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## **Current Tax Issues Affecting U.S. Multinational Enterprises**

*by Robert J. Patrick\**

This may be a good bridge between the excellent and comprehensive discussions of the major issues that preceded to a more particular discussion of specific matters of tax practice. What I will talk about are policy-oriented issues primarily involving U.S. tax policy and some comparative practices and approaches around the world. I would like to emphasize what I feel is an increasingly important question of perspective for further developments in U.S. international tax practice.

The subject of comparative cross-fertilization of various cultures and approaches to taxes is, I think, both terribly important and extremely fascinating. A recent experience with the Treasury Department provides one vivid example of the very different perspectives that one could have on how countries approach their tax laws. With some prodding from the Securities and Exchange Commission, the Internal Revenue Service (IRS) discovered the leverage that was available in the Internal Revenue Code (I.R.C.) with respect to the problem of payment of bribes, particularly in multinational operations. This came at the time when there was a meeting in Washington of tax administrators of France, Germany, Britain, and the United States.

The IRS had prepared a spectacular dossier on the subject, with newspaper clippings and files which they brought to the meeting. They sat down to talk with their colleagues of the other governments about the whole problem of payment of bribes and how tax policies could be used to prevent such practices around the world. This was before the United States actually moved specifically to legislate on this question. The IRS outlined theories that might be used to disallow deductions for bribes by U.S. companies.

After the presentation, the U.S. administrators asked how other countries were dealing with the problem, assuming that there would be a consensus that such undesirable activity should be prevented as a matter of tax policy. The British were first. They said it certainly was a problem, but that they didn't really think it was a tax problem. They had been asked to testify before a commission and testified that this was really not something that ought to be dealt with in the tax laws.

Germany was next. They said they agreed that there was a problem and that there was an important tax consideration. They had, therefore, instituted a new practice. They now require that the person receiving the

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bribe must be identified before a deduction will be given to the person paying the bribe. Then the bribe is included in the income of the recipient if taxable in Germany.

France also agreed that bribery was a problem, and that it was a problem of tax administration. Their position was that before any deduction could be taken for a bribe, there must be proof that the bribe had actually been paid.

At that moment, there was a clear illustration that people viewed the tax laws and their relative significance for policy from quite different perspectives.

I will now try to illustrate some major issues and problems involving U.S. companies internationally in the areas of tax laws and foreign investment. The discussion will be in the context of the aggregate effect of U.S. rules and it will raise a question as to whether, in future consideration of tax policy, the United States should continue the trend of the past 20 years to increase the burden of U.S. taxation of foreign business operations of U.S. companies. In varying degrees, the U.S. I.R.C. has been a great innovator in the international tax area and an exporter of tax rules.

I will start simply with the development after 1962 of our intercompany pricing rules, particularly the U.S. approach of writing very detailed pricing rules. Some of that precedent saw its appearance in work being done at the Organization for Economic Cooperation and Development, (OECD) and the work of the committee of experts—the ad hoc experts—of the United Nations. Following the U.S. thinking on this, both groups are publishing documents in which they have attempted to set up guidelines for various intercompany transactions.

The year 1962 saw not only the stimulus for the writing of rules in the United States on intercompany pricing, but also the beginning of the so-called tax haven legislation. Canada subsequently adopted tax haven rules for holding companies under FAPI (Foreign Accrual Property Income). Germany evolved something similar to the U.S. rules on current taxation of earnings of tax haven subsidiaries. Japan has followed with legislation in the area, and in the last year, France has also adopted tax haven legislation. France has taken a slightly different approach, looking at deductions and designating a number of countries as tax havens. Under their rules, special evidence must be supplied indicating the bona fide arm's-length nature of any payments made by French taxpayers to recipients in these tax haven countries.

In my judgment, none of these laws appear to go as far as the U.S. legislation under Subpart F. They tend to have less effect on the taxation of exports and less effect on transactions between foreign affiliates not dealing with the parent company. They are mainly concerned with personal and corporate holding companies, while dealing much less with taxation of trade in goods and services carried on by bona fide operating subsidiaries.

A third major innovative area in U.S. law encompasses several rules

which involve the use of the foreign tax credit system for the resolution of double taxation problems. A corollary I.R.C. rule that had perhaps not really been developed until the 1970's allocates expenses between domestic and U.S. source income for determining what is foreign and what is domestic net income. This is, in my experience, a subject that has barely been thought about in most other countries. I am not sure many of them would accept the detailed U.S. approach in allocating expenses incurred by a domestic company, although it seems that this problem exists equally between countries avoiding double taxation through foreign tax credits and countries that have an exemption system for foreign source income.

For many companies, the U.S. allocation rules have a significant impact on the amount of foreign tax credit allowable. This is particularly true for high technology and pharmaceutical companies with large domestic research expenses. The development of the current U.S. rules, over what turned out to be a lengthy process, and a substantial number of compromises in the U.S. law, leaves the United States in front in terms of concern about this problem and the impact on its companies. There is some indication that the Treasury Department, perhaps by the end of Spring 1980, will be publishing some statements on alternative considerations to the rules that were adopted as recently as 1976, particularly on the allocation of research expense.

In yet another area, the United States, in 1976, went from an administrative consideration of the question of the treatment of bribes to enacting legislation involving tax penalties for bribes, as well as additional tax penalties for cooperation with international boycotts to which the United States was not a party. At the same time, the movement towards multi-lateral arrangements and more consistent agreements among the developed countries of the world on bribes and boycotts has lagged substantially. The United States again remains considerably out in front in these areas.

In 1976, the United States severely tightened the rules on exemption of income for U.S. citizens living abroad who were employed by foreign or domestic companies. These changes almost eliminated any exclusion for being a non-resident citizen of the United States. The rules were intended to enforce the principle that U.S. citizens pay U.S. income tax regardless of where they live or how long they live there. That is not, I think, a principle that has been emulated at any time anywhere else except for the Philippines.

Even in the area where there was domestic legislation designed to improve the tax position of U.S. companies competing internationally through the 1971 DISC (Domestic International Sales Corporation) export tax incentive, the climate was such that any incentive was virtually eliminated.

Today the innovative policy area is in the question of foreign tax credits, specifically, what is a creditable foreign tax? While re-examina-

tion of this question by the IRS affects all overseas business, it has particular significance in the resource area.

One basically finds throughout the world that countries are, in one way or another, increasing their take on resource transactions as prices rise. The role of international oil companies is changing as countries move to increase their share of revenues, particularly from the production end. The new role of the companies in some countries, where there has been preexisting production, has been to become simply buyer or seller and no longer a producer of oil. In other areas in which there is old or new production in which multinationals are involved, the increase of governments' share may take the form of renegotiation of a royalty, which being a two party transaction, may have some limitation on the discretion of the foreign government. On the other hand, obviously the government may be in a position to insist on increased taxes. It is possible to change the tax unilaterally by increasing tax rates or one can disallow deductions for certain activities, or one can impose a schedular system where one limits the area of the application of a new tax to particular activities and segregates it from other activities.

The final step is one that has increased utilization in developing countries around the world. In this step the country looks at what it anticipates it would want to realize in net revenues and determines that, after application of all other royalties, income taxes and fees, the total does not constitute a sufficient percentage of the income, then an additional payment is to be made. That additional payment may or may not be deductible in computing other taxes. While such arrangements are designed to increase state shares of petroleum revenue, much of the same phenomenon occurs in some of the hard minerals in developments throughout the world.

The U.S. tax issue has always been whether there are applicable statutory foreign tax credits and, more recently, whether credits are to be given by treaty. The Treasury Department has recently been tending to make credits available under a treaty with controlled and circumscribed limitations. Such is the case with the recent treaty with the United Kingdom. A similar limitation is involved in discussions with Norway on the special Norwegian petroleum taxes.

More than 60 years ago, the United States provided statutory foreign tax credits for all businesses abroad. Special limitations were imposed by Congress in 1975 and 1976, in the case of oil and gas income in order to restrict the amount of credit available on extraction income taxes in any one country and to limit excess credits arising from extraction income.

In the last two years, the Treasury Department has viewed that legislation as less effective than it should have been. There is some disagreement as to the basis for the Treasury criticism. I think the issue is basically over how losses on overseas extraction are to be computed. The Treasury feels there is some slippage as to the use of excess credits, so there is a dispute. In any event, there has been legislation on the subject

pending for two years. This legislation was proposed by the Carter Administration to further tighten the utilization of credits.

Meanwhile, new regulations proposed a year ago that attempt to define creditable income taxes have substantial potential affect on extraction activities, certainly of oil companies, but they apply generally to any resource taxation. There are several presumptions dealing not with how the credits are mechanically utilized, but with the so-called royalty versus tax issue. The proposed regulations took some rather sweeping new positions in a set of presumptions. One is the rebuttable presumption, but only rebuttable on audit. That presumption is that if the petroleum company on its extraction income pays a tax, the rate of which is higher than the general applicable corporate tax, in the foreign country, then the company is deemed to pay no income tax whatsoever.

A second presumption that is conclusive applies not to the U.S. statutory provisions for creditable tax under Section 901, but to Section 903, which recognizes credits for taxes imposed in lieu of an income tax. This involves a "comparability" requirement that the tax collected has to be about the same amount as collected under the generally applicable tax.

A third rule is addressed to the phenomenon of combined, makeup, or additional payments. It provides conclusively that if an income tax is combined with another payment, and there is reference to a third amount that must be collected, or one amount is creditable under local law against another, the only amount that is creditable for U.S. purposes is the amount of income tax to the extent it exceeds all other payments.

Finally, all substantial deductions must be allowed by the foreign tax law and this is tested by reference to deductions allowed under the Internal Revenue Code. The type of issue raised by this rule is illustrated by the nondeductibility of royalties paid to the provinces in Canada for Canadian federal tax purposes.

All of these new concepts contained in the proposed foreign tax credit regulations raise problems that were best summarized as to their potential effect by the Staff of the Joint Committee on Taxation, which stated to the Committee on Ways and Means that virtually no petroleum taxes anywhere appeared creditable under the proposed regulations.

The proposed regulations are now under extensive review. One waits to see what may be repropounded in this area, and there is the impression that there may be something further administratively on this in a matter of weeks.

The results will obviously effect the petroleum industry and other resource industries subject to these rules, including future investment and exploration. The results may also include further dependence on OPEC, not only on OPEC suppliers themselves, but on non-U.S. companies producing foreign oil if U.S. companies become non-competitive in finding and producing foreign oil.

If one looks at the more restrictive approach being taken towards the foreign tax credit and places it in the perspective of a significant line of

policy decisions to increase the tax burden on U.S. foreign investment, it seems to me to be appropriate to step back and ask what we are doing and what others are doing. If one looks, for example, at German tax incentive laws for investment in resources in developing countries and the pattern of other tax laws generally, it seems to me that the United States is considerably out of step in its approach to taxation of foreign income.

As with Mr. Bourassa's comment today that the United States is no longer a totally independent economic power, we can add that there are other concepts that have been held in the United States that are no longer true today. One of these has been that the United States basically sets the rules for international taxation, that its influence and impact are necessarily great and that the multinational companies of any consequence are really only the U.S. companies. This has been the premise upon which most of the U.S. international tax policy has been based since the 1950's.

I question whether a position of U.S. dominance in the future is assured. Some reassessment should be made of the way we look at our foreign investment in the resource and manufacturing areas. U.S. access to foreign markets and the holding of productive assets abroad has been undervalued to a considerable extent in U.S. policy decisions.

I would conclude with the modest suggestion that U.S. policy should be such that tax considerations do not drive domestic investors away from the most economically productive investments, wherever they can be made. I would assert that implementation of such a policy would support a broad application of foreign tax credit rules and continued support for deferral for operating subsidiaries abroad. Appreciation of the role of U.S. foreign investment does not necessarily call for tax incentives, but it does require some attention to immediate competitive burdens.