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United States Tax Effects of Foreign Losses: A Symmetry Analysis

William C. Gifford Jr.

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United States Tax Effects of Foreign Losses: A Symmetry Analysis

William C. Gifford, Jr.*

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The international tax literature lacks any comprehensive discussion of the impact of foreign losses on the United States income tax liability of United States persons. Many significant aspects of the subject are left unexplored in the decisional law as well. This may be explained by the profitability of United States direct investment abroad since 1950. During 1962-1965, for example, United States persons invested about $15 billion abroad in manufacturing facilities and earned an average return on investment estimated in one Treasury study at 11.7 percent.

1. Of the major texts and casebooks on the international aspects of United States income taxation, only my forthcoming work treats the subject of foreign losses broadly. See W. Gifford, INTERNATIONAL TAX PLANNING ch. II, § 8 (forthcoming 1974).
3. The phrase, "foreign losses," in this discussion will not be limited to losses which technically arise from or are allocable to "sources without the United States" within the meaning of the INT. REV. CODE OF 1964 [hereinafter cited as IRC]. See IRC §§ 861(b), 862(b), 863(a)-(b). Rather, the phrase is used broadly to include losses which arise out of business activity carried on abroad by "United States persons"; see IRC § 7701(a)(30), whether directly through an individual citizen or resident's sole proprietorship, a partnership, or corporate branch or indirectly through a domestic or foreign corporation. The losses may be "current," arising from day to day operations of the business, or "terminal," arising upon the disposition or winding up of the foreign business. Current losses include normal operating losses as well as losses connected with fluctuations in the value of foreign currency. Terminal losses include losses on a sale or other disposition of the assets of the foreign business or the shares of an incorporated business, expropriation of such assets or shares, a liquidation of an incorporated business, or a decrease in the value of stock or securities therein.
4. IRC § 7701(a)(30) defines "United States persons" to include citizens and residents, domestic partnerships, domestic corporations, and domestic estates and trusts.
5. Like the commentary, the decisions are primarily limited to foreign tax credit computations, source of taxable income, currency exchange losses, expropriation losses, and war losses.
7. G. Hufbauer and F. Adler, supra note 6, Tables 2-1 & 2-2. While most foreign ventures have been profitable, there have been wide variations of profitability, and some foreign ventures actually lost money. During fiscal 1966, of the total of 19,617
However limited the extent of foreign losses in the past, United States investors may become more concerned with such losses in the future, as worldwide competition among multinational and local enterprises increases, as worldwide interest rates and other costs increase, and as widespread monetary adjustments occur. Moreover, with the taxation of foreign income on every significant congressional agenda for tax reform, the tax treatment of foreign losses has become a particularly appropriate and timely subject for analysis.

This article will analyze the United States tax treatment of foreign losses under existing law by applying a symmetry test and then recommend changes which would eliminate asymmetries in the present treatment of foreign income and loss.

active controlled foreign corporations, 4,305 reported net losses totaling $728,224,000 for the period. U.S. Treasury Dep't Publication No. 479, Foreign Income and Taxes Reported on Corporation Income Tax Returns 270-73 (1973) [hereinafter cited as Treasury Publication No. 479].

8. See, e.g., Rose, Multinational Corporations in a Tough New World, FORTUNE, August 1973, at 134 ("Still, by the mid-Seventies, overseas investment should begin to lose its attractiveness. It is expected that, instead of expanding at a rate of ten percent a year, multinational companies will maintain a more modest rate of overseas growth—say, between five and seven percent.").

9. S. 151, 93d Cong., 1st Sess. (1973) and H.R. 62, 93d Cong., 1st Sess. (1973), the "Burke-Hartke Bill," would end the deferral of United States tax on the earnings of foreign subsidiaries of domestic corporations, repeal the foreign tax credit for corporations, and eliminate the earned income exclusion for employees of domestic corporations and their foreign affiliates. H.R. 1040, 93d Cong., 1st Sess. (1973), the "Corman Bill" or the "Tax Equity Act of 1973," would restrict losses attributable to mineral properties located outside the United States, repeal entirely the exemption for earned income from foreign sources, repeal the special deduction allowed to Western Hemisphere trade corporations (WHTC's), eliminate the deferral of United States tax on the earnings of foreign subsidiaries of domestic corporations, repeal the tax exemption for ships under foreign flag, and restrict the foreign tax credit to foreign taxes imposed on income taxable by the United States. The House Ways and Means Committee held hearings on tax reform, including changes affecting the taxation of foreign income beginning in March 1973. The administration proposals for tax reform include provisions eliminating the deferral of United States tax on "foreign tax haven manufacturing corporations" ("run away plants" and foreign corporations which take advantage of foreign tax incentives). They also include provisions for taxing the profits from activities not fully subject to United States tax to the extent of foreign losses previously deducted against domestic income. Department of the Treasury, Proposals for Tax Change, April 30, 1973, at 159-75. The administration's proposals were "clarified" in a Treasury release, Foreign Tax Haven Manufacturing Corporations, June 11, 1973. Representative Vanik has introduced a substitute foreign trade policy bill, H.R. 8943, designed to influence the final trade bill, with provisions repealing the Western Hemisphere trade corporation and DISC provisions, changing the foreign tax credit to a deduction, eliminating deferral on taxation of foreign income, and removing certain rapid depreciation advantages for foreign investment.

10. No data are published concerning the impact of foreign losses on United States tax. See Staffs of Treasury Dep't and Joint Comm. on Internal Revenue Taxation, Estimates of Federal Tax Expenditures, June 1, 1973 (estimating revenue losses totaling $675 million for 1972, attributable to such international Code provisions as the earned income exclusion ($50 million), the exclusions for individuals ($10 million) and corporations ($80 million) in United States possessions, WHTC's ($50 million), DISC's ($100 million), deferral of income of foreign subsidiaries ($325 million), and lack of gross-up for less developed country corporations ($60 million).
I. The Symmetry Criterion

An evaluation of the present scheme of taxation of foreign losses requires the development of an analytic framework for the undertaking, in view of the previous inattention to this area on the part of Congress and commentators alike. While the traditional criteria of equity\(^1\) and neutrality\(^2\) as well as such pragmatic criteria as domestic economic effects,\(^3\) international economic effects,\(^4\) and administrative convenience\(^5\) all suggest themselves as candidates for judging the present system, a different criterion—symmetry—will be employed.

Symmetry requires, at a minimum, that a loss incurred by a taxpayer in connection with an activity which would have produced taxable income if profitable, be deductible against other income of the taxpayer.\(^6\) More strictly, symmetry would seem to require that the character and timing of the recognition of any such loss be the same as the character and timing of any income which the activity would have produced.\(^7\) This criterion has been recognized as a proper standard for gauging the effectiveness of an income tax system's treatment of gains and losses.\(^8\)

While the legislative history of the Internal Revenue Code [Code] provisions dealing with the taxation of foreign income is relatively prodigal in its discussions of the how's and why's for the taxation of profits, it is virtually silent as to the tax effects of losses and the reasons therefor.\(^9\) This situation is understandable in view of

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11. See note 199 infra.
17. Pechman notes that the timing problem is a kind of asymmetry: Taxpayers can time sales to realize losses promptly while postponing gains as long as possible. Id. The Musgraves appear to accept this characterization of the tax effects of timing. See R. Musgrave & P. Musgrave, Public Finance in Theory and Practice 231, 482-85 (1973).
19. The Revenue Act of 1962 represents the most comprehensive congressional examination of the taxation of foreign income to date, but the related committee reports advert to the tax effects of foreign losses in only three areas: IRC §§ 952(c), (d) (limiting subpart F income to earnings and profits of a controlled foreign corporation, reduced by certain deficits). S. Rep. No. 1881, 87th Cong., 2d Sess. 241-42 (1962); IRC § 1247(a)(2)(A) (excluding net operating loss deduction from computation of taxable income of foreign investment companies electing to distribute at least 90 percent of taxable income annually), id. at 294-95; and, obliquely, by reference to "consolidated earnings and profits" of related corporations under IRC § 963, id. at 266.
the historical preponderance of gains over losses from foreign\textsuperscript{20} as well as domestic sources.\textsuperscript{21} Absent any indication in the legislative history as to how and why losses in a particular situation should be treated, the taxation of gains in that situation, which did receive the focus of the congressional intent, should logically serve as the guide in evaluating the tax effects of losses. The very paucity of legislative history specifically relating to the tax effects of foreign losses thus buttresses the validity of the symmetry criterion,\textsuperscript{22} except where the legislative history of a specific Code provision indicates a special purpose for treating losses differently from income.

II. Application of the Symmetry Criterion to United States Tax Treatment of Foreign Losses

A close scrutiny of relevant Code provisions reveals that the treatment of foreign income and foreign losses is often asymmetrical.

A. Current Losses

1. In General

The direct effects of current operating losses are set forth in a straightforward fashion in the Code. The tax of an ordinary United States resident, citizen, or domestic corporation is based on his, her or its taxable income.\textsuperscript{23} The definition of “taxable income” begins

\begin{itemize}
\item \textsuperscript{20} See Treasury Publication No. 479, supra note 7, at 270-73. (Of the foreign subsidiaries of domestic corporations with accounting periods ending July 1965 through June 1966, 15,047 subsidiaries earned $16,986,497,000 before taxes while 4,305 subsidiaries reported losses of $728,224,000.)
\item \textsuperscript{21} Id. at 278. The 5,732 domestic parent corporations of the foreign subsidiaries referred to in note 20 supra reported aggregate net income (less deficits) of $39,905,875,000.
\item \textsuperscript{22} In other contexts Congress has focused on the tax effects of losses and deliberately made them asymmetrical in order to effect some clearly articulated policy. See, e.g., S. Rep. No. 1631, 77th Cong., 2d Sess. 46-47 (1942) (IRC § 165(g)(3), permitting ordinary loss on worthlessness of stock or securities of a subsidiary, as a matter of equity in light of consolidated return provisions); id. at 51 (IRC § 1231, providing ordinary loss and capital gain treatment on sales of depreciable property and real property used in a trade or business, as a “material benefit to businesses which, due to depressed conditions, have been compelled to dispose of their plant or equipment at a loss”); H.R. Rep. No. 2198, 85th Cong., 2d Sess. 2 (1958) (IRC § 1244, permitting ordinary loss deduction on sale of “small business stock,” in order to increase the volume of outside funds available for financing small business). No such explicit formulation of congressional intent exists for the tax effects of the foreign losses discussed herein. Accordingly, it is not a sufficient answer to the implications of the symmetry criterion, when considering a given Code provision, to refer to a general intention of benefiting taxpayers investing abroad. A much more plausible explanation of asymmetrical loss treatment in the foreign context is congressional inattention.
\item \textsuperscript{23} IRC §§ 1 and 11(a) set forth sweeping jurisdictional rules, imposing tax on the taxable income of “every individual” and “every corporation,” respectively. IRC §§ 871
\end{itemize}
with the taxpayer's gross income "from whatever source derived" and subtracts therefrom deductions which are also determined and allowed without regard to source. Computation of the taxable income of these taxpayers may thus involve subtraction of foreign operating losses from domestic gross income.

Profits and losses of a foreign branch of a regular domestic corporation, which are treated as described above, thus seem to occasion almost perfectly symmetrical tax consequences. But if the taxation of a foreign branch over a period of time, rather than during a single taxable year, is considered, a significant asymmetry appears. This asymmetry, which results from the ability of a domestic corporation to use losses of a foreign branch to offset other income of the corporation during one or more periods and then subsequently shield the foreign project from United States tax, will be discussed in connection with the treatment of foreign subsidiaries.

2. Special Cases

Special cases involving certain classes of United States citizens and domestic and foreign corporations involve variations from the norm just described.

a. Citizens Abroad

Section 911 of the Code provides that a citizen who is present and 881 cut back this assertion of taxing jurisdiction and limit the taxation of nonresident aliens (and citizens of United States possessions, IRC § 932(a)) and foreign corporations to certain income from sources within the United States and income connected with the conduct of a trade or business within the United States.

24. IRC § 61(a).
25. IRC § 63(a).
26. If the result of a subtraction is less than zero, the loss may be carried to other taxable years, within certain statutory limits. See IRC § 172.
27. The only possible exception arises in the foreign currency area. A foreign branch of a domestic corporation may recognize losses as they arise under the "trans- action" or "net worth" methods of accounting for branch profits; currency gains may go unrecognized under the "profit and loss" method. If, as seems most likely, these methods are "accounting methods" within IRC § 446, cf. Amer. Pad & Textile Co., 16 T.C. 1304 (1951), a taxpayer may not shift from one method to another from year to year without the Commissioner's permission. See generally Ravenscroft, Tax Management Portfolio No. 280, supra note 2, at A-7 to 11. Changes in the regulations could cure this asymmetry. The regulations applicable to controlled foreign corporations could serve as the model for branch treatment. Those regulations in effect require controlled foreign corporations to recognize currency gains and losses as they arise. See Treas. Reg. § 1.964-1(d)-(e) (1964).
29. "Citizen" is defined for tax purposes in Treas. Reg. § 1.1-1(c) (1956) to include "every person born or naturalized in the United States and subject to its jurisdiction." If the last phrase is not redundant, it is even more puzzling. In any event the regulations refer to the Immigration and Nationality Act (8 U.S.C. §§ 1481-89 (1970)) with respect to loss of citizenship, which presumably incorporates the ruling in Afroyim...
in foreign countries\textsuperscript{30} for a period of at least 17 of 18 consecutive months\textsuperscript{31} is exempt from United States tax on the first $20,000 of his or her earned income\textsuperscript{32} from foreign sources,\textsuperscript{33} and a citizen who becomes a bona fide resident\textsuperscript{34} of a foreign country for a period including a whole taxable year may be exempt on the first $20,000 or $25,000\textsuperscript{35} of his or her earned income.\textsuperscript{36} In either case, where the citizen has any income during the taxable year from sources within the United States or earned income in excess of the maximum exemption, an allocation of the taxpayer's items of deduction must be made to prevent items properly attributable to the exempt earned income from reducing other items of gross income.\textsuperscript{37}

Apart from losses which figure into this allocation of deductions for purposes of determining a taxpayer's includable earned income in a given taxable year, net losses have presented a special problem under § 911. In Brewster \textit{v. Commissioner},\textsuperscript{38} the taxpayer, a bona fide resident of Ireland, engaged in the business of farming there. Her farming losses exceeded the gross income derived from the farming business in Ireland each year for a six-year period.\textsuperscript{39} On

\begin{quote}
v. Rusk, 387 U.S. 253 (1967), and makes inadvertent loss of citizenship (and qualification for the benefits of IRC § 911) most unlikely. It is not clear why resident aliens are not eligible for the benefits of IRC § 911(a)(2). See Treas. Reg. §§ 1.911-1(a)(9), (b)(7) (1957) define “foreign country” to mean territory under the sovereignty of a government other than the United States. Mere presence on a foreign flag ship on the high seas is not presence in a foreign country. Bebb, 36 T.C. 170 (1961).


32. IRC § 911(a)(2).

33. IRC §§ 861-63 set forth rules for determining the geographic source of various items of gross income.

34. The regulations define bona fide residence by reference to the principles of IRC § 871. Treas. Reg. § 1.911-1(a)(2) (1957). Treas. Reg. § 1.871-2(b) (1957), in turn, characterizes as “residents” persons living in a country with no definite intention as to their stay or for a purpose which requires an “extended stay” to accomplish. The cases postulate a one-year rule of thumb, but consider a variety of factors. See, e.g., Scott \textit{v. United States}, 432 F.2d 1388 (Ct. Cl. 1970).

35. The exemption increases to $25,000 after three consecutive years of bona fide residence. IRC § 911(c)(1)(B).

36. IRC § 911(b) defines “earned income” generally as “compensation for personal services actually rendered.” In addition to the determination of what is earned income, the principal areas of dispute under § 911 have been the presence or residence requirements, \textit{supra} notes 31 and 34, the source of income, and the exclusion of amounts of earned income “paid by the United States or any agency thereof.” IRC §§ 911(a)(1)-(2). The last area has proved particularly troublesome in the case of citizens employed by foreign governments or quasi-public bodies whose salaries are paid with funds from United States bodies such as the Agency for International Development. See, e.g., Marty, P-H 1972 Tax Ct. Mem. ¶ 72,011, 1972 CCH Tax Ct. Mem. 26 (1972).

37. IRC §§ 911(a), 265(1); Treas. Reg. § 1.911-2(d)(6) (1965).


39. Her total gross income from farming for 1956-60 was $122,399.91, of which $36,718.16 was determined to constitute “earned” income attributable to personal services instead of to capital, which was also a material income-producing factor in the business. Her Irish farming deductions totaled $619,721.27, of which $37,447.35 was allocable to earned income. 55 T.C. at 292, 255.
\end{quote}
her tax returns she did not claim any exclusion of her gross income from farming as “earned income” under § 911, but used all of the deductions to reduce income otherwise subject to United States income tax. The courts agreed with the Internal Revenue Service's contention that the statute mandatorily excluded the taxpayer's “earned income” from her gross income and disallowed the deductions properly allocable to the earned income, even though the deductions thus disallowed exceeded the taxpayer's earned income from farming.40

This result is consistent with Hempel,41 an earlier Tax Court decision in which the large foreign expenses of an opera singer were disallowed because she received a small amount of gross income abroad.42 Both Brewster and Hempel thus seem to contemplate a kind of symmetry in § 911 which denies a taxpayer the right to offset foreign losses against items of United States income where the profits (if any) from the activity to which the losses relate are not fully subject to United States tax. The only asymmetry here is a minor one: While earned income above $20,000 or $25,000 is taxable, operating losses in excess of $20,000 or $25,000 resulting from an individual citizen's activities abroad are not deductible under the Brewster-Hempel doctrine.

b. Lack of Consolidated Return Privilege for Certain Domestic Subsidiary Corporations

One or more domestic corporations controlled43 by a single domestic parent corporation may generally elect to file a consolidated federal income tax return.44 The profits and losses of the corporate members of the affiliated group filing a consolidated return are offset in arriving at “consolidated taxable income,”45 which is computed and taxed without regard to its geographic source or the

40. Section 911(b) limits “earned income” from a business in which both personal services and capital are material income-producing factors to no more than 30 percent of the taxpayer's share of the net profits of the business. The court restricted this rule to situations where the business is profitable, but permitted the taxpayer to offset against United States income the “major part” of her Irish farming losses, not attributable to personal services. 473 F.2d at 163.
42. Her “earned” gross income from foreign sources was $16,20 in 1958; her expenses claimed allocable thereto, $12,001.98. 1947 P-H Tax Ct. Mem. at 666, 6 CCH Tax Ct. Mem. at 748.
43. Section 1504(a) defines an “affiliated group” of corporations eligible to file a consolidated return as one connected by 80 percent direct stock ownership with a common parent corporation or other includable corporations.
44. IRC § 1501.
provenance of the deductions which enter into the computation.\textsuperscript{46} The Code, however, excludes certain domestic corporations with foreign income from the privilege of joining a consolidated return: corporations entitled to the benefits of § 931 ("possessions corporations");\textsuperscript{47} corporations organized under the China Trade Act ("China Trade Act corporations");\textsuperscript{48} and corporations which qualify or have qualified as a Domestic International Sales Corporation (DISC).\textsuperscript{49} Since the taxable income of each of these excluded corporations is subject to favorable treatment under the Code\textsuperscript{50} an easy inference would be that the Congress simply adopted a symmetrical approach and denied the excluded corporations the right to offset foreign losses against domestic income. The chief obstacle to such a view is that the Western Hemisphere trade corporation, which is in effect exempt from tax on up to 14/48ths of its income,\textsuperscript{51} may be included in a consolidated group. Apart from this large-scale asymmetry, the treatment of income and loss of the "special" domestic corporations listed above is riddled with internal asymmetries.

(i). \textit{Possessions Corporation}

To qualify as a "possessions corporation," the corporation must be domestic,\textsuperscript{52} derive at least 80 percent of its gross income\textsuperscript{53} for the three-year period preceding the close of the taxable year from sources within a possession of the United States,\textsuperscript{54} and derive at least 50 percent of such gross income from the active conduct of a trade or business within a possession.\textsuperscript{55} A possessions corporation includes

\begin{itemize}
  \item The foreign tax credit limitation of § 904, see pp. 337-39 \textit{infra}, which depends on the source of taxable income, does apply to the affiliated group in much the same way as it applies to a single domestic corporate taxpayer. See Treas. Reg. § 1.1502-4 (1966). \textit{But cf.} IRC § 1503(b); Treas. Reg. § 1.1503-1 (1955).
  \item IRC §§ 1504(b)(4), 1504(b)(5), 1504(b)(7), 1504(b)(9).
  \item The favorable treatment ranges from exemption of up to all foreign source income in the case of a possessions corporation, see IRC § 951(a), or China Trade Act corporation, see IRC § 941(a), to exemption of one-half of the export-related income in the case of a DISC, see IRC §§ 991, 995.
  \item IRC § 922.
  \item IRC § 931(a). Section 901(d) treats a possessions corporation subsidiary as "foreign," however, for purposes of entitling its shareholders to an "indirect" credit under § 902 for foreign (including possessions) taxes paid by the subsidiary.
  \item Rev. Rul. 56-316, 1956-2 \textit{Cum. Bull.} 597, holds that a corporation meets a similar test under IRC § 921 only if the corporation in fact has gross income and thus suggests that a corporation without any gross receipts or with a gross loss (gross receipts minus cost of goods sold) for the relevant three-year period could not qualify as a possessions corporation.
  \item "Possessions" for this purpose include Puerto Rico, Panama Canal Zone, American Samoa, Guam, and Wake and Midway Islands, Treas. Reg. § 1.931-1(a)(1) (1957). Section 931(c) specifically excludes the Virgin Islands.
  \item IRC §§ 931(a)(2)(A).
\end{itemize}
in gross income only gross income derived from sources within the United States.\textsuperscript{56}

The principal impact of § 931 on a possessions corporation operating at a loss\textsuperscript{57} is to allow deductions only to the extent they are connected with income from sources within the United States.\textsuperscript{58} The Internal Revenue Service has ruled that qualification under § 931(a) is elective so that a corporation with net losses from operations in a possession may avoid the bar of deductions not connected with United States income simply by electing out of § 931 status when it operates at a loss.\textsuperscript{59}

Until recently, however, the IRS had ruled that a corporation could not waive its eligibility under § 931 for the purpose of enjoying the consolidated return privilege.\textsuperscript{60} The Service read the legislative history to require this result, despite the fact that the consolidated return provisions\textsuperscript{61} echo the phrase “entitled to the benefits [of § 931]” which was construed to mean that § 931 treatment was elective.\textsuperscript{62}

The Service’s reading\textsuperscript{63} of the statute thus restricted the utility of losses of a possessions corporation to their availability as carryovers to other taxable years of the corporation under the net operating loss

\textsuperscript{56} IRC § 931(a). The exemption of foreign source income is obviously the most attractive feature of possessions corporation status. Other advantages, enjoyed in common with other domestic corporations, include the ability to transfer tax-free under § 351 and without an advance ruling under § 367, appreciated property, including intangibles justifying maximum prices under § 482 for goods manufactured by the corporation, to a possessions corporation subsidiary, and the ability to liquidate the subsidiary tax-free under § 332 without a § 367 ruling. The “economic penetration” requirement of § 931(a)(2) and the availability of local tax exemptions in Puerto Rico, P.R. Laws Ann. tit. 13, § 252, and American Samoa, 26 Rev. Code of Amer. Samoa §§ 26.0101 et seq., have made possessions corporation subsidiaries most popular as vehicles for manufacturing activities there. Unless the taxation of amounts “received” within the United States under IRC § 931(b) can be read to frustrate a tax-free liquidation, it is possible to transfer assets to a possessions corporation subsidiary, operate a manufacturing business in the possession for a period of years, and then distribute all of the assets of the subsidiary, including its accumulated profits, to the parent corporation in liquidation— all without payment of any income taxes to the United States or to the possession. See B. BITTKER & J. EUSTICE, FEDERAL INCOME TAXATION OF CORPORATIONS AND SHAREHOLDERS § 17.13 (3d ed. 1971).

\textsuperscript{57} Another possible consequence is disqualification from § 931 status of a corporation operating at a gross loss. See note 53 supra.

\textsuperscript{58} IRC § 931(d). The only exception applicable to a corporation is for charitable contributions. IRC § 931(d)(2)(C).


\textsuperscript{61} IRC § 1504(b)(4) (“Corporations entitled to the benefits of section 931 . . . ”).

\textsuperscript{62} See I.T. 3365, 1940-1 Cum. Bull. 92, 93. The language construed by the 1940 ruling was contained in the predecessor of § 931, but is identical with the present phrase, “entitled to the benefits of this section.” IRC § 931(d)(1).

provisions of the Code,\textsuperscript{64} or to their effect on the amount of the corporation's earnings and profits potentially taxable as dividends when distributed to its corporate shareholder.\textsuperscript{65} In \textit{Burke Concrete Accessories, Inc. v. Commissioner}\textsuperscript{66} the Tax Court rejected the position of the Service regarding the availability of the consolidated return privilege and held that an affiliated group included an otherwise eligible possessions corporation with net losses, since the corporation derived no "benefits" from its qualification under § 931.\textsuperscript{67}

The Service recently agreed to follow \textit{Burke} and thus exacerbated the asymmetry created by its prior ruling that § 931 qualification was elective only as to treatment of the possessions corporation.\textsuperscript{68} Thus, if a corporation entitled to the benefits of § 931 has net income, that income is not subject to United States tax (if the corporation elects § 931 treatment), whereas if such a corporation has a net loss, that loss may be used to offset taxable income of other corporations in a consolidated group.

(ii). \textit{China Trade Act Corporation}

A corporation organized under the China Trade Act of 1922,\textsuperscript{69} and owned by United States citizens or residents of Formosa, Hong Kong, the United States, or its possessions is, in effect, exempt from tax on income from sources within Formosa and Hong Kong under § 941.\textsuperscript{70} Because of the fact that only four China Trade Act cor-

\textsuperscript{64} IRC § 172.
\textsuperscript{65} IRC §§ 301, 316(a).
\textsuperscript{67} The implications of \textit{Burke} extend beyond the treatment of losses and may permit any accumulated earnings and profits of the loss corporation to be paid tax-free to the shareholder, see Treas. Reg. § 1.1502-14(a)(1) (1966), and IRC §§ 243, 246(a)(2)(B). It is therefore not surprising that Congress has already proposed legislation clarifying the elective nature of section 931 status and curtailing the consolidated return dividend exclusion by denying the dividends-received deduction for dividends "out of earnings and profits of a corporation attributable to amounts excluded from the gross income of such corporation under section 931," H.R. 11148, 92d Cong., 2d Sess. § 1 (1972). See H.R. Rep. No. 92-1300, 92d Cong., 2d Sess. 1-2 (1972).
\textsuperscript{68} See Rev. Rul. 73-498, 1973 Int. Rev. Bull. No. 46, at 19, revoking Rev. Rul. 65-295, 1965-2 Cum. Bull. 323. Rev. Rul. 65-295, while denying the consolidated return privilege to a possessions corporation operating at a loss, did allow the corporation to elect out of § 931 treatment in filing its own tax return. This elective feature was asymmetrical. If the corporation had net income one year, it could escape United States taxation by electing § 931 treatment. If it had a net loss, it could refuse to elect § 931 treatment, deduct the loss on its return without regard to the deduction limit imposed by § 931 and, if necessary, carry the loss forward to offset subsequent taxable income. This subsequent income could then, of course, be earned without regard to the source restrictions of § 931.
\textsuperscript{70} Section 941(a) allows the corporation a deduction for the proportion of its taxable income from Formosa and Hong Kong sources which the stock owned by the persons enumerated in the text bears to the total outstanding stock.
corporations are currently active, any arguable asymmetries in the treatment of foreign gain and loss by § 941 are of trivial importance.

(iii). DISC

To qualify as a DISC a domestic corporation must have "nominal" capitalization of at least $2,500, satisfy an "export receipts" test and an "export assets" test, and elect to be treated as a DISC. A DISC is not subject to income tax. Instead, the DISC's shareholders pay tax on about one-half of its earnings currently and on the remainder of the earnings when they are distributed, when the shareholder disposes of his stock, or when the corporation ceases to qualify as a DISC. The effect is to defer the imposition of income tax on approximately one-half of the DISC's income, an effect consciously designed to promote export-related activities and investments which satisfy the receipts and assets tests.

In the most unlikely event that a DISC has a loss year, the deficit first reduces "other earnings and profits" of the DISC, then "accumulated DISC income," and finally "previously taxed income." Since the first two categories of earnings are taxable to the shareholder if distributed while the last category is not, the effect of the loss is to reduce potentially taxable amounts dollar-for-dollar. A DISC is not eligible to join in filing a consolidated

71. 5 CCH 1973 STAND. FED. TAX REP. ¶ 4,377.01.
72. IRC § 992(a).
73. IRC § 992(a)(1)(C).
74. IRC § 992(a)(1)(A).
75. IRC § 992(a)(1)(B).
76. IRC § 992(a)(1)(D).
77. IRC § 991.
78. IRC §§ 995(b)(1), 996(f)(2).
79. IRC § 996(f)(1); cf. IRC § 996(a)(5).
80. IRC § 995(c).
81. IRC § 995(b)(2).
82. See, e.g., S. REP. No. 92-437, 92d Cong., 1st Sess. 12-13 (1971).
83. Section 994, permits a DISC and a controlling shareholder which is a "related supplier" to avoid the rigors of § 482 and use mechanical "safe haven" rules for pricing intercompany sales, commissions, and rentals. Apart from any profit justifiable under § 482, the pricing rules permit the DISC to earn a net profit equal to the greater of 4 percent of its gross receipts, IRC § 994(a)(1), or 50 percent of the combined taxable income of the DISC and the related supplier, IRC § 994(a)(2). Although the proposed regulations, in a dubious bit of statutory reconstruction, generally provide that these pricing rules do not apply to the extent that they would cause the related supplier to realize a loss on any transaction, see proposed Treas. Reg. § 1.994-1(e)(1), 37 Fed. Reg. 19627 (1972), they specifically and in all events permit the related supplier to reimburse the DISC for any losses which the DISC would otherwise suffer, proposed Treas. Reg. § 1.994-1(e)(1)(f), 37 Fed. Reg. 19627 (1972).
84. IRC § 996(b)(1).
85. IRC § 996(b)(2).
86. IRC § 996(b)(3).
87. IRC §§ 301, 316(a).
88. IRC § 996(a)(2).
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return\textsuperscript{89} and cannot otherwise make its losses currently available to offset income of its shareholder. Since a loss year for such a corporation is highly improbable, the symmetry implications of DISC loss treatment will not be discussed in this article.

(iv). Western Hemisphere Trade Corporation

A Western Hemisphere trade corporation (WHTC) is a domestic corporation\textsuperscript{90} which conducts all of its business (except for "incidental"\textsuperscript{91} purchases) in countries in North, Central, or South America, or in the West Indies.\textsuperscript{92} Once qualified, a WHTC may reduce its entire taxable income, regardless of source, by a special deduction which lowers the top corporate tax rate by 14 percentage points—from 48 percent to 34 percent at 1973 rates.\textsuperscript{93}

Even though profits are thus taxed at a reduced rate, losses may directly offset, dollar-for-dollar, the taxable income of related corporations filing a consolidated return, since the definition of an affiliated group includes WHTC's.\textsuperscript{94} In the absence of a consoli-

\textsuperscript{89} IRC § 1504(b)(2).

\textsuperscript{90} IRC § 921.

\textsuperscript{91} The regulations define "incidental" as "minor" or "nonrecurring or unusual in character" rather than as "incident to" the business of the corporation. Treas. Reg. § 1.921-1(a)(1) (1957). See Otis Elevator Co. v. United States, 356 F.2d 157 (Ct. Cl. 1966) (16.9 percent permissible); Topps of Canada, Ltd., 36 T.C. 326 (1961) (34 percent non-Western Hemisphere purchases too high).

\textsuperscript{92} The corporation must do its business "within" the countries, not on the high seas, Rev. Rul. 66-340, 1966-2 CUM. BULL. 283, and perhaps not on land not subject to the sovereignty of any nation, such as Antarctica. Cf. Rev. Rul. 67-52, 1967-1 CUM. BULL. 186; Treas. Reg. § 1.911-2(f) (1965), Rev. Rul. 55-105, 1955-1 CUM. BULL. 94, lists Puerto Rico, the Virgin Islands, and the Bahamas as qualifying countries, but not Bermuda and the Falkland Islands. The corporation must derive at least 95 percent of its gross income from foreign sources for the three-year period preceding the close of the taxable year. IRC § 921(1), Rev. Rul. 56-316, 1956-2 CUM. BULL. 597, holds that a corporation must have gross income to meet this test, so that a corporation with a "gross loss" (gross receipts minus cost of goods sold) would not qualify as a WHTC. The regular source rules of §§ 861-63 determine source of income for this purpose. Treas. Reg. § 1.921-1(c) (1957). Accordingly, a corporation engaged in the purchase and resale of goods can meet this test merely by arranging for title to the goods to pass outside the United States, IRC § 862(a)(6), Rev. Rul. 64-198, 1964-2 CUM. BULL. 189. To qualify for WHTC treatment, a corporation must also derive at least 90 percent of its gross income during the same three-year period from the "active" conduct of a trade or business. IRC § 921(2). It is clear that a relatively inactive export operation can meet this test. See A.P. Green Export Co. v. United States, 284 F.2d 383 (Ct. Cl. 1960).

\textsuperscript{93} IRC § 922 defines the amount of the special deduction as the corporation's taxable income (computed without regard to the special deductions) multiplied by a fraction whose numerator is 14 percent and whose denominator is the sum of the normal and surtax rates in IRC § 11 for the year. At 1973 rates, the fraction is 14/48ths \([14\%/\(22\%+26\%\)]\). It is not clear whether this unique deduction has the effect of reducing the earnings and profits of the WHTC for purposes of determining the extent to which distributions therefrom are taxable as "dividends." For analogies, see B. Birken & J. Eustice, supra note 56, at 7-17.

\textsuperscript{94} IRC § 1504(b), Cf. IRC § 1503(b) (special rule for application of overall foreign tax credit limitation where affiliated group includes "one or more Western Hemisphere trade corporations").

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dated return election, the losses may be carried over to reduce the corporation's taxable income in other years or may reduce the corporation's earnings and profits which will be taxed when distributed.

The asymmetry is obvious: While the Code subjects the taxable income of a WHTC to a maximum tax rate 14 percentage points below the top corporate rate, it does not similarly restrict the use of WHTC losses.

c. *Foreign Subsidiary Corporations*

Foreign corporations are taxed on business income only to the extent that it is "effectively connected" with the conduct of a trade or business within the United States and on certain other income only to the extent that it is "from sources within the United States." Where a foreign corporation has operating losses, the Code generally allows only those deductions "connected with income which is effectively connected with the conduct of a trade or business within the United States." The regulations provide a system of allocation designed to make the difficult but necessary determinations of what constitutes a "connection." But this problem is of only minor significance for present purposes, since it is generally not economical for a United States investor to form a foreign subsidiary to engage in business in or invest in the United States. The principal tax

95. IRC § 172. Use of a loss as a carryover to years in which the corporation qualifies as a WHTC will offset income otherwise taxable at a reduced rate, and thus not be so advantageous as use of the losses currently by other corporations filing a consolidated return.

96. IRC §§ 301, 316(a). Since a corporate shareholder may exclude from taxable income at least 85 percent, IRC § 243(a)(1), and as much as 100 percent, IRC § 243(a)(3) & Treas. Reg. § 1.1502-14(a)(1) (1966), of dividends from a WHTC, this use of losses is less advantageous than their application as carryovers.

97. Section 882(a)(1) imposes tax at the regular corporate rates on the net taxable income of this description. Sections 864(b) and (c) define "trade or business within the United States" and "effectively connected," respectively. See generally S. Roberts & W. Warren, U.S. INCOME TAXATION OF FOREIGN CORPORATIONS AND NONRESIDENT ALIENS chs. V-VB (1966).

98. Section 881(a) imposes a 30 percent tax on the gross income received from United States sources as "interest, dividends, rents, salaries, wages, premiums, annuities, compensations, remunerations, emoluments, and other fixed or determinable annual or periodical gains, profits and income," and gains on certain sales or exchanges of property. Bilateral income tax conventions to which the United States is a party often reduce or eliminate the 30 percent rate on some categories of income. See, e.g., Convention with The Netherlands on Double Taxation and Taxes on Income, April 29, 1948, arts. VII, VIII, IX, 62 Stat. 1757 (1948), T.I.A.S. No. 1855.

99. IRC § 882(c)(1)(A).


101. A corporate investor would not receive a credit for United States income tax paid by the subsidiary. IRC § 901(b).
attraction of a foreign corporation for a United States person is its use as a vehicle for foreign business activity.

(i). "Deferral" of Loss as Well as Gain

The income of a foreign corporation not engaged in business or investment in the United States and not deriving income from sources therein is generally not subject to United States income tax until it is distributed to a United States shareholder as a dividend or, in certain cases, upon the United States shareholder's sale or exchange of the stock at a gain. When the earnings of the foreign corporation are thus repatriated to or realized by a corporate investor, the United States tax is offset dollar-for-dollar by the foreign income taxes paid on the earnings under the "indirect" foreign tax credit provisions of the Code, up to the limit imposed by § 904.

The Code deals with losses of a foreign corporation in a rather symmetrical fashion. Except to the extent of the possibility of offsetting a foreign corporation's losses against its own United States income, a United States shareholder cannot use the foreign corporation's current operating losses to offset directly other income subject to United States tax, although such losses will reduce the amount of the earnings and profits of the foreign corporation and, thereby, may reduce the amount ultimately taxable as a dividend to the United States shareholder. The statute specifically excludes foreign corporations from membership in an affiliated group eligible to file a consolidated return.

102. The principal exceptions are foreign corporations with "tainted" income or assets caught by the foreign personal holding company, IRC §§ 551-58, or subpart F, IRC §§ 951-64, provisions. See pp. 330-34 infra.
103. IRC §§ 11(f), 881-82.
104. IRC §§ 11(a), 61(a)(7).
105. IRC § 1248(a).
106. IRC §§ 902, 960.
107. As net operating loss carryovers under § 172 or as deductions allocated in part to United States income under § 882(c)(1)(A).
108. IRC § 882(c)(1)(A). Rev. Rul. 73-226, 1973-21 INT. REV. BULL. 7, identifies a very narrow area in which a domestic parent corporation might obtain a current ordinary deduction for losses of a foreign subsidiary corporation. Where the parent made payments to creditors of its subsidiary, who were also customers of the parent, "[s]olely to prevent damage to the [parent's] existing goodwill," the payments were deductible by the parent as ordinary and necessary business expenses under § 162.
109. As taxable income, positive or negative, is the starting point for computation of the earnings and profits of a corporation, including a foreign corporation. See generally B. BITTGER & J. ETUCE, supra note 56, at ¶ 7.03-04; cf. IRC § 964(a); Treas. Reg. § 1.964-1 (1964).
110. See IRC §§ 301, 316(a), 1248(a).
111. IRC § 1504(b)(3).
Timing of Formation

The fact that losses of a foreign branch may be used to reduce directly other United States income of a domestic corporation, while losses of a foreign corporation may not be so used, reflects an underlying asymmetry which may affect a United States investor's strategy in planning foreign operations. A domestic corporation which plans a foreign venture expected to lose money during its start-up period may operate the venture as a branch for the initial period, deducting the losses currently, and then incorporate the venture abroad when it has turned the corner and begun to generate profits. No legislative or judicial doctrine appears to require "recapture" of the losses in the way the depreciation recapture provisions and the "tax benefit rule" operate in other contexts, and the Commissioner of Internal Revenue apparently does not take such start-up losses into account in issuing the rulings under §367 which are a prerequisite to tax-free incorporation of a foreign subsidiary.

It is doubtful that the courts and the Commissioner have the ability to stop this practice under existing law. Neither §367 nor §269, both of which would require a showing of a tax avoidance
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purpose for the incorporation transaction, appears to apply, since any tax avoidance takes place prior to the incorporation transaction. Thus, an asymmetry results from a taxpayer's ability both to obtain deductible losses during unprofitable start-up years and to shield income in subsequent years from United States taxation.

(iii). Contiguous Country Subsidiaries

One exception to the general treatment of a foreign corporation is that § 1504(d) permits a domestic corporation owning all the stock of a corporation formed in a country contiguous to the United States (i.e., Canada or Mexico) to elect to treat the corporation as a domestic corporation for purposes of the income tax law, including the consolidated return provisions, if the corporation can be shown to be organized and maintained solely for the purpose of complying with the laws of the foreign country as to title and operation of property. The effect of such an election on the treatment of losses of the foreign corporation is the nearly perfect symmetry described in the previous discussion of foreign branches.

A different situation may obtain, however, where an electing contiguous country corporation suffers losses in one year and expects profits in the following year. The question arises whether the election under § 1504(d) can be rescinded in order to defer the United States tax on the profits. Although the statute and the consolidated return regulations suggest no reason why the option to be treated as a domestic corporation is not a two-way street for the taxpayer, the reorganization branch of the Internal Revenue Service views the election of domestic corporation status as equivalent to the liquidation of the foreign corporation. The Service may also view the "de-election" of a contiguous country corporation as equivalent to an incorporation transaction under § 351, gain on which would be tax-free only if an advance ruling under § 367 were secured. Even

118. IRC § 1504(d). The qualification rules are strictly construed and thus present definitional problems. Rev. Rul. 71-22, 1971-2 CUM. BULL. 326, holds that a foreign corporation used to obtain the benefits of a foreign grant program restricted to corporations organized under laws of that country does not qualify.

119. The IRS apparently views an election under § 1504(d) as involving a transfer of assets from a foreign corporation to a domestic corporation, a transaction which would require an advance ruling under §§ 367, 368(a)(1)(D) in order to avoid recognition of any gain as a tax-free reorganization. See F. Peck, CONSOLIDATED TAX RETURNS § 3.03 (2d ed. 1973); 25 TAX LAW. 566 (1972).

120. It is not known whether the Service would attempt in this fashion to forestall use of a contiguous country subsidiary's startup losses through a § 1504(d) election, which the parent corporation would presumably revoke when the subsidiary became profitable. Though the Service is understood to view termination of § 1504(d) status as a § 351 transaction, see note 119 supra, § 367 may simply not prohibit such transactions. See p. 328 supra. This problem may not be as significant as the election
so, the Service may well view itself as powerless to prevent the change back to foreign corporation status in situations designed to avoid current United States tax on expected earnings, or to attach conditions of "recapture" or other penalties to any § 367 ruling.\textsuperscript{121}

The potential asymmetry thus results from the ability to utilize losses in unprofitable years to offset other United States taxable income while deferring United States taxation of income in profitable years.

(iv). \textit{Subpart F}

In terms of the number of foreign corporations affected, subpart F of the Code\textsuperscript{122} contains even more important exceptions to the above-described general treatment of profits and losses of foreign corporations. "Subpart F income"\textsuperscript{123} of a controlled foreign corporation\textsuperscript{124} includes specified kinds of income from sales of goods between related persons,\textsuperscript{125} income from the performance of specified services for related persons,\textsuperscript{126} passive investment income,\textsuperscript{127} and income from the insurance of United States risks.\textsuperscript{128} Such income is taxed to United States shareholders\textsuperscript{129} as it is earned,\textsuperscript{130} without regard to whether it is distributed.\textsuperscript{131} The amount of income so taxed is limited, however, to the earnings and profits of the corporation with respect to an existing subsidiary, since the stock of a newly-formed loss corporation is likely not to have appreciated substantially in value by the time its business begins to show a profit.

121. \textit{See} p. 328 \textit{supra}. In cases in which the losses of the subsidiary have exceeded the parent company's investment therein, the "excess loss" provisions of the consolidated return regulations may help to reduce the tax avoidance possibilities. The consolidated return regulations define "excess losses" to include losses of a subsidiary which exceed the parent corporation's investment therein and require such losses to be added to the parent's income whenever the investment in the subsidiary is disposed of. \textit{Treas. Reg. § 1.1502-19} (1966).

122. IRC §§ 951-64.

123. "Subpart F income" is defined in IRC § 952(a) to include the items enumerated in the text and extended by IRC § 954(b)(3) to include all of a corporation's gross income where more than 70 percent of the corporation's gross income would otherwise be subpart F income.

124. Defined by IRC § 957(a), with certain exceptions, as a foreign corporation of which more than 50 percent of the total combined voting power of all classes of stock entitled to vote is owned (after application of the attribution rules of §§ 958(a)-(b)) by United States shareholders on any day during the taxable year of the foreign corporation.


128. IRC §§ 952(a)(1), 953.

129. Defined by IRC §§ 951(b), 957(d) and 7701(a)(30) to include, with certain exceptions, United States citizens, residents, partnerships, corporations, trusts, and estates owning (after application of the attribution rules of §§ 958(a)-(b)) 10 percent or more of the total combined voting power of all classes of stock entitled to vote of a foreign corporation.

130. IRC § 951(a)(1)-(3).

131. Distributions (or investments in United States property) of amounts previously taxed are not includable in the shareholder's gross income. IRC § 959(a).
trolled foreign corporation for the current year.\textsuperscript{132} In addition, certain amounts invested in "United States property"\textsuperscript{133} by a controlled foreign corporation are taxed as constructive dividends to United States shareholders.\textsuperscript{134}

Current losses of a controlled foreign corporation affect the amount of any "minimum distribution" which the United States shareholder chooses to receive in order to avoid having to include in its own income the foreign corporation's subpart F income.\textsuperscript{135} The amount of the minimum required distribution is inversely proportional to the effective foreign tax rate of the foreign corporation\textsuperscript{136}—the ratio of the foreign taxes paid by the foreign corporation for the year to its pre-tax earnings and profits for the year.\textsuperscript{137} Moreover, where the United States shareholder makes a chain\textsuperscript{138} or group\textsuperscript{139} minimum distribution election—in effect combining the foreign taxes and earnings and profits of several related foreign corporations to arrive at a single consolidated effective foreign tax rate\textsuperscript{140}—losses of one of the

\textsuperscript{132} IRC § 952(c). The amount of current earnings and profits is reduced by deficits in earnings and profits of the controlled foreign corporation, id., or certain related controlled foreign corporations, IRC § 952(d), in the same or other years.

Because of the current earnings and profits ceiling, current losses of a controlled foreign corporation preclude taxation of the shareholder under IRC § 951(a)(1)(A)(i). Rules for determination of the earnings and profits of a controlled foreign corporation for purposes of subpart F are set out in Treas. Reg. § 1.964-1 (1964). The regulations provide detailed instructions for translating foreign currency financial statements of the corporation into United States dollar statements consistent with generally accepted financial and tax accounting principles in the United States.

\textsuperscript{133} IRC § 956 defines the taxable amount as the increased investment, measured from year-end to year-end, in tangible property located in the United States, intangibles such as patents and copyrights acquired or developed for use in the United States, and stock and debt obligations of United States persons.

\textsuperscript{134} IRC § 951(a)(1)(B). Amounts taxed under this section may be excluded from gross income when distributed to the United States shareholder, or, apparently, when reinvested in United States property. IRC § 959(a)(2).

While the United States property provisions, unlike the provisions limiting the taxation of subpart F income to the amount of the controlled foreign corporation's current earnings, purport to subject all accumulated and current earnings of the corporation to tax, see IRC § 956(a)(1), the opinion in Estate of Leonard E. Whitlock, 59 T.C. 490, 508-09 (1972) (dictum), appeal docketed, 10th Cir., May 25, 1973, casts doubt on the constitutionality, under Eisner v. Macomber, 252 U.S. 189 (1920), of taxing accumulated, as opposed to current, earnings thereunder. Under this view current losses of a controlled foreign corporation would preclude taxation of the shareholder under § 951(a)(1)(B). But see Dougherty, 7 CCH 1973 STAND. FED. TAX REP. ¶ 7538 (1973) (it is constitutional to tax accumulated earnings from years prior to enactment of subpart F).

\textsuperscript{135} Section 963 allows a domestic shareholder to exclude its share of the subpart F income of its controlled foreign corporations by electing to have them distribute a certain percentage of their earnings and profits for the current year. IRC §§ 951(a)(1)(A)(i), 963(a). The election may be made with respect to a single controlled foreign corporation or chains or groups of controlled foreign corporations.

\textsuperscript{136} IRC § 963(b).

\textsuperscript{137} IRC § 963(d).

\textsuperscript{138} IRC § 963(c)(2).

\textsuperscript{139} IRC § 963(c)(3).

\textsuperscript{140} IRC § 963(d)(2).
corporations may be used to reduce the earnings and profits of other corporations in the chain or group.\textsuperscript{141} This will reduce the size of the required minimum distribution.

While the Code provides for the inclusion of subpart F income in the gross income of a United States shareholder, it is asymmetrical in failing to permit the direct deduction by the shareholder of any net losses of the controlled foreign corporation.\textsuperscript{142}

Another potential asymmetry results from the possible effects of losses of a foreign subsidiary on the minimum distribution computation with respect to the controlled foreign corporation itself for years other than the loss year. The principal question is whether a current foreign loss will reduce earnings and profits of any year other than the year of loss. A related question is whether, if the loss produces tax benefits with respect to some other year under the applicable foreign tax law (such as a loss carryback producing a refund of taxes paid in an earlier year), the amount of the tax benefit will affect the amount of the "taxes paid"\textsuperscript{143} by the foreign corporation for the earlier year or, at least, the earnings and profits\textsuperscript{144} of either the current or the prior year.\textsuperscript{145}

142. It is conceivable that the subpart F provisions could be read to permit such direct deduction. IRC § 951(a)(1)(A)(i) requires inclusion in gross income, in the absence of a minimum distribution, of a United States shareholder's pro rata share of a controlled foreign corporation's subpart F income. The latter amount is defined in § 951(a)(2) as the amount which the shareholder would have received in a pro rata distribution of the corporation's subpart F income—pro rata with time as well as stock ownership dimensions. Section 952(c) limits the subpart F income of a controlled foreign corporation to its earnings and profits for the year, an amount which can, quite clearly, be negative. Section 952(a)(2) includes "foreign base company income" in "subpart F income." Section 954(a) defines the former term, and § 954(b)(5) specifically provides that deductions properly allocable to foreign base company income shall be taken into account. There are two obstacles to the direct deduction of "deficits" (foreign base company income exceeded by deductions properly allocable thereto) under this scheme. First, § 951(a)(2) might be read to preclude the distribution of a negative sum. Second, § 961, which explicitly provides only for upward adjustments to stock basis for the amount of subpart F income imputed and included, might be read to preclude downward adjustments by addition of a negative amount.

Since the function of § 951(a)(2) is simply to define "pro rata share," it may well be logical to recognize a hypothetical negative distribution for this purpose, or at least not to require application of § 951(a)(2) at all in the case of a 100 percent controlled subsidiary whose ownership is unchanged throughout the taxable year. The regulations and the legislative history are completely silent as to this possibility. See Treas. Reg. §§ 1.951-1 (1965); H.R. Rep. No. 1447, 87th Cong., 2d Sess. 57-66 (1962); S. Rep. No. 1881, 87th Cong., 2d Sess. 237-79 (1962); H.R. Rep. No. 2508, 87th Cong., 2d Sess. 29-36 (Conf. Report 1962).

143. Foreign "taxes paid" constitute the numerator of the "effective foreign tax rate" fraction. IRC § 963(d).
144. "Earnings and profits" constitute the denominator of the "effective foreign tax rate" fraction. Id.
145. The relevant cases and rulings suggest at least three possible outcomes.

The argument that a current foreign loss does not affect the foreign taxes paid and earnings and profits for any other year is based primarily on Rev. Rul. 64-146, 1964-1 COMM. BULL. 129, which holds that a tax refund arising from a net operating
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If the impact of the foreign loss (and any related refund of foreign taxes) is not confined to the year of the loss for purposes of the minimum distribution requirement, then the effect would be asymmetrical since gains realized in that year (and the foreign taxes paid thereon) would have affected the computation of the minimum distribution amount only for that year.

Finally, an asymmetry in the treatment of gains and losses in the foreign currency area may arise under subpart F in relation to the deemed paid foreign tax credit of § 902. Under the regulations, a United States corporate shareholder of a foreign subsidiary must compute the earnings and profits of the subsidiary, for purposes of computing the § 902 foreign tax credit with respect to dividends therefrom, under the full subpart F rules, which require unrealized currency exchange gains and losses to be taken into account,146 whenever the United States shareholder elects the benefits of the minimum distribution provisions.147 In other years for which no minimum distribution election is made, however, the earnings and profits of the subsidiary may be computed without regard to unrealized exchange gains and losses.148 A United States shareholder wishing to maximize its indirect foreign tax credits per dollar of dividends received from

loss carryback increases earnings and profits of an accrual basis corporation for the taxable year in which the right to the refund arises, rather than the earlier year to which the loss may be carried back. Because only current earnings and profits are thus affected by the operating loss, it would follow that no adjustment to the amount of foreign taxes paid in the earlier year is in order, since any such adjustment would ipso facto affect the earnings and profits of the earlier year.

The second possible outcome of the instant question would be based on Steel Improvement & Forge Co., 36 T.C. 265 (1961), rev'd on other grounds, 314 F.2d 96 (6th Cir. 1963), and Pacific Gamble Robinson Co. v. United States, 62-2 U.S. Tax Cas. ¶ 9160, 9 Am. Fed. Tax R. 2d 483 (W.D. Wash. 1961), which support the proposition that the amount of foreign taxes paid in the earlier years should be reduced to reflect a refund arising in a subsequent year. If this rule is correct, then it would be necessary to reduce the earnings and profits of the earlier years by the losses carried back to them in order to coordinate low-tax and low-earnings years in the way necessary for rational functioning of both the § 902 foreign tax credit and the minimum distribution provisions. See E. Owens, supra note 2, at 127-28. One problem with such an adjustment is, unsurprisingly, Rev. Rul. 64-146, 1964-1 Cum. Bull. 129, which holds, in effect, that a net operating loss does not affect earnings and profits of earlier years.

A third possibility is that the foreign taxes paid by the subsidiary must be reduced by any amount thereof subsequently refunded, pursuant to Steel Improvement and Pacific Gamble Robinson, but that Rev. Rul. 64-146 and the general treatment of deficits under subpart F as an annual concept preclude reducing the earnings and profits of the subsidiary for the earlier year. This would, of course, be the worst outcome possible for United States shareholders because it would increase the required minimum distribution with respect to the earlier year, and decrease the § 902 foreign tax credit allowable with respect to the earlier year, even though the average income and foreign tax rate of the subsidiary for the current and earlier years would reflect both the loss and its effect on the subsidiary’s foreign tax liability.

147. See generally Ravenscroft, Currency Revaluation and Devaluation—Tax Effects, supra note 2, at &p; 13 to 17, &p; 27 to 28; Treas. Reg. § 1.902-3(c)(3)(ii) (1965).
a given subsidiary will subject the subsidiary to a minimum distribution election whenever the subsidiary has unrealized exchange losses and make no minimum distribution election whenever the subsidiary has unrealized exchange gains. Although separate accounting periods are necessarily involved, the treatment of currency exchange gains and losses of a given foreign subsidiary may thus be quite asymmetrical, with losses recognized and gains unrecognized in the computation of the denominator of the § 902 foreign tax credit fraction.

B. Terminal Losses

The fact that some foreign losses cannot be used currently to offset income of a United States investor underscores the importance of the treatment accorded foreign terminal losses.

1. Citizens and Domestic Corporations

Upon termination of business operations abroad a United States citizen conducting the business as a sole proprietor and a domestic corporation with a foreign branch will generally realize capital gain on a sale or exchange of real or depreciable property used in the trade or business, but an ordinary loss on such dispositions of the property. This asymmetrical treatment of gains and losses on property used in the trade or business applies equally in the domestic context.

If the United States investor conducts the foreign business through a separate domestic corporation, the various possibilities of termination transactions at the shareholder level include sale, liquidation, reorganization, worthlessness, or expropriation. Some of these will result in nonrecognition of gain or loss. The factors which influence choice of termination method apply equally in the domestic context, with one exception: Expropriation of the stock of a domestic corporation is treated as an involuntary conversion of the stock certificates producing ordinary loss treatment.

149. IRC § 1231(a). Gains and losses on sales or exchanges of inventory and accounts receivable will generally be ordinary in character. See IRC §§ 1221(1), (4). Gains and losses with respect to sales or exchanges of other assets will generally be capital. See IRC § 1231. Other losses incurred in the trade or business, such as expropriation losses, will be ordinary in character. See IRC §§ 165(a), 1231(a); Rev. Rul. 72-1, 1972-1 Cum. Bull. 52.

150. See, e.g., IRC §§ 332, 354, 368(a).

151. IRC § 165(a); Rev. Rul. 72-1, 1972-1 Cum. Bull. 52. It should be noted that, in the unlikely event that gain was realized on the involuntary conversion, § 1033(a) would permit deferral of recognition of the gain to the extent similar property is received or purchased with the proceeds of the conversion. The tax treatment of nationalization of a subsidiary is thus asymmetrical and advantageous to United States investors whether gain or loss is realized on the nationalization. This situation is
2. Foreign Corporations

Where the chosen investment vehicle is a foreign corporation several special considerations may enter the picture upon termination of the investment.

a. Section 1248

Gain on the sale or exchange of stock of a controlled foreign corporation by a United States shareholder is taxed as a dividend under § 1248, rather than as a capital gain, to the extent of the earnings and profits accumulated while the shareholder owned the stock.\(^{152}\) The Internal Revenue Service has adopted this constructive dividend as the measure of tax avoidance in certain reorganizations involving foreign corporations and imposes inclusion of the dividend in a shareholder's income as the "tollcharge" for the advance ruling under § 367 required for nonrecognition treatment of any additional gain on the transaction.\(^ {153}\)

Disposition of stock of a controlled foreign corporation at a loss, however, precludes the application of § 1248 by its own terms or as the "tollcharge" measure for a § 367 ruling.\(^ {154}\)

Termination of a United States shareholder's interest in a foreign corporation in a complete liquidation will have much the same effect as a sale or exchange. If, on the one hand, the United States shareholder controls the foreign corporation and the transaction meets the other requirements of § 332, gain will not be recognized if the shareholder secures an advance ruling under § 367 on the transaction.\(^ {156}\) If there is a loss, no § 367 ruling is required,\(^ {157}\) and the loss will not be recognized.\(^ {158}\)
If the liquidation is “taxable” and subject to § 331, on the other hand, any gain or loss will be recognized.\textsuperscript{159} A gain will be taxed as a dividend to the extent of the earnings and profits yardstick of § 1248\textsuperscript{160} and as capital gain to any remaining extent.\textsuperscript{161} A loss, however, will normally be capital in character\textsuperscript{162} since, again, § 1248 will not apply to a liquidation in which loss is recognized.\textsuperscript{163}

Section 1248 thus creates an asymmetry in that it requires that gains on the sale or exchange of stock of a controlled foreign corporation or on the taxable liquidation thereof be taxed as ordinary income to the extent of the earnings and profits of the corporation, but does not allow losses resulting from such transactions to be treated as ordinary in character, even though there may be a deficit in the earnings and profits account of the controlled foreign corporation.

The detrimental effect of this asymmetry on a shareholder disposing of such a corporation at a loss is somewhat mitigated by the availability of ordinary loss treatment in two situations. First, as in the case of a domestic subsidiary, a United States shareholder which owns at least 80 percent of the stock of an insolvent foreign corporation may be able to obtain an ordinary loss deduction with respect to the presumably worthless stock.\textsuperscript{164} Second, ordinary loss treatment may be available if the loss occurs through expropriation.\textsuperscript{165}

\textsuperscript{159} IRC § 331(a).
\textsuperscript{160} IRC § 1248(a).
\textsuperscript{161} See IRC § 1221.
\textsuperscript{162} See IRC § 1221.
\textsuperscript{163} IRC § 1248(a).
\textsuperscript{164} IRC § 165(g)(3).
\textsuperscript{165} The expropriation may take the form of a seizure of the stock. The Internal Revenue Service views nationalization of a corporation formed under the laws of the expropriating country as confiscation of the stock certificates of the corporation. See Rev. Rul. 72-1, 1972-1 CUM. BULL. 52. Expropriation may also take the form of a seizure of assets. Variations on these two modes of expropriation arise in situations in which the expropriating country ostensibly compensates the taxpayer for the seizure—perhaps with blocked currency, long-term obligations bearing little interest, or setoffs of tax assessments of doubtful validity for earlier years—raising difficult questions as to the amount or timing of the loss. See generally Peel, supra note 2.

An expropriation loss will normally present the same tax issues as the other types of terminal losses considered herein. If the expropriation takes the form of a nationalization of the United States shareholder’s stock interest, the loss will be deductible under § 165(a), which allows a deduction for losses not compensated by insurance or otherwise. The transaction is treated as an involuntary conversion of the stock and is subject to § 1231. If the loss exceeds the United States shareholder’s § 1231 gains for the year, it will produce an ordinary loss. See IRC § 1231(a); Garrigo v. United States,
b. Source of Gain or Loss

A second asymmetry in this context results from the manner in which the source of terminal loss is determined. The source rules of the Code and present regulations provide that the source of gain on the sale (and, presumably, exchange, liquidation, or other disposition) of stock of a foreign corporation is determined solely by the place of the sale, but the rules do not explicitly provide for the treatment of losses. Under the regulations such losses must be allocated to a taxpayer's other income from sources within and sources without the United States on a gross income basis, if no more appropriate basis of apportionment is available. This approach is asymmetrical in that it fails to provide a means for independently determining the source of terminal losses, while providing such a means with respect to terminal gains.167

C. Indirect Effects of Losses on the Foreign Tax Credit

In addition to the above-described direct effects of foreign losses on the tax liability of United States persons, foreign losses may indirectly affect liability for United States tax in an asymmetrical fashion through their impact on the foreign tax credit.

The most mechanical indirect effect of a foreign loss arises under

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296 F. Supp. 1110 (N.D. Tex. 1968). The Internal Revenue Service will apparently disregard a forced "sale" of shares pursuant to a foreign expropriation decree, and will treat any payment received as compensation in connection with the involuntary conversion, thus preserving the prospect of ordinary loss treatment. See Rev. Rul. 72-1, 1972-1 Cum. Bull. 52.

Where the expropriating country seizes the assets of the corporation rather than the stock, the analysis becomes somewhat more complex. The expropriation would clearly constitute an involuntary conversion, producing a § 1231 loss potentially ordinary in character if a domestic corporation were involved. See IRC § 1231(a). The loss of the foreign corporation will not necessarily produce an ordinary loss or similar tax benefits to the United States investor, however. The ordinary loss will have the effects described above of any other operating loss of a foreign corporation. In addition, the loss will normally reduce the gain or increase the loss recognized upon the subsequent liquidation of the foreign corporation, or perhaps help to establish, as a factual matter, the worthlessness of the United States investor's stock interest therein. See IRC § 165(g)(3). The limited utility of a capital loss on the taxable liquidation of a foreign corporation suggests the possibility that a corporate United States investor whose foreign corporation is faced with an inevitable expropriation of the corporation's assets may well find it desirable to negotiate an expropriation of its stock interest.

Alternatively, the United States investor might seek to have the foreign corporation obtain "compensation" in the form of a debt obligation of the foreign country, which could be distributed in liquidation of the foreign corporation. A subsequent loss on the obligation would produce an ordinary loss to a corporate shareholder in the guise of a "bad debt" deduction under IRC § 166(a)(1). See Rev. Rul. 72-1, 1972-1 Cum. Bull. 52.


167. The most noteworthy aspect of terminal losses is their effect on a taxpayer's source of taxable income for purposes of the foreign tax credit limitation. See pp. 338-39 infra.
the foreign tax credit limitation provisions. Under the "per country" limitation, a United States taxpayer's credit for taxes paid to a given country cannot exceed the proportion of the taxpayer's pre-credit United States tax liability which the taxpayer's taxable income from sources within that country bears to taxable income from all sources.\textsuperscript{168}

Under the optional "overall" limitation, the credit for taxes paid to all foreign countries cannot exceed the proportion of United States tax liability which taxable income from sources without the United States bears to taxable income from all sources.\textsuperscript{169} Each form of limitation requires determination of "taxable income" from certain geographical sources. The Code sets forth detailed rules governing the source of various items of gross income\textsuperscript{170} and then provides:

From the items of gross income specified . . . there shall be deducted the expenses, losses, and other deductions properly apportioned or allocated thereto, and a ratable part of any expenses, losses, and other deductions which cannot definitely be allocated to some item or class of gross income.\textsuperscript{171}

Losses will thus directly affect the size of the limitation by reducing the amount of taxable income from various sources without the United States.\textsuperscript{172}

\textsuperscript{168} IRC § 904(a)(1). In algebraic terms the taxpayer's credit for taxes paid to a given country is:

\[
\text{Maximum Credit} = \frac{\text{Pre-Credit U.S. Tax} \times \text{Taxable Income from Sources Within the Foreign Country}}{\text{Total Taxable Income}}
\]

\textsuperscript{169} IRC § 904(a)(2). Algebraically:

\[
\text{Maximum Credit} = \frac{\text{Pre-Credit U.S. Tax} \times \text{Taxable Income from Foreign Sources}}{\text{Total Taxable Income}}
\]

It should be noted that the limitations apply separately to certain categories of foreign-source income—interest income, IRC § 904(d)(1)(A); DISC dividends, IRC § 904(d)(1)(B); and other income, IRC § 904(d)(1)(C)—so that low-taxed income in one category cannot lower the average effective foreign tax rate and thereby avoid the limitation.

If there are foreign tax credits in a given year in excess of the limitation being used, they may be carried over to other years in accordance with IRC § 904(d) and allowed to the extent permitted for the carryover year.

\textsuperscript{170} IRC §§ 861(a), 862(a).

\textsuperscript{171} IRC §§ 861(b), 862(b).

\textsuperscript{172} Another effect of losses on the computation of the indirect foreign tax credit, see p. 327 supra, occurs whenever foreign taxes are paid or accrued for a year in which the foreign subsidiary has a deficit in its current earnings and profits account. Here the "crack" question arises: Do foreign taxes paid for a year in which the subsidiary has negative earnings and profits fall into a crack and become unavailable as credits upon the payment of dividends, since the taxes are not paid "on or with respect to" the earnings and profits of a particular year? Or should the year-by-year credit computation ever be relaxed in this situation, in order to further the purpose
United States Tax Effects of Foreign Losses

While other considerations may militate against choice of the per-country limitation,\textsuperscript{173} it has one clear advantage to the taxpayer: Under the per-country limitation on the foreign tax credit, losses incurred in a foreign country by a United States taxpayer may produce a double tax benefit. First, the loss may reduce the United States tax on domestic source income in the year of the loss. Second, when business operations in the loss country become profitable, a foreign tax credit will be allowed for the taxes of that country against what would otherwise be the United States tax on the income from that country. The latter is, in effect, an instance of asymmetrical treatment of losses since profits from a given foreign country increase the per-country foreign tax credit limitation, while losses do not decrease the limitation.

A second potential asymmetry results from the fact that a foreign operating loss may affect the United States shareholder's indirect foreign tax credit computations with respect to the foreign corporation for years other than the loss year. Section 902 allows certain United States shareholders to deduct an indirect foreign tax credit on dividends from foreign corporations.\textsuperscript{174} If a current loss has an of avoiding double taxation? There is as yet no authority on this question, which is becoming increasingly important. This problem is illustrated by the potential effect of a distribution in 1973 by a United Kingdom subsidiary of its current and accumulated profits. The distribution may render the subsidiary liable for payment of Advanced Corporation Tax ("ACT," computed at the rate of 3/7ths of the distribution) in an amount exceeding the subsidiary's current earnings and profits. See Finance Act 1972, c. 41, Part V, §§ 84-87, CCH British Tax Guide. If the ACT is viewed as "on or with respect to" the current earnings, the amount paid in excess of current earnings and profits may fall into the crack. It may be difficult to characterize the ACT as imposed on past profits since, under United Kingdom tax law, the ACT will reduce corporate tax only on future profits. Perhaps the ACT will be treated as an advance payment of tax on the profits of future years and allowed as a credit when those profits are distributed. This particular problem urgently needs administrative resolution.

173. If the taxpayer has taxable income from sources within the United States and at least one foreign country and a net loss in one or more other foreign countries, the per country limitation will prevent the foreign loss from offsetting income from another foreign country, thus increasing the taxpayer's effective foreign tax rate and decreasing the foreign tax credit limitation which the overall method would permit. If the taxpayer has a net loss in the United States and at least one foreign country and taxable income from sources in one or more other foreign countries, the overall limitation will permit a higher foreign tax credit where one or more foreign tax rates are higher than the United States rate. See E. Owens, supra note 2, at 604-05. Otherwise, the limitation under the per-country and overall methods will be the same, as long as no country imposes its tax at an effective rate greater than the taxpayer's effective United States tax rate.

174. A domestic corporate shareholder receives a credit for foreign income taxes paid on the earnings and profits of a 10 percent-or-more owned first-tier foreign subsidiary, a 10 percent (second-tier) subsidiary thereof, or a 10 percent (third-tier) subsidiary of the second-tier subsidiary, provided such second- or third-tier subsidiary is ultimately 5 percent-or-more owned by the domestic parent corporation. IRC §§ 902(a)-(b). If one of the controlled foreign corporations has subpart F income, then "special" foreign tax credit rules provided by regulation, see Treas. Reg. § 1.963-4(c) (1984), permit the United States corporate shareholder to compute its indirect foreign tax credit with respect to dividends from the controlled foreign corporation on the basis of its earnings
effect on the foreign tax credit computations for years other than the loss year—either directly, by reducing earnings and profits for other years, or indirectly, as the result of a tax benefit under foreign law (such as a refund of foreign taxes paid for the earlier year)—then the effect will not be symmetrical since gain will affect the computation only for the current year.\textsuperscript{175}

III. Evaluation of Results of Application of the Symmetry Criterion

A significant number of asymmetries in the United States tax treatment of foreign loss and foreign gain have been identified. Before the inference is drawn that these asymmetries ought to be eliminated, the soundness of the symmetry criterion will be further tested. Implications of the symmetry principle will be compared with those of the traditional criterion of neutrality and such pragmatic criteria as domestic economic effects and administrative convenience.

A. Neutrality

A principal policy objective in taxation of foreign income, discussed in both the legislative history of particular provisions\textsuperscript{176} and in analyses of this policy,\textsuperscript{177} is neutrality. The term is often used in

and profits reduced by losses of any other member of a chain or group to which the corporation belongs, with the result that dividends from one of the profitable members will carry with them an “accelerated” foreign tax credit. The asymmetry here described does not derive from the effects of losses under a “chain” election under subpart F, however, but rather from the effect of the loss on the loss corporation itself.

\textsuperscript{175} This question is conceptually equivalent to the question of whether current losses affect the minimum distribution computation in other years for corporations with subpart F income, discussed in note 145 supra, since foreign “taxes paid” constitute the numerator of both the indirect foreign tax credit formula, IRC §§ 902(a)-(b), and the “effective foreign tax rate” fraction, IRC § 963(d), and “earnings and profits” constitute all or part of the denominator of both the indirect foreign tax credit formula, IRC §§ 902(a)-(b) and the “effective foreign tax rate” fraction, IRC § 963(d). See Treas. Reg. §§ 1.902-3(c)(1), (2) (1965). Therefore, the analysis in note 145 supra applies with equal validity here.


two inconsistent senses—domestic neutrality\textsuperscript{178} and foreign neutrality.\textsuperscript{179}

Ideal domestic neutrality exists if tax considerations do not affect a United States investor's choice between an investment project located in the United States and an investment project located abroad.\textsuperscript{180} This will be the case only if the taxes paid to the foreign jurisdiction in which the investment is located and to the United States on account of the foreign investment are equal to the taxes that would have been paid if the project were located in the United States.\textsuperscript{181} With the total tax burden set equal to the United States level, investment decisions will be based solely on projections of pre-tax income and other real economic factors.\textsuperscript{182}

Foreign neutrality, in the words of one commentator, is "equal treatment of Americans investing in foreign operations and their non-American competitors."\textsuperscript{183} In contrast to domestic neutrality's requirement of equality to the United States investor of overall tax rates on domestic and foreign income, foreign neutrality requires equalization of the tax treatment of United States persons investing abroad and the treatment accorded their foreign competitors by foreign taxing jurisdictions. Such competitors fall into two categories—investors who are indigenous to the tax jurisdiction where the investment is made and investors from foreign countries other than the United States.\textsuperscript{184} True foreign neutrality will be impossible to achieve if the total tax burden on indigenous investors differs even slightly from the burden on non-United States foreign investors or if there are differences in the overall tax burdens on foreign investors from various countries. Thus, because of the variety of tax burdens imposed by foreign countries on non-American counterparts of American investors, foreign neutrality is not a realistic goal of tax policy.\textsuperscript{185} Therefore, the following discussion considers only the implications of domestic neutrality.\textsuperscript{186}


\textsuperscript{179} See, e.g., L. Krause \& K. Dam, \textit{supra} note 177, at 53-54; P. Musgrave, \textit{Issues and Arguments} 119-20 (Ms. Musgrave calls foreign neutrality "capital-import neutrality" and states that it is "based on a false concept of neutrality," id. at 120); J. Pechman, \textit{supra} note 177, at 140.

\textsuperscript{180} See, e.g., J. Pechman, \textit{supra} note 177, at 140.


\textsuperscript{182} See, e.g., L. Krause \& K. Dam, \textit{supra} note 177, at 45.

\textsuperscript{183} Id. at 45.

\textsuperscript{184} See id. at 53.

\textsuperscript{185} See id. at 53-54.

\textsuperscript{186} It may simply be noted that, in practical terms, the two concepts have precisely opposing implications. If it is assumed that the most common type of competitor
The Code attempts a rough degree of domestic neutrality by granting a credit for foreign taxes paid directly or indirectly by a United States investor. The credit provision, however, falls short of imposing the effective domestic tax rate on enterprises abroad since other Code sections create significant non-neutralities. The most obvious is the deferral of United States tax on the foreign earnings of a controlled foreign subsidiary until repatriation. An investment project located abroad in a low-tax jurisdiction will be more attractive because of the deferral privilege than an investment project in the United States yielding the same pre-tax returns.

Perfect domestic neutrality requires a tax system which preserves the ratio of foreign and domestic pre-tax returns. This could be accomplished by elimination of the deferral privilege, allowance of which a United States investor will face abroad will be an indigenous investor, then foreign neutrality will be most closely approximated if the United States investor has the same overall tax burden as the indigenous investor. Relying on assumptions once again, if the indigenous and the United States investors are both taxed equally by the investment jurisdiction, the foreign neutrality principle requires that the United States forego taxing the proceeds earned by the United States investor so that his overall tax burden will equal that of the indigenous investor.

A perfect and indefinite deferral privilege will achieve the closest possible approximation of foreign neutrality under these assumptions. If a United States investor enjoys such a privilege, the effect will be to free his investment decisionmaking from the inevitability of a United States tax, assuming no repatriation is contemplated, though not to eliminate tax considerations from the investment decision.

Since with the help of perfect deferral a United States investor may choose the taxing jurisdiction to which he will be subject and not be subject to additional United States tax, an investment decision made under conditions of ideal foreign neutrality will rest on two considerations: the projected pre-tax net income and the projected tax burden. Thus while a United States investor under ideal domestic neutrality will look only to projections of pre-tax earnings since the tax will in any event equal the United States tax, a United States investor operating under conditions of ideal foreign neutrality will look to projections of income net of taxes.

This difference reflects the basic inconsistency (given the stated assumptions) of principles of domestic and foreign neutrality. The inconsistency is illustrated in the present United States tax treatment of foreign income of controlled foreign subsidiaries. The privilege to defer indefinitely most United States tax on earnings of such corporations is at the heart of whatever foreign neutrality the Code achieves since it allows, at least to a limited extent, an investor to choose investment projects in jurisdictions with taxes lower than those imposed by the United States and to enjoy the benefits of the tax differential without United States tax consequences. This feature is, on the other hand, the most significant deviation from whatever domestic neutrality the Code achieves, and for exactly the same reason. From the opposite perspective, the aspects of the Code which constitute deviations from ideal foreign neutrality, such as taxation of subpart F income, represent a tendency toward restoration of domestic neutrality.

188. See p. 327 supra.
189. See P. Musgrave, Issues and Arguments 81-87 (Ms. Musgrave notes that the deferral privilege is of benefit only in the interval before repatriation of the foreign earnings to the United States shareholder of the foreign subsidiary); L. Krause & K. Dam, supra note 177, at 46; note 197 infra.
190. See L. Krause & K. Dam 45-46; P. Musgrave, Issues and Arguments 109; J. Pechman, supra note 177, at 140.
credit for foreign tax without restriction as to amount, and extension of present tax incentives accorded investment in the United States to investment projects located abroad.

The implications of the symmetry criterion are basically consistent with this "ideal" version of domestic neutrality. Symmetry requires consistent treatment of gains and losses. If deferral of taxation on accumulated earnings and profits of controlled foreign corporations were ended, the symmetry principle would call for current deductibility of losses. This would coincide with "ideal" domestic neutrality since domestic corporations can generally deduct current losses when computing taxable income.

The fact that a system of taxation which creates ideal domestic neutrality would be symmetrical reflects nothing more than the basic symmetry in the United States tax treatment of domestic-source gains and losses. The easy conclusion that symmetrization of present provisions of the Code dealing with foreign income would always promote domestic neutrality is, however, false.

In some instances symmetrization would appear to have the opposite effect. For example, symmetrization of subpart F to allow direct deduction of the loss equivalent of subpart F income will tend to decrease the degree of domestic neutrality which subpart F presently achieves in its asymmetrical treatment of income and loss. Subpart F is a partial but not complete corrective to the basic non-neutrality created by the deferral privilege. Allowing direct deduction of losses under subpart F will lessen the tax burden which

191. See P. MUSGRAVE, ISSUES AND ARGUMENTS 112-14 (Ms. Musgrave observes that true neutrality would require the refund of any noncreditable excess of foreign taxes over United States taxes on the same income, i.e., if the foreign tax rate exceeds the domestic rate). At present, the neutrality achieved by the foreign tax credit is limited by IRC § 904 to situations where the foreign tax rate does not exceed the United States rate. See p. 338 supra. For arguments that full crediting of foreign taxes (and presumably refund of noncreditable foreign taxes) encourages higher foreign tax burdens which are, in effect, borne by the United States government, see P. MUSGRAVE, ISSUES AND ARGUMENTS 87-88.

192. Certain United States tax incentives are presently restricted to property used predominantly in the United States. See IRC § 167(m); Treas. Reg. § 1.167(a)-11(b)(2)(iv) (1971) (maximum accelerated depreciation); IRC § 48(a)(2) (investment credit).

193. The only divergence would result from the fact that the system for taxing domestic source gains and losses is itself asymmetrical in some instances. See, e.g., J. PECHMAN, supra note 177, at 140 (treatment of domestic capital losses asymmetrical since they are not deductible in full against both capital gains and ordinary income).

194. IRC §§ 951-64.


196. Subpart F ended deferral primarily on holding company investment income and income earned by corporations established in tax-haven countries in order to take advantage of the low rate there. It did not entirely vitiate the non-neutrality created by the deferral privilege. See, e.g., L. KRAUSE & K. DAM, supra note 177, at 52; P. MUSGRAVE, ISSUES AND ARGUMENTS, supra note 177, at 85-87; J. PECHMAN, supra note 177, at 140.
the provision presently creates. This, in turn, will reduce the overall corrective impact of subpart F on the non-neutrality created by the deferral privilege.197

However, in most cases symmetrization of existing provisions will tend to increase the overall degree of domestic neutrality achieved by the Code by equalizing effective tax burdens paid by United States investors on foreign and domestic investment.198 Thus the implications for reform which emerge from the symmetry analysis are generally consistent with the principle of domestic neutrality.199

B. Pragmatic Criteria

1. National Growth

From the national growth point of view, taxation of foreign income should perhaps be heavier than taxation of domestic income

197. In two other cases, symmetrization might enhance existing non-neutrality in the Code. If the restriction on losses attributable to earned income incurred by citizens abroad were symmetrized to accord with the exemption of the first $20,000 or $25,000 of earnings by such citizens from United States tax, see p. 349 infra, then the effect would be to increase the attractiveness, from a tax standpoint, of foreign employment. This, in turn, would enhance the existing non-neutrality of the citizens abroad exemption.

Symmetrization of § 1248 to allow ordinary loss treatment for terminal losses incurred in the disposition of a controlled foreign subsidiary, see p. 351 infra, would tend to reduce the overall tax burdens imposed by the section. The section is already an inadequate antidote to the non-neutrality created by the deferral privilege. See, e.g., L. KRAUSE & K. DAM, supra note 177, at 46-47; P. MUSGRAVE, ISSUES AND ARGUMENTS, supra note 177, at 81-82. Therefore, symmetrization of § 1248 would, by diminishing the adverse impact of the section on the taxpayer, intensify the existing non-neutrality created by deferral.

198. In the following instances, symmetrization would tend to increase the overall degree of neutrality achieved by the Code:

Timing of foreign subsidiary incorporation. See pp. 328-29 supra & p. 348 infra. If deferral were denied altogether as a corrective measure, there would be a high degree of neutrality. If "recapture" of the initial loss were required, a lesser degree of neutrality would be achieved.

Possessions corporation. See pp. 321-23 supra & p. 349 infra. Section 931 is presently non-neutral because it allows a United States investor to take advantage of lower tax rates in the possessions and be exempt from United States tax. The "double-win" asymmetry increases the tax incentive to invest in the possessions. Symmetrization would reduce the incentive and thus promote neutrality.

WHTC. See pp. 325-26 supra & pp. 349-50 infra. The special reduced rate of taxation of WHTC income is non-neutral. The asymmetrical allowance of loss deductions without limit increases this non-neutrality. Thus, symmetrization would lead to greater neutrality.

Contiguous Country Corporations. See pp. 329-30 supra & p. 350 infra. Such corporations exhibit the non-neutrality of deferral as do other controlled foreign subsidiaries. But the contiguous country status creates an additional potential tax advantage: the ability to offset other United States-taxable income with losses during unprofitable years but defer United States taxation of income in profitable years. This "double-win" asymmetry enhances the non-neutrality of the deferral privilege. Symmetrization would eliminate any non-neutrality except that created by deferral.

199. Discussion of the implications of a second traditional principle—domestic equity—is omitted since equity is substantially the same as the neutrality principle viewed from the perspective of what burden the taxpayer "ought" to bear rather than what degree of incentive or nonincentive the tax system should give to various investment decisions. See L. KRAUSE & K. DAM, supra note 177, at 44, 54-56.
in order to prevent foreign investment from unduly reducing the level of domestic investment and limiting the growth of domestic output. Here the economic argument is that a United States company's investment in production facilities abroad reduces its funds for domestic investment in itself, and the negative multiplier effects throughout the economy exceed any expansionary effects of increased exports attributable to the foreign facilities. Accordingly, foreign investment is said to lead to a slower growth of the domestic economy.200 This argument has been shown to be limited, however, to situations where the domestic economy is at full employment levels for all domestic resources or where sectors of the domestic economy experience "resource bottlenecks" or sectoral full employment.201 One can generalize that the symmetry criterion will be consistent with national growth whenever the implication of symmetry is to increase the tax costs of foreign investment under the present scheme of rules. Symmetrization of gain and loss treatment would increase the tax cost in some instances202 and decrease it in others.203 Thus, the symmetry criterion is not completely consistent with the implications of the national growth theory. This divergence may not be significant if the national growth theory is limited to the special cases of full resource employment noted above.204 In any event, the as yet inconclusive nature of the underlying economic argument makes the national growth measuring rod a very inexact one for judging the symmetry criterion.

2. Efficiency

Maximum national efficiency requires that the gross (before tax) returns on domestic investment be equal to the net (of foreign taxes) return on foreign investment, because national income includes gross returns from domestic investment but only the net return on foreign investment. Foreign investment is profitable to a private investor, however, beyond the point where it is profitable to the nation, since

201. L. KRAUSE & K. DAM 56-62.
202. Introduction of symmetrical treatment to losses of possessions corporations, for instance, would increase the overall tax costs of this form of foreign investment and would thereby be consistent with the national growth objective. See note 198 supra.
203. The symmetrization of subpart F, for instance, to allow direct use by a United States investor of certain types of losses of a foreign subsidiary would lower the relative United States tax costs of such investment and thus diverge from the domestic growth principle. See pp. 343-44 supra.
204. If, on the other hand, full resource employment becomes a continuing problem, national growth may well become a fairly low national priority. See generally D. MEADOWS, D. MEADOWS, J. RANDERS, W. BEHRENS, THE LIMITS TO GROWTH (1972).
the private investor will invest abroad up to the point where the net return on its foreign investments equals the net return on its domestic investments.205

The only way to meet the national efficiency criterion appears to be repeal of the foreign tax credit and elimination of deferral.206 Symmetrical treatment of foreign losses will sometimes be consistent with this criterion. This is not so in all areas, however, particularly where symmetry will reduce present foreign investment costs. But again, while focusing on an important economic consideration, we have in hand an inadequate yardstick for judging the symmetry criterion. It may well be that national efficiency will not merit top priority in the formulation of international economic policy in view of the current emphasis on trade, development, and energy.207

3. Administrative Convenience

Here the question is whether applying the symmetry criterion to reform the United States taxation of foreign losses would generate increased administrative difficulties, for the government or for taxpayers.

One way in which both parties would be well served is in the certainty which symmetrical treatment of losses would afford each. It is clear that the present rules are uncertain in a number of areas. Symmetrization would reduce this uncertainty. A symmetrical character rule for terminal losses, for instance, would take a good deal of heat off the application of § 165(g)(3), which forces taxpayers to kill their subsidiaries with the utmost care and planning and which forces the government to stretch to find the tiniest bit of value received in order to deny the taxpayer an ordinary loss.208

Apart from reducing legal complexities in this area, symmetrical treatment of losses would aid taxpayers in their financial planning. A discontinuous rate-of-return function, which must be used under the present tax system wherever losses and profits are not taxed sym-
metrically, makes investment analysis more cumbersome than it would be with the continuous function which a symmetrical tax system would make possible.\textsuperscript{209}

Finally, one might ask whether symmetrical treatment of losses would not increase their significance and thus increase the government's auditing job. The considerations here are manifold. First, losses are already significant, and the administrative problem is that no one really knows in what way. Second, as noted, symmetrical treatment would decrease the auditing effort to some extent by eliminating some potential legal controversies. On the other hand, permitting a foreign subsidiary's losses to offset directly the income of its United States parent corporation would undoubtedly increase the number of taxable entities which the Internal Revenue Service has to audit.\textsuperscript{210}

4. Results of Evaluation of the Symmetry Criterion

The implications of the symmetry criterion generally coincide with those of the domestic neutrality standard in the context of foreign losses. While the symmetry implications sometimes conflict with the goals of national growth and national efficiency, these goals themselves are of uncertain significance and thus should not serve as a conclusive test of the validity of the symmetry criterion. Finally, while symmetrization would increase the administrative burden on the Internal Revenue Service somewhat, it would vastly simplify financial planning by United States taxpayers. The conclusion which emerges is that asymmetries in the United States tax effects of foreign profits and losses should be eliminated wherever possible.

IV. Implications for Reform

The application of the symmetry principle to the Code provisions presently governing United States tax treatment of foreign income and loss has revealed a number of asymmetries. Technical changes

\textsuperscript{209} Cf. R. Schlaifer, Probability and Statistics for Business Decisions § 5.3.2 (1959).
\textsuperscript{210} In the case of foreign subsidiaries subject to scrutiny by a foreign taxing jurisdiction, however, the Service might alleviate the audit problem through reliance on the foreign jurisdiction. Alternatively, weight might be given independently significant accounting determinations of the subsidiary's losses, such as certified reports to shareholders. The accounting profession's principles include the consolidation of the operating results of domestic corporations with their foreign subsidiaries, AICPA, Accr'g Research Bull. No. 43, ch. 12, ¶¶ 8-9, and even more significantly normally require full provisions for the United States and foreign taxes ultimately payable on the repatriation of earnings of a foreign subsidiary, Accr'g Principles Board, Opinion No. 23 (April 1972).
in the form of amendments to specific Code sections and regulations would largely eliminate these asymmetries. In addition to pointing up the need for such changes, the symmetry criterion also bears on the broader issue of the desirability of basic reforms in the system for taxing foreign income.

A. Technical Changes

1. Timing of Foreign Subsidiary Incorporation

The asymmetry which results from the ability of a domestic corporation to obtain deductible losses during the unprofitable "start-up" years of a foreign enterprise by operating it as a branch and then, when it becomes profitable, to shield its earnings from United States tax by incorporating it as a foreign subsidiary, might prove difficult to correct within the framework of current Code provisions. In theory, the straddle approach of separating deductible losses from nontaxable profits or the incorporation itself might be attacked under existing judicial or statutory doctrines. The government has used these approaches rather sparingly in the foreign field, however, particularly in recent times after losing all but the most glaring cases in earlier periods. The annual accounting doctrine may well prove a serious impediment to corrective administrative action in this area, as the present administration seems to concede. A legislative solution may thus be necessary. Possible approaches would include a "recapture" requirement or denial of the benefit of deferral of United States tax on the income of the new foreign corporation.

211. See pp. 318 & 328-29 supra.


214. See, e.g., Siegel, 45 T.C. 566 (1966). For a government win see Kaspare Cohn Co., 35 B.T.A. 646 (1937). An alternative approach would be for the Internal Revenue Service to refuse to issue advance rulings under § 367 on foreign incorporations unless the United States transferor agrees to "recapture" any earlier losses of the predecessor business. The recapture might take the form of payment of a "tollcharge" measured by the tax benefits realized from the prior losses, since the Service already imposes similar conditions on issuance of § 367 rulings in other areas. See Rev. Proc. 68-23, §§ 3.01(1), 3.02(1)(d), 3.03(1)(b), (l)(g), and 5.02, 1968-1 Cum. Bull. 821.

215. See note 116 supra.

216. The administration has proposed the former course. See id.
2. United States Citizens Abroad

Since only the first $20,000 or $25,000 of earned income of a United States citizen abroad is exempt, the symmetry criterion would require that only the first $20,000 or $25,000 of operating losses be denied the citizen abroad.\footnote{217}

3. Possessions Corporation

Since a "possessions corporation" is exempt from United States tax on its foreign source income, the symmetry criterion would require that the corporation's losses not offset income otherwise subject to tax.\footnote{218} Specifically, the losses should not reduce the corporation's income by carryovers to years in which it fails to qualify as a possessions corporation, and the losses should not reduce the income of members of a consolidated group of corporations.\footnote{219}

4. Western Hemisphere Trade Corporations

The implication of the symmetry criterion for the taxation of WHTC's is relatively straightforward. Just as the Code subjects the taxable income of a WHTC to a maximum tax rate 14 percentage points below the top corporate rate, it should restrict the use of losses of a WHTC.\footnote{220} They should offset in full only income of the corporation in carryover years in which it meets the WHTC definitional tests. In other cases, including carryover years in which the affiliated group\footnote{221} consists of any non-WHTC's, the losses should be

\footnote{217. See pp. 318-20 supra. A simple amendment to the regulations providing for the disallowance of expenses related to exempt profits would suffice. For a possible model, see Treas. Reg. § 1.911-1(a)(3) (1957) (disallowing deductions attributable to excludable gross income).

218. See pp. 321-23 supra.

219. Probably the most direct approach would be to follow the model provided for foreign corporations and, in all events, deny the possessions corporation all deductions other than those attributable to the income from sources within the United States and amounts received within the United States which are subject to tax. Thus denied deductions attributable to its business operations in one or more possessions, there would be no net losses from such operations to offset other income of the possessions corporation or of related corporations. This result, consistent with the symmetry criterion, would resolve the problem presented in Burke Concrete Accessories, 56 T.C. 588 (1971), and in Rev. Rul. 73-498, 1973 Int. Rev. Bull. No. 46, at 19, regardless of whether the consolidated return provisions are clarified. It would be possible to make the suggested change through an amendment to the regulations. Amendments to the § 931 regulations could provide, on the authority of IRC § 265(l), for disallowance of deductions attributable to gross income excluded under § 931(a), and make § 931(a) mandatory, not elective, to all corporations which meet its terms.

220. See pp. 325-26 supra.

221. If the changes suggested herein are implemented, WHTC's ought to be allowed to continue to be members of affiliated groups, since the proportional reduction of deductible losses will eliminate the present "consolidation" asymmetry, described at pp. 320-21 supra.}
fractionally reduced so that they offset other income only to the extent that such income would be taxable in the hands of a WHTC.\textsuperscript{222}

5. \textit{Contiguous Country Subsidiaries}

The asymmetry resulting from the ability of such corporations to offset other taxable income with their losses during unprofitable years but to defer United States taxation of income in profitable years\textsuperscript{223} resembles the asymmetry created by the incorporation as a foreign subsidiary of a branch with a history of loss but a prospect of profit.\textsuperscript{224} Here, as in that situation, a legislative solution may be required.\textsuperscript{225}

6. \textit{Subpart F}

The most far-reaching implications of the symmetry criterion affect the operation of subpart F.\textsuperscript{226} In particular, losses from transactions which would have produced subpart F income should be currently deductible by the United States shareholder. This change would permit simplification of the existing rules governing carryovers of deficits and minimum distributions.

Just as the rules governing the current taxation of subpart F income are extremely complex, providing for the current deductibility of losses from transactions which would have produced subpart F income if profitable would also be a complex undertaking. The best approach would probably be to begin with the existing framework of rules defining and taxing "subpart F income" and to modify them by legislation to provide for addition of negative amounts thereof to the gross income of United States shareholders.\textsuperscript{227}

\textsuperscript{222} The most direct means to this end would be to provide that the losses must be reduced by the \$922 fraction before they are carried over to other years or used by non-WHTC members of a consolidated group. Under this proposal, for example, a WHTC's operating loss of \$100 would be reduced by \$29 [(14/48) \times (\$100)] to \$71, which might carry over to non-WHTC years or reduce the taxable income of non-WHTC corporations.

\textsuperscript{223} See pp. 329-30 \textit{supra}.

\textsuperscript{224} See pp. 318 & 328-29 \textit{supra}.

\textsuperscript{225} The possibilities include a "recapture" requirement, denial of the benefit of deferral of United States tax to the extent of prior losses, or complete elimination of deferral by making a \$1504(d) election irrevocable.

\textsuperscript{226} See pp. 330-34 \textit{supra}.

\textsuperscript{227} Even this approach would generate its own complexities. For example, does the rule cover transactions involving negative gross profit? How does the "30-70" rule apply? How should the shareholder take the losses into account in computing its "deemed-paid" foreign tax credit and the overall or per country limitation thereon? Whatever the difficulty in providing for the current deduction of subpart F losses, the difficulty would be offset somewhat by the simultaneous elimination of the complex special loss rules applicable to the computation of subpart F income and to
United States Tax Effects of Foreign Losses

If this approach is deemed too drastic a departure from current practice, the Treasury could at least eliminate the potentially asymmetrical effect of gains and losses on the computation of minimum distribution amounts under subpart F\textsuperscript{228} by making clear—through regulation or ruling—that earnings and profits of a foreign corporation with a current loss will be a negative amount, \textit{i.e.}, the amount of the loss offset by the amount of any related refund of foreign taxes.

Finally, the asymmetrical effect of foreign currency gains and losses on the indirect foreign tax credit of § 902 under subpart F\textsuperscript{229} could be corrected by requiring in all cases that unrealized currency gains and losses be taken into account for purposes of computing the § 902 foreign tax credit.

7. Terminal Losses

a. Character

The treatment of gain and loss on the sale or exchange of stock of a controlled foreign corporation or on the liquidation thereof is asymmetrical since gains are taxed as ordinary income, to the extent of the earnings and profits of the corporation, while losses on the disposition of an interest in the corporation are normally capital losses.\textsuperscript{230} The symmetry criterion would indicate that losses on sales and exchanges, as well as liquidations, should be ordinary in character, at least to the extent of any deficit in the earnings and profits account of the controlled foreign corporation. Such a rule might obviate the need for the special rules for worthlessness and expropriation, which have proved tantalizing targets for the tax planning efforts of taxpayers with unsuccessful foreign operations.

b. Source

Symmetry requires that the source of terminal losses, like the source of terminal gains, be determined on an independent basis.\textsuperscript{231}

\textsuperscript{228} See p. 332 \textit{supra}.
\textsuperscript{229} See pp. 333-34 \textit{supra}.
\textsuperscript{230} See pp. 335-36 \textit{supra}. The principal exceptions on the loss side occur in the context of worthless stock of certain subsidiaries and expropriations, where ordinary loss may result.
\textsuperscript{231} See p. 337 \textit{supra}. Some case law suggests that such losses may have an independent source. \textit{See} Commissioner v. Ferro-Enamel Corp., 134 F.2d 564 (6th Cir. 1943), rev'd 1942 B.T.A. Memo No. 107; Stockholms Enskilda Bank, 40 B.T.A. 107
8. **Foreign Tax Credit**

The asymmetrical impact of gains and losses on the per-country foreign tax credit limitation—profits increase the limitation but losses do not decrease it\(^{232}\)—probably requires a legislative solution. One method of remedying this double tax benefit situation would be to amend the foreign tax credit limitation provisions to eliminate the per-country limitation, since losses and gains have symmetrical effects under the overall limitation. A second approach, and one which has been advanced seriously by the Treasury,\(^{233}\) is to reduce the limitation on the foreign tax credit in subsequent years after the United States taxpayer sustains a foreign loss.\(^{234}\)

The second potential asymmetry in the foreign tax credit context—gains will affect computation of the credit only for the current year but a current loss may affect the credit computation for other years\(^{235}\)—is equivalent to the minimum distribution asymmetry in subpart F and the same symmetrization advocated there (restriction of the impact of loss to the current year) is appropriate here.\(^{236}\)

**B. Changes in the Basic System for Taxing Foreign Income**

The previous section has touched on relatively narrow technical changes which application of the symmetry criterion to the present United States tax law would require. It seems proper at this point to ask whether this examination of the tax effects of foreign losses carries with it any implications for broader changes in the basic United States system for taxing foreign income.

While previous legislation in the foreign area tended to be “liberalizing,” in the sense of reducing the United States tax burden on foreign income, the Revenue Act of 1962 was the first effort of wide scope to increase the burden.\(^{237}\)

\(^{232}\) See pp. 338-39 supra.

\(^{233}\) See Proposals for Tax Change, supra note 9, at 169-75.

\(^{234}\) Mechanically, the reduction in the limitation could take the form of a reduction in taxable income from sources within the country of the loss in later years when the United States taxpayer derives income from sources within that country.

\(^{235}\) See pp. 339-40 supra.

\(^{236}\) See p. 351 supra.

\(^{237}\) President Kennedy had sought far-reaching changes including an end to deferral. See Hearings on the President's 1961 Tax Recommendations Before the House Ways and Means Comm., 87th Cong., 1st Sess. 3, 8-10, 260-65, 301 passim (1961). The 1962 Act, however, was directed only at certain “abuses,” such as tax haven operations, “captive” insurance companies, and disguised dividends consisting of “increased investment in United States property.” It contained a number of relief provisions...
United States Tax Effects of Foreign Losses

Since 1962, nearly all congressional enactments affecting the taxation of foreign income of United States persons have been fairly technical.238 The declining balances of trade and payments, coupled with a resulting loss of confidence in the international value of the dollar, rates of unemployment unacceptably high to some congressional and most labor leaders, and a suspicion that the United States tax advantages accorded foreign investment have produced an “export of jobs,” have led to a renewed legislative interest in curtailing these advantages.239

The question of the proper congressional response to current legislative proposals must be answered on the basis of economic analysis of the effects of the various legislative alternatives in light of the priorities assigned to objectives of our international economic policy such as balance of payments, growth, efficiency, and domestic employment. While it would be frivolous to suggest that symmetry should provide the touchstone here, it is submitted that the desirability for simplification of the Code provisions in this complex area, which symmetrization would effect, provides respectable support for any proposed system which meets other policy objectives.

Each of the recent proposals for change of the present system of taxing foreign income has one common element—the elimination to some extent of the deferral of United States tax on the foreign income of controlled foreign corporations.240 One of the most commonly

which have apparently enabled United States multinational corporations to cope with its complex provisions without serious complaints. See, e.g., Statement of T. Jenks, supra note 177, at 1740-42 (criticizing only the United States property provision of subpart F, despite complexity of other subpart F provisions).


239. See note 9 supra. The first of the legislative proposals, and the most drastic to date, is the Burke-Hartke Bill. Id. More recently, and less drastically, the administration advanced in connection with its Trade Bill, H.R. 6767, 93d Cong., 1st Sess. (1973), tax proposals ending deferral in the case of controlled foreign corporations which take advantage of foreign “tax holidays” and similar incentives or which establish “run away plants” abroad, modifying the limitation on the foreign tax credit, and providing for “recapture” of certain foreign losses. See Proposals for Tax Change, supra note 9.

240. See note 9 supra.
The proposed means of elimination of deferral is broadening the impact of subpart F. This approach has a serious shortcoming, however. Subpart F and related provisions make earnings and profits a most important measuring rod. Problems arise from the fact that some items of income and expenditure are included in the computation of taxable income, but not of earnings and profits, or vice versa, and from the fact that various transactional operations on earnings and profits are not fully defined.

These problems have led to suggestions that any elimination of deferral should take the form of direct taxation of the taxable income of controlled foreign subsidiaries, not their earnings and profits, presumably as a means of eliminating undue complexity in the Code. This may be accomplished by extension of the consolidated return rules, on a mandatory basis, to all controlled foreign subsidiaries of United States shareholders. This system would seem

241. See, e.g., the Burke-Hartke Bill, supra note 9.
242. The amount of earnings and profits of a controlled foreign corporation governs the amounts included in, see IRC §§ 952(c), 955, 956, and excluded from, see IRC § 963, a United States shareholder's gross income.
243. For example, the amounts expended for payment of federal income taxes, see Rev. Rul. 63-63, 1963-1 CUM. BULL. 10.
244. For example, exempt income such as interest on tax exempt municipal bonds. See Treas. Reg. § 1.912-6(b) (1955).
245. For example, redemptions. See Baker v. United States, 460 F.2d 827 (6th Cir. 1972). See generally B. Bittker & J. Eustice, supra note 56, at ¶ 7.05. To be sure, the Treasury has promulgated detailed rules under § 964 for the computation of earnings and profits for purposes of subpart F. Treas. Reg. § 1.964-1 (1964).

Even these rules, however, fail to resolve many important practical problems. Part of the difficulty here stems from the existence of several earnings and profits concepts within subpart F. Compare IRC §§ 952(c), (d), with § 963 and § 1248. Additional complexity results from the extremely important role of earnings and profits in the computation of the indirect foreign tax credit, see note 175 supra, and the unknown or undefined role of §§ 367 and 381 in certain corporate liquidations and reorganizations involving second- and higher-tier foreign subsidiaries. See T.I.R. 978, May 24, 1968. Cf. Rev. Rul. 70-373, 1970-2 CUM. BULL. 152; Rev. Rul. 68-351, 1968-2 CUM. BULL. 307. See generally Cole, A Treasury View of Progress and Problems in the International Tax Field, 36 J. Tax. 124 (1972); Landis & Currier, The Future of Section 367, 25 Tax Law. 253 (1972).

246. See, e.g., Statement of J. Glasmann, supra note 177, at 1695.
247. Such an approach would, of course, tax only subsidiaries of corporate shareholders. Equity may demand direct taxation of foreign corporations owned by individuals as well. If so, the consolidated return rules might be supplemented by additional rules covering individuals.

Some foreign tax jurisdictions have instituted a consolidation system, though on a permissive basis. Foreign subsidiaries of French and German corporations may elect to report the taxable income (or losses) of their foreign operations on a consolidated basis under certain circumstances, although they are not required to do so. See Code Général Des Impôts, art. 209 quinquies; Steueranpassungsgesetz § 15(2), Auslandsinvestitionsgesetz (Art. 2 of the Tax Amendment Law of 1969 of 18 August 1969, BGB I 1969 I, at 1211). For analysis of the French system, see A Comparative Analysis of the Classical, Dual Rate, and Imputation Taxation Systems and an Examination of the
to solve the technical problems of foreign startup losses,248 permit the abolition of subpart F with its numerous complexities within and without the loss area,249 render moot the semi-explored niceties of the indirect foreign tax credit,250 and reduce the importance of the exceptions to the general rule that terminal losses on foreign direct investments are capital in character.251 Indirect effects of the adoption of a consolidation approach would be a dramatic reduction of the need for application of § 482 in the foreign area252 with attendant gains in national and international tax administration, a possible narrowing of the scope of §§ 367253 and 1491-92, and the elimination of some definitional problems of § 1504(d).254 Moreover, adoption of the consolidated return rules in the foreign area would provide the framework for extension of complete domestic tax neutrality to the United States taxation of foreign income, including

Corporate Tax Systems in Belgium, France, Germany, Italy, the Netherlands and the United Kingdom, 12 EUROPEAN TAXATION 1/112, 1/154 (1972). For analysis of the German system, see CCH WORLD TAX SERIES: GERMANY ch. 11/2.2d (2d ed. 1969).

248. See pp. 318 & 328-29 supra. The incorporation step would not avoid taxes, since the foreign transferee corporation would be subject to tax.

249. See pp. 330-34 supra; PRESIDENT'S TASK FORCE ON BUSINESS TAXATION, supra note 177, at 35, 47, recommending, inter alia, revision of the present subpart F provisions to include only an improper accumulations test.

250. See notes 145 & 175 supra.

251. See p. 336 supra.

252. IRC § 482 permits the Secretary of the Treasury to allocate gross income and deductions between or among organizations controlled by the same interests, upon a determination that the allocation is necessary to prevent the evasion of taxes or clearly to reflect the income of the organizations. The authorities consistently articulate the standard guiding the Treasury's application of § 482 to controlled taxpayers as arm's-length dealings among uncontrolled taxpayers. See Treas. Reg. § 1.482-1(b)(1) (1968). In the international context, the Internal Revenue Service has most commonly applied this provision to allocate income on the sale of property from a foreign subsidiary corporation, exempt from United States tax, to a taxable controlling United States shareholder. See Treasury Department, Summary Study of International Cases Involving Section 482 of the Internal Revenue Code, January 8, 1973.
Section 482 is a "one-way" street: A taxpayer may not invoke the section where it inadvertently overpriced property, funds, or services to a foreign subsidiary, causing a loss to the subsidiary. But cf. Treas. Reg. § 1.482-1(d)(3) (1962). The one-way street nature of § 482 cuts particularly deeply in the foreign area. Because a foreign subsidiary without any United States connected income will be exempt from United States income tax while its domestic parent corporation will be subject to the full United States corporate tax rate, the parent corporation will feel acute pressure to err on the low side in setting prices to its foreign affiliates. If the parent company charges a price which is determined (with hindsight) to be too high, the taxpayer cannot invoke § 482 to reduce the price to an arm's-length level. This aspect of § 482 is double-edged, since the foreign country of an affiliate may identify the overcharge, invoke its version of § 482, and in effect tax all or part of the income which the parent corporation has already reported for United States income tax purposes. If foreign subsidiaries could be included in an affiliated group of corporations filing a consolidated return, the "one-way street" view of § 482 would not present a United States tax problem, since the income of both the parent corporation and its foreign affiliates would be subject to United States tax currently. The foreign tax problem, of course, would remain.

253. See note 115 supra.
254. See note 118 supra.
accelerated depreciation, the ADR rules, the investment credit, and percentage depletion.\footnote{233}

Finally, the adoption of the consolidation approach would be a convenient means for eradicating many of the present asymmetries in the United States tax treatment of foreign gain and loss.\footnote{250}

\footnote{255} The stakes involved in the elimination of deferral are not at all clear, although they are apparently not so low as indicated by the 1970 average effective foreign tax rate of 43.3\% (before withholding taxes) for foreign corporations controlled by United States persons. United States Tariff Commission, Report to Senate Comm. on Finance, 93d Cong., 1st Sess., Implications of Multinational Firms for World Trade and Investment and for U.S. Trade and Labor 444 (1973). In proposing elimination of deferral where a foreign corporation receives the benefits of a foreign tax holiday or other tax incentives—a proposal which, most multinationals complained, would almost completely end deferral—the Treasury estimated that there would be no “substantial" revenue gain. Proposals for Tax Change, supra note 9, at 161.

\footnote{256} The asymmetries which would be eliminated would be those discussed herein with respect to start-up losses, contiguous country subsidiaries, subpart F, the indirect foreign tax credit, and terminal losses in situations where § 1248 would apply if gain were present. Remaining asymmetries would include those under the Code provisions applicable to citizens and domestic corporations (IRC §§ 911, 921-22, 931, 991-97) and the foreign tax credit limitation.