, 79 Tex. L. Rev. 1525, 1527 (2001) (“From 1913 through the 1950s, U.S. multinational corporations operated free from current U.S. current income tax to the extent that they conducted operations through foreign subsidiaries.”).

4 Cynthia Ram Sweitzer, *Analyzing Subpart F in Light of Check-the-Box*, 20 Akron Tax J. 1 (2005).

5 H.R. Rep. No. 1447, 87th Cong., 2d Sess. (1962).

6 See 26 U.S.C. § 951 *et seq.*

location but rather should apply the tax code neutrally to all activity. Instead, the Subpart F regime is motivated by a desire to equalize taxes on all types of U.S. corporate activity even if the necessary result is double taxation of those activities. “[W]orldwide 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.”⁸

One reason for the continued difficulty in enforcing Subpart F is that it was designed for a corporate model that may be outdated.

Subpart F in Practice

Congress and executive branch officials have implicitly recognized that the present worldwide taxation system has serious flaws, and they have pared back the effectiveness of Subpart F and implemented export assistance programs such as the Foreign Sales Corporation (FSC) and the Extraterritorial Income Exclusion Act (ETI).⁹ In 1996, the IRS and

the Treasury sought to simplify the rules that determine whether a business taxpayer is a corporation or a partnership. This “**check the box**” regulation permits U.S. companies with **Controlled Foreign Corporations (CFCs)** to opt those subsidiaries out of Subpart F with sufficient tax planning. The IRS unsuccessfully sought to overturn “check the box,”¹⁰ failing due to wide perception that the regulation has been effective at paring back many of the harmful effects of Subpart F. President Obama’s similar proposal in 2009 was dropped by 2010.¹¹

One reason for the continued difficulty in enforcing Subpart F is that it was designed for a corporate model that may be outdated. “[S]ubpart F has not kept up with the changes in business models..., especially knowledge-based companies operating in an integrated global manner, unlike the manufacturing companies that were the norm when Subpart F was enacted.... Subpart F also assumes that companies manufacture their own products and does not contemplate outsourcing to contract manufacturers, which has become the norm in many industries....”¹²

7 Sweitzer, *supra* at 6. See also Terrance R. Chorvat, *Ending the Taxation of Foreign Business Income*, 42 Ariz. L. Rev. 835, 836 (2000) (“[M]ost of the important trading partners of the United States have adopted territorial systems.”); Bret Wells, *Interest Allocation: A Regime Desperately in Need of Sound Policy*, 53 Tax Law. 859, 869 (2000) (“[T]he U.S. tax system puts global companies at a decisive disadvantage.”); Steven V. Melnik, *Corporate Expatriations—The Tip of the Iceberg: Restoring the Competitiveness of the United States in the Global Marketplace*, 8 N.Y.U. J. Legis. & Pub. Pol. 81, 113 (2004) (“U.S. companies are subjected to a hurdle that foreign competitors in territorial tax systems do not face, and a hurdle foreign competitors investing in the U.S. do not face when they repatriate profits to their home countries.”); Eric Tak Han, *Is Capitalism Un-American? An Analysis of Corporate Inversions and Expatriation Proposals in Response*, 27 Hastings Int’l & Comp. L. Rev. 511, 525 (2004) (note) (“This ‘worldwide’ system of taxing corporate income is very anti-competitive, causing many companies to give up their U.S. charters and instead become foreign-based companies... [T]he solution is not more legislation to close the loophole to an already confusing patchwork with respect to the Internal Revenue Code.”).

8 John P. Steines, Jr., *Whether, When, and How to Tax the Profits of Controlled Foreign Corporations*, 26 Brook. J. Int’l Law 1595, 1599 (2001).

9 See Sweitzer, *supra*, at 29.

10 IRS Notice 98-11, 1998-1 C.B. 433 (withdrawn by Notice 98-35, 1998-2 C.B. 34).

11 Morgan Lewis, *Obama’s 2011 Budget: Check-the-Box off the Table; Subpart F Expanded* (Feb. 2, 2010), http://www.morganlewis.com/pubs/Tax_2011ObamaBudget_LF_02feb10.pdf (“The revenue provisions in the new budget alter previous proposals in at least two important aspects: the 2011 budget does not include the previously proposed limitations on ‘check-the-box’ elections but replaces them with a dramatic expansion of the subpart F anti-deferral rules.”).

12 John M. Peterson, Jr. & Bruce A. Cohen, *Corporate Inversions: Yesterday, Today, and Tomorrow*, 632 PLI/Tax 719, 785-86 (2004).

The major obstacle to a complete overhaul of the Subpart F system is continued unease about corporate inversions and offshoring activity by American companies, which often lead to political outcry and calls for Congress to act. “The straightforward approach of taxing domestic and foreign corporations on a similar footing seems to be tax heresy. Instead, we have watched Congress after Congress burdened with an imagined duty to keep American corporations onshore and yet taxed globally, struggle with one flawed regime after another.”¹³

Companies generally state that such decisions are driven by a desire to remain globally competitive, but the ability to escape Subpart F burdens is certainly a factor. Opponents of increasing overseas activity by U.S. companies are concerned about the effects on the U.S. workforce at home and suspicious that such decisions are not a long-term positive trend. Regardless of the cause, they are happening frequently even in the face of political pressure to curtail them, and many scholars urge a move toward a territorial system to reflect this reality.¹⁴

The inconsistent treatment of active royalties from related versus unrelated parties effectively penalizes U.S. companies for owning a controlling interest in their licensees, no matter how real and active and unlike a “tax haven” the operation is.

The Strange Case of Taxing Overseas Active Royalty Income Involving Related Parties

The Subpart F compromise primarily reflects the Treasury’s suggestion to impose U.S. taxes on overseas “passive” income while permitting deferral of “active” income. Consequently, “active” income from overseas dividends, interest, rents, and royalties can be deferred.¹⁵ However, rents and royalties must not only be “active” to be eligible for deferral, but must also have been “received from a person other than a related person.”¹⁶ Royalty income, unless received from third parties (**unrelated parties**) and even if it meets the stringent “active” test, is subject to Subpart F taxation. Thus, the tax treatment of royalties received from foreign operations under the U.S. company’s direct ownership and opera-

Figure 1

Subpart F Treatment of Overseas Royalty Income

“Passive” Income generally.....	Not Eligible for Deferral
“Active” Income generally	Eligible for Deferral
“Passive” Royalty Income	Not Eligible for Deferral
“Active” Royalty Income	Eligible for Deferral Unless Received from Related Person

13 Ferguson, *supra* at 957.

14 See e.g. Michael S. Kirsch, *The Congressional Response to Corporate Expatriations: The Tension Between Symbols and Substance in the Taxation of Multinational Corporations*, 24 Va. Tax Rev. 475, 482 (2005) (“[S]ome legislators view expatriations in a sympathetic light, as an understandable response to an overreaching tax code, and argue that the phenomenon reflects the need to curtail drastically the scope of U.S. international taxation.”); Elizabeth Chorvat, *You Can’t Take It With You: Behavioral Finance and Corporate Expatriations*, 37 U.C. Davis L. Rev. 453, 456 (2003) (“Corporate expatriations, which historically have occurred primarily in the insurance and oil and gas industries, are now occurring among a wider distribution of American industries.”); J. Clifton Fleming, Jr., Robert J. Peroni, & Stephen E. Shay, *Fairness in International Taxation: The Ability-to-Pay Case for Taxing Worldwide Income*, 5 Fla. Tax. Rev. 299, 305 (2001) (“[M]any in the U.S. multinational business community, and some academic commentators, argue that considerations of fairness, simplification, competitiveness, and/or efficiency support abandonment of the residual U.S. tax on the foreign-source active business income of U.S. resident corporations.”); William Lee Andrews III, *A Mighty Stone for David’s Sling: The International Space Company*, 1 Regent J. Int’l L. 5, 12 (2003) (“The territorial system gives countries maximum freedom to set their tax rates and minimizes the type of conflict arising when one country taxes income earned in another country.”); T. Chorvat, *supra* at 848-52 (“Only if all countries were to adopt the territorial system would firms be neutral as to where the parent corporation resides.”).

15 See 26 U.S.C. § 954(c).

16 *Id.*

tion is less favorable than those received from operations by third parties.

Whatever the intent of the drafters of Subpart F, U.S. businesses are capable of engaging actively in business overseas and earning royalty income from related persons without it being the type of tax haven activity that Subpart F seeks to discourage.

The 1962 Treasury explanation of its draft sheds little light on Treasury officials' rationale for subjecting active royalties to heightened restrictions when they involve related persons:

Foreign personal holding company income covers mainly dividends, interest, rents, and royalties when they constitute "passive" income or "tax haven" type income. Passive dividends, interest, rents, and royalties are those received from unrelated persons not in connection with the active conduct or trade of a business. Tax-haven dividends, interest, rents, and royalties are those received from related persons in connection with income-producing activities located outside of the country of incorporation of recipients.

[...]

[This change] would remove the objection that section 13 treats certain types of operating income as "passive" income in non-tax haven situations. Thus,

companies engaged in the active business with unrelated persons of banking, financing, shipping, insurance, and leasing of property would not be covered by the foreign base company income provisions.¹⁷

As Subpart F nears its fiftieth anniversary, and as globalization and competitiveness become more pressing concerns, serious reconsideration of the U.S. international tax system may be in order.

In adopting the Treasury language, the Senate commented:

[An] important modification provides that certain income otherwise defined as foreign personal holding company income is not [so treated] when it arises in connection with certain actual business activities. Specifically, it is provided that rents and royalties received from an unrelated person and derived from the active conduct of a trade or business will not be considered foreign personal holding company income.¹⁸

In short, active income is generally eligible for deferral, unless it is active royalty income received from a related person (see Figure 1). Passive royalty income is not eligible for deferral regardless of from whom it is received.

¹⁷ Department of the Treasury, *Draft of Statutory Language with Accompanying Explanation of Amendments Proposed by the Secretary of the Treasury* at 1-3 (May 1962), in Revenue Act of 1962, *Hearings Before the Committee on Finance on H.R. 10650*, 87th Cong., 2d Sess. (Part 11) 4415 (1962).

¹⁸ S. Rep. No. 1881, 87th Cong., 2d Sess. 188 (1962).

This treatment is a strange departure from the general rule of Subpart F, which is to tax “passive” income immediately but permit deferral of “active” income. The drafters of the provisions seemed to believe that royalty income from related parties was necessarily passive income, although they cited no evidence for the view. Further, if that was the case, the provision would be unnecessary because such income would already be made ineligible for deferral by virtue of not being “active” income.

The “related parties” exception may have been meant to discourage firms from operating as overseas tax havens, but instead introduces uncertainty and distortions for legitimate business activity.

Whatever the intent of the drafters of Subpart F, U.S. businesses are capable of engaging actively in business overseas and earning royalty income from related persons without it being the type of tax haven activity that Subpart F seeks to discourage. “Royalty income derived in the conduct of an active business does not fit the mold of easily movable income that may be acquired by purchasing a liquid asset.... Active royalty income from third-party royalties cannot be acquired through passive liquid investments. It can only be acquired by actively developing or marketing an intangible as part of an active business.”¹⁹ The inconsistent treatment of active royalties from related versus unrelated parties effectively penalizes U.S. companies for owning a controlling interest

in their licensees, no matter how real and active and unlike a “tax haven” the operation is. The “related parties” exception seems to evidence vigilance against an eventuality that cannot occur, given the “active” requirement.

Given that firms operating abroad for purely business reasons are potentially harmed by the “related parties exception,” and given that firms using royalty income as a tax haven are excluded by other provisions of law, the provision has no coherent rationale. It is one example of the internal conflict of Subpart F itself, caught between (1) a determination to make U.S. companies pay taxes on their activities in other countries and (2) a determination to ensure that U.S. companies are not made uncompetitive in those overseas markets by excessive U.S. taxation.

A move toward territoriality would also reduce compliance costs, prevent capital “lockout” effects, and remove impediments that discourage foreign firms from headquartering in the United States.

Conclusion

As Subpart F nears its fiftieth anniversary, and as globalization and competitiveness become more pressing concerns, serious reconsideration of the U.S. international tax system may be in order. Such a decision may involve serious tradeoffs: “[F]rom a tax collection standpoint, it could be said that a worldwide tax system is better than a territorial taxation system as a tax revenue source. However, if the focus of analysis were the

19 Covington & Burling, *Foreign Royalty Income: Response to the Treasury Briefing Paper* (May 10, 1993), at 2.

enhancement of international trade competitiveness, the territorial taxation system would be more favorable.”²⁰ A move toward territoriality would also reduce compliance costs, prevent capital “lockout” effects, and remove impediments that discourage foreign firms from headquartering in the United States.²¹ The high federal corporate income tax relative to other countries exacerbates this problem.

In the meantime, Subpart F should be scrubbed of policies that no longer work in

today’s global economy. The “related parties” exception may have been meant to discourage firms from operating as overseas tax havens, but instead introduces uncertainty and distortions for legitimate business activity. The “active” test can effectively police against tax haven behavior until such time that the United States decides to forego taxing profits from activities occurring beyond its borders.



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²⁰ Rosendo Lopez-Mata, *Income Taxation, International Competitiveness, and the World Trade Organization's Rules on Subsidies: Lessons to the U.S. and to the World from the FSC Dispute*, 54 Tax Law. 577, 586 (2001).

²¹ See Scott A. Hodge, *Ten Reasons the U.S. Should Move to a Territorial System of Taxing Foreign Earnings*, Tax Foundation Special Report No. 191 (May 2011).