SMALL BUSINESS ADMINISTRATION
OFFICE OF THE CHIEF COUNSEL FOR ADVOCACY

THE EFFECT ON SMALL BUSINESS OF FOREIGN TAX CREDITS AND
DIVIDEND REPATRIATION RULES USED BY LARGE BUSINESS

M.D. WILLER & CO., INC.
Michael D. Willer, Principal Investigator

Contract No. 7189-OA-83
February 1984
PREFACE

Information disclosed in this paper was obtained from public sources and from private sources under a promise of non-attribution. Information relating to named corporations is entirely from public sources. None of the tax and operating practices herein described should be identified with any corporation unless clearly indicated by the text.

ABBREVIATIONS

USMN  United States based Multi-National Corporation
CFC   Controlled Foreign Corporation, of USMN
DISC  Domestic International Sales Corporation
FTC   Foreign Tax Credit
GAAP  Generally Accepted Accounting Principles
CONTENTS

INTRODUCTION ................................. 1

METHODOLOGY AND INFORMATION SOURCES .................... 4

ACCOUNTING AND TAX OPTIONS OF USMNs ..................... 11

  Organizational Structure
  Financing Off-shore Activities
  Accounting Methods
  Tax Matters

APPENDIX ........................................... 50
LIST OF TABLES

TABLE I  USMN FINANCIAL DATA........... 10

TABLE II INFORMATION FROM IBM CORPORATION
  1982 ANNUAL REPORT.................. 28
INTRODUCTION

Our objective in performing this study was to determine how various tax provisions, foreign and domestic, relating to the repatriation of foreign profits by USMNs, affect their decisions to invest/reinvest in foreign countries in preference to the U.S. The purpose was to learn the impact of such decisions on small business.

There is no doubt that USMNs export jobs and investment in the sense that they finance and control a large amount of off-shore resources and activities. They participate in world markets, finance activities globally, and in turn, are owned by shareholders all over the world.

That the export of an activity or investment off-shore by a USMN has an effect upon domestic small business cannot be denied. Small business, under any 'trickle-down' economic model, accrues some revenue, however indirectly, from the operations of big business. It is common knowledge that a catering truck can't call on a factory that has been closed.

Our study finds that it is possible to describe quite clearly and currently the amount of off-shore investment of USMNs from their annual reports and SEC filings. Similarly, we can accurately determine their income from foreign sources. Even the number of foreign employees is often given.

The problem with the topic is not in defining what has historically happened, but in learning the reason why.
In every example we have seen of job or investment export by a USMN a reason other than a tax consideration has been evident. What is also evident is that jobs are exported in much more abstract terms than the simple relocation of a factory to a low cost labor area; though that also happens. USMNs export jobs by contracting with others to produce goods for them, which are then imported to the U.S. or incorporated into a product that is imported. Thus, when Caterpillar contracts to have engines made in Korea, or Dow Jones has keypunching of its databases done in Asia, jobs are being exported in the sense of our study. But no tax motive can be found, only market forces.

Readers of the popular financial press may be familiar with the recent agreement by AMC to joint venture a plant with the Peoples Republic of China to produce and sell Jeeps in China, with a hope of exports to Asia later. The labor cost expected was given as 50 cents an hour. In this example an off-shore investment is being made. But, surely, there can be no fundamental objection to selling Jeeps produced in China by Chinese. The technology transferred to the Chinese plant was produced and is supported by American jobs.

Example and argument can be given almost endlessly. The issue of job and investment export goes to the heart of the political process and is recognized as a sensitive topic around the world. For every country that has jobs they wish to keep there are countries offering incentives to attract them to their locale. Even governments compete.
In the discussion which follows we will show that very substantial disincentives to the free repatriation of foreign profits by USMN parent companies obviously exist. But our work also arrives at the conclusion that these disincentives are not so severe as to be the fundamental cause of job or investment export. Rather, it seems to be pure market forces that drive such decisions.

In accepting such a representation from USMNs we are persuaded by a review of their financial flows and resources in deciding the materiality of such tax disincentives to repatriation. We also consider the fact that USMNs do repatriate profits in a variety of ways, some of them quite indirect, leaving a smaller problem to consider.

The study offered by our proposal was to provide a base upon which future research could be built. We offered to provide a background to the topic that would aid in a resolution of the question.

We feel what is presented will provide an insight into the rich complexities of the issues and problems which surround the topic.
METHODOLOGY AND INFORMATION SOURCES

We began our research by carefully evaluating the content of previous research related to our topic, as cited by our statement of work. The three studies are:


These studies are valuable in understanding the mechanical application of tax rules and illustrate, in theory, how a U.S. Multinational Corporation might be influenced by certain foreign and domestic tax law. Each of them point out their limitations and the complexity of the topic, with which we agree.

The most serious limitation is that the data are generally from compilations of items reported in tax returns, usually for 1972 or earlier. That information is not relevant today. It is prior to DISC and prior to significant amendments to Subpart F of the Internal Revenue Code. Further, compilations, even within industry lines, cannot be related to other significant evidence that exists; such as individual audited balance sheets and fund flow statements.

Our knowledge of corporate reporting requirements led us to utilize company filings with the Securities and Exchange
Commission (Form 10K and Exhibit 22 to form 10K) which includes the audited annual reports by reference.

We selected a sample of companies, on a survey basis, not attempting to obtain a statistically valid sample, by simply opening pages of a Standard and Poors directory at random. If any company appeared thereon that was a USMN it was selected. All companies thus appearing were selected unless we thought we had already obtained a reasonably good sample of the industry represented.

We reviewed nineteen audited annual reports each of which comprised a three year history ending December 31, 1982. We reviewed the list of subsidiaries and tax structure, in addition, of one other corporation (RCA). The purpose of the review was to determine the quality of the information generally available and the extent to which it would aid in a reasonably complete understanding of our topic.

We find the amount of relevant information on the subject of foreign earnings, assets, liabilities, taxes, investment, and even intentions regarding repatriation of profits to be detailed, current, and much more useful than tax return data. We offer that future research using valid samples ought to be able to report the historical performance and future intentions of USMNs quite definitively. More importantly, this information is generally available very soon after the end of each year. A modest computer program (personal computer size) could easily deal with the amount of data required.
Such information may not clearly disclose the *reason* why USMNs behave in any particular way but will define exactly what has been done. It appears to us a clear understanding of actual USMN foreign financing and tax structure does not generally exist.

In Table I we present selected information about each of the USMN financial statements reviewed. The data is as of December 31, 1982 except that Net Foreign Income (after taxes except as noted) is for the year 1982. The information is presented only to illustrate that detailed, topical, and current information exists. It is interesting to note that the amount, in total, of Untaxed Foreign Earnings of our surveyed companies totals about 12.4 billions. That is about five percent of the total book value (equity and loan capital) of all U.S. off-shore investment as of December 31, 1980 as reported by the U.S Department of Commerce. From this observation we conclude a statistically significant sample can easily be constructed.

We then selected the more significant companies on our list and obtained the list of their subsidiaries as filed in Exhibit 22 of Form 10K (SEC) each year. This list provides the ownership hierarchy, tax tier, domicile, and ownership of each significant subsidiary. We do not claim to be able to fully generalize from our sample. We do offer that matters of tax planning are clearly reflected in the organizational structure of each company that are current, specific, and which can be related to audited financial information. This is another source of information that goes beyond that available from tax return
data compilation. We present the organization chart of IBM as Appendix A to this report for illustration.

During the course of our research we interviewed and corresponded with the top tax or financial officials of five of the companies from our sample. We did so under a promise of non-attribution. We were very pleased with those companies that were so forthcoming in dealing with us because they were generally the most significant companies on our list.

As a matter of further interest, we contacted a large and rapidly expanding U.S. company that has not yet engaged in off-shore activities, but which we expected would do so soon from information we had.

We also interviewed four partners in local offices of international accounting firms. None of the partners were involved in the audits of any of the companies we questioned, though other of their offices were. No information was disclosed about such companies to us by the accountants and none was requested by us. We simply wanted to know if the accountants to USMNs would corroborate what USMNs told us and if they knew of any technique at issue of which we were unaware. We find that accountants in the role of independent auditors do not have significant input into the decisions of USMNs about decisions to go off-shore. Their advice is asked at times about tax structure. They do a lot of actual tax return preparation and research. But the decision is usually by the USMN. The accountant is just another source of input.
Our approach to interviewing USMNs was to conceal the fact that our research was evaluating the effect of USMN decisions (to go off-shore) upon small business. We also concealed the ultimate use of our information. In both cases the concealment was simply by omission to say, and not by any misrepresentation. We did not want any bias to enter in, if it could be avoided.

The facts we learned from our questioning can be summarized as follows:

1. None of the firms have ever determined to not undertake a domestic business opportunity or investment because of the tax cost of repatriating foreign earnings.

2. Each company further states that if a domestic opportunity for expansion or investment were to develop in the future they have access to sufficient resources or techniques to finance any such opportunity without incurring a significant tax cost in utilizing accumulated foreign earnings.

3. Each company plans to finance foreign operations out of accumulated foreign earnings to some extent. They do not accrue U.S. or foreign (withholding) taxes in their financial statements in respect of earnings that are intended to be permanently invested off-shore.

4. Decisions about off-shore activities are driven by basic economic facts such as labor costs, and other fundamentals such as the location of natural resources and business opportunities. Tax costs of repatriating foreign earnings are considered if earnings are planned to be repatriated. Such costs are considered as costs against which a pricing decision must be made.

5. Corporate structure is organized to minimize the tax cost that arises upon repatriation of earnings.

These points were each unanimously given by each firm except for the last, and only one firm hedged saying that no generalization was possible.
If the information presented to us as fact is true, and our surveyed firms are representative of all USMNs, then our question has been decided.

The fact that USMNs do export both jobs and investment has not been changed, nor has the detrimental impact upon small business been ameliorated. It simply shows that the very narrow tax problem of repatriating foreign earnings is not significant to the question.

The study could not be complete, as a matter of interest to the principal investigator, without further substantiation of the position taken by the very significant firms involved. We also wanted to look at examples of job export and investment export, less rigorously, and to study tax law to see why USMNs are able to state so clearly that tax considerations do not have a great bearing on such decisions.

In that connection we examined details of U.S. tax law and publicly available tax planning advice issued by international accounting firms. We reviewed the popular financial press for current examples of job and investment export by USMNs that would aid in the resolution of the issue. We even acquired literature of foreign countries that attempt to entice U.S. business to locate in their locale by offering tax and capital grant incentives.

Our findings generally support the contentions of the USMNs we queried and provide a background for examining the topic in the future.
TABLE I
USMN FINANCIAL DATA
From 1982 Annual Reports and 10K Filings

(billions)

<table>
<thead>
<tr>
<th>Company</th>
<th>SHARER EQUITY (2)</th>
<th>UNTAXED (3)</th>
<th>FOREIGN EARNINGS</th>
<th>DEFERRED TAXES (2)</th>
<th>NET FOREIGN INCOME</th>
</tr>
</thead>
<tbody>
<tr>
<td>Atlantic Richfield Company (ARCO)</td>
<td>$9.9</td>
<td>$2.70</td>
<td>$0.30</td>
<td>$0.09</td>
<td>$0.30</td>
</tr>
<tr>
<td>Getty Oil Company</td>
<td>5.1</td>
<td>1.20</td>
<td>0.05</td>
<td>0.09</td>
<td>0.90</td>
</tr>
<tr>
<td>Phelps Dodge Corporation</td>
<td>1.0</td>
<td>0.17</td>
<td>0.05</td>
<td>0.14</td>
<td>0.02</td>
</tr>
<tr>
<td>The Coca Cola Company</td>
<td>2.8</td>
<td>0.17</td>
<td>0.05</td>
<td>0.14</td>
<td>0.50</td>
</tr>
<tr>
<td>The Goodyear Tire &amp; Rubber Company</td>
<td>2.5</td>
<td>0.11</td>
<td>0.05</td>
<td>0.03</td>
<td>0.09 (1)</td>
</tr>
<tr>
<td>General Electric Company</td>
<td>10.2</td>
<td>1.70</td>
<td>0.05</td>
<td>0.00</td>
<td>0.80 (1)</td>
</tr>
<tr>
<td>Ford Motor Company</td>
<td>6.1</td>
<td>1.05</td>
<td>0.05</td>
<td>0.01</td>
<td>0.80</td>
</tr>
<tr>
<td>The Singer Company</td>
<td>0.4</td>
<td>0.01</td>
<td>0.05</td>
<td>0.03</td>
<td>0.01</td>
</tr>
<tr>
<td>I. U. International Corporation</td>
<td>0.3</td>
<td>0.05</td>
<td>0.05</td>
<td>0.03</td>
<td>0.03</td>
</tr>
<tr>
<td>Raytheon Company</td>
<td>1.7</td>
<td>0.16</td>
<td>0.02</td>
<td>0.03</td>
<td>0.03</td>
</tr>
<tr>
<td>Allegheny International</td>
<td>0.7</td>
<td>0.10</td>
<td>0.02</td>
<td>0.03</td>
<td>0.03</td>
</tr>
<tr>
<td>IBM Corporation</td>
<td>20.0</td>
<td>1.64</td>
<td>0.03</td>
<td>0.03</td>
<td>0.03</td>
</tr>
<tr>
<td>Gould, Inc.</td>
<td>0.9</td>
<td>0.14</td>
<td>0.03</td>
<td>0.03</td>
<td>0.03</td>
</tr>
<tr>
<td>General Re Corporation</td>
<td>1.1</td>
<td>0.12</td>
<td>0.03</td>
<td>0.02</td>
<td>0.02</td>
</tr>
<tr>
<td>CIGNA Corporation</td>
<td>4.6</td>
<td>0.35</td>
<td>0.03</td>
<td>0.02</td>
<td>0.02</td>
</tr>
<tr>
<td>Frank B. Hall</td>
<td>0.2</td>
<td>0.01</td>
<td>0.02</td>
<td>0.01</td>
<td>0.01</td>
</tr>
<tr>
<td>Blount, Inc.</td>
<td>0.1</td>
<td>0.01</td>
<td>0.01</td>
<td>0.01</td>
<td>0.04</td>
</tr>
</tbody>
</table>

Notes:
(1) Net income before taxes.
(2) Excludes credit or financial subsidiaries in most cases.
(3) Untaxed means no U.S. tax has been accrued, nor have foreign withholding taxes been accrued that would arise if a dividend were paid. However, substantial foreign tax credits are available in most cases that would substantially eliminate any U.S. tax upon remittance.
ACCOUNTING AND TAX OPTIONS OF USMNs

ORGANIZATIONAL STRUCTURE

The first choice that presents itself when contemplating an off-shore activity is the form of entity to use. Choices are:

A. Operate as a branch of a U.S. domiciled corporation, which might be a branch of the USMN parent or a subsidiary thereof. Branches are currently taxed by the U.S. and usually receive more favorable treatment in the remittance of profits to the home office as compared to dividend distributions. Branch entities are quite common in the international banking industry and are also employed in 'start-up' of foreign operations where losses, real or tax, are expected.

B. Operate any export phase of the U.S. portion of USMN activity through a Domestic International Sales Corporation (DISC). DISC is an artifice of U.S. tax law that need exist only on paper, though some do exist as operating companies. Profits arising from export sales may be 'parked' in a DISC but still availed of by the a USMN parent through a variety of permissible devices. DISC, in turn, often creates further foreign sales companies to assist sales activities. DISC must be a domestic (U.S.) corporation but may also operate through foreign branches. There is no limit to the number of DISCs a USMN might create.
C. Operate in a local jurisdiction (foreign) through a 'first tier' controlled foreign corporation (CFC) organized in that jurisdiction. Such a CFC then is subject to the tax treaty, if any, between the U.S. and the local foreign jurisdiction. The CFC may, in turn, operate through branches in other foreign countries. For many purposes such branches will be treated as separate CFCs for U.S. tax administration purposes, but may enjoy favorable profit remittance between branch and head office (of the CFC) that would not be available in a parent-subsidiary relationship.

D. Within a foreign country, create two CFCs. One is an operating company the other is a holding company. The relationship to each other is parent-subsidiary. Such a relationship often enjoys exemption from some types of payments between the affiliated CFCs being included in Subpart F income (explained later) which would otherwise result in current U.S. taxation.

E. Create one or more off-shore companies to hold, in turn, title to CFCs. The effect is to create another tier in the hierarchy of ownership which may or may not be placed in a third country. This procedure may be used to take advantage of tax treaty provisions between the two foreign countries or to use a tax treaty between the U.S. and the third country to maximum advantage.
At this point, note that organization of CFCs is constrained by the U.S. tax rule that the foreign tax credit is available in respect of foreign income taxes paid by subsidiary CFCs down to the third tier of ownership. USMNs are not constrained from creating lower tiers of ownership, but the tax implications change considerably.

F. Certain operations may be conducted through 'Possession Corporations' operating in designated U.S. Possessions and Puerto Rico to a specified extent and which, in turn, may earn income elsewhere in the world to an extent specified in the law; the amount of which has a relationship to the amount of possession business activity.

G. Operations may be conducted through partnerships of off-shore CFCs of unrelated USMNs and MNs or their CFCs, as is common in the oil industry. Partnerships, or interests in partnerships, may or may not considered a tier in the ownership hierarchy or a CFC depending on a number of complex factors.

The foregoing organizational choices, items A through G, report only the predominant forms of doing business ordinarily used by USMNs in creating their 'transactional' structure, by which we mean the structure that leads from an actual transaction with an unrelated party to a USMN parent. Some USMNs stop at this point in creating the structure of their enterprise. IBM Corporation is an example and their organization chart as of December 31, 1982 is reproduced herein as Appendix A.
Other USMNs organize differently for a variety of purposes. In the 1982 annual report of Getty Oil Company, for example, it is disclosed that 152 undisclosed subsidiaries exist which, in the aggregate, would not constitute a significant subsidiary.

Such legends are quite common in the reports of USMNs. Such subsidiaries are used for a variety of purposes, many of them related to tax or tax treaty considerations. They may be used to hold title to property as nominee or serve as non-profit conduits in certain types of transactions or to change the character of income under local tax options.

We also note that the U.S. entities in an organization chart have a choice of domicile between states.

Finally, on the matter of choice of organizational structure, it must be recognized that entities may be formed that do not deal with the outside world, but that are availed of to deal in transactions among the affiliates.

Our research indicated that USMNs organize to achieve minimum tax costs, all things considered, as one would expect. This fact was given us directly by USMNs. They are not, however, able to absolutely control their world-wide liabilities through clever manipulation because of tax law, discussed elsewhere, financial requirements of lenders and shareholders, and a variety of other factors. USMNs report that they see the cost of repatriating that portion of their accumulated foreign earnings that they expect to repatriate as a cost of doing business against which pricing decisions are made.
A review of audited financial statements indicates that USMNs neither intend to repatriate all of their foreign earnings nor do they consider the cost of repatriation of earnings permanently required to finance off-shore activities in pricing decisions. We examined the organizational structures of ten USMNs. Their structures were obtained from the annual filing of their list of subsidiaries and affiliates with the Securities and Exchange Commission, such as the example of IBM Corporation presented herein as Appendix A. A great deal of information can be adduced from the SEC filing because in addition to the name of the subsidiary, its ownership and domicile is disclosed. Our review of the sample of lists supports the representation of USMNs to us that they attempt to minimize tax costs through organizational structure.

FINANCING OFF-SHORE ACTIVITIES

The second area usually addressed by a USMN in contemplating an off-shore activity is the question of how to finance it, both at inception and on a continuing basis. Our research has as one of the concerns to be addressed the idea USMNs export investment. That they invest off-shore, in substantial amounts, is given. While the figures of the U.S. Department of Commerce do not distinguish, exactly, between USMNs and other U.S. persons, it is reasonable to assume that the total reported book value of direct investment in foreign countries is largely
by USMNs. At the end of 1980 the amount was $213.5 billions (which may be compared to direct foreign investment in the U.S. at the same date of $65.5 billions).

In advance of discussing options available to finance foreign operations we make the point, discussed in detail under the topic of accounting options, that USMNs do not deal in the limited concept of 'net income' after taxes but, instead, in cash flow which encompasses a wide variety of resources from which investment is expended.

The financing options a USMN might consider in establishing or continuing an off-shore activity are:

A. Finance directly with a contribution of capital from the U.S. Parent or its domestic subsidiary. This technique uses domestic assets and subsequent remittances in respect of invested capital are generally considered to be dividends, which are least desirable from a foreign tax point of view as withholding taxes often result.

B. Finance the CFC with loaned funds. The advantage is that principal is often repaid without tax consequences. Interest is generally deductible by the CFC and taxable to the parent, though also sometimes subject to foreign withholding taxes. Once the loaned capital is repaid the CFC is then in the same position as under item A. Further remittances are dividends.

C. Instead of supplying capital directly, the loan or equity capital might be supplied through an off-shore
intermediary CFC. Advantages are obtained by using favorable tax treaty countries to reduce or eliminate withholding taxes on the interest element flowing back to the lender. USMNs often finance off-shore through the use of a Netherland Antilles corporation to avoid the U.S. requirement for withholding 30% tax on interest paid. Avoiding withholding taxes on payments to lenders enables a lesser net interest rate to be obtained.

At this point we note that the major concern of USMNs in deciding on how to finance any off-shore activity is in how to manage the risk of loss from currency fluctuation. USMNs must operate in local jurisdictions in the local functional currency. When long term assets or liabilities are denominated in a local currency different from the reporting currency of the USMN parent a translation loss may occur.

Rules regarding gains and losses from foreign currency translation are complex, both for financial reporting purposes, and also for tax purposes. As explained later, currency gain or loss enters directly into the calculation of 'earning & profits' of a CFC. Earnings & profits, not taxable or financial income, is used in determining the character and source of remittances from a CFC in deciding what portion is to be treated as a dividend.

The Financial Accounting Standards Board (FASB) requires companies to report gains or losses from currency translation
in annual reports. Our review of annual reports, and experience, reveals very considerable attention is given to the problem of protecting the assets and earnings of an enterprise from exposures such as have occurred over the last several years.

Thus USMNs adopt a technique of managing liabilities by attempting to finance locally or in the same currency as the functional currency of the local jurisdiction, and in about the same amount to which they are exposed. USMNs often centralize their borrowing and lending activities, and they further segregate them between domestic and off-shore.

Tax law, and many tax treaties, provide the banking and finance business with very favorable treatment, from the point of view of taxation, as compared to business profits. For example, Subpart F of the Internal Revenue Code does not reach interest earned from related parties if the recipient CFC is engaged in the banking or finance business and the businesses of both parties are predominantly with unrelated parties. The definition of 'predominant' is liberal; 70% of the gross business of both parties must be with unrelated persons. However, the banking and finance business is conducted with high leverage and on the basis of selling liabilities. Debt to capital ratios of between 15/1 and 30/1 and more are common. Thus it is not difficult for a USMN to centralize off-shore financing to manage off-shore, intercountry capital requirements without creating an undue tax problem via Subpart F.
In fact, a review of the organization charts of a number of USMNs reveals that foreign banks, insurance companies, and finance companies are commonly used. We further note that these off-shore finance companies (or any CFC) may bank in the U.S. without the deposits or investments being considered as an investment in U.S. property.

D. Operations off-shore may be financed by raising permanent capital from a variety of sources including the sale by the CFC of its USMN parent stock in the public market, capital grants from host governments, or the re-deployment of available off-shore cash flows.

E. Within a local jurisdiction plant and equipment may be financed by local or cross-border leasing transactions with an unrelated party. The subject of cross-border leasing with a related party is treated later in this report. Such transactions (with unrelated parties) are used frequently in less stable areas or in areas where local tax laws are so favorable that tax advantage is passed on to the rentee or lessee in the form of lower financing costs, such as in the way a United States lessor might consider investment tax credits available in respect of the ownership of property in pricing the financing element of a lease.

From what has been said, it should appear clear that the choice of financing methods is closely intertwined with the choice of organizational structure, previously discussed. In a
large organization literally thousands of possible choice combinations exist.

An important observation, however, is that financing methods are first geared toward the protection of company assets against loss, undue risk, and cost of funds. When earnings upon the invested capital accrue, the first consideration is identically the same because earnings are the same as capital once earned. Since, as we will later show, remission of earnings to the U.S. parent is often not contemplated, such considerations carry less weight.

ACCOUNTING METHODS

We next address the topic of accounting options available to a USMN. It is in this area that we must make an essential point. Accounting serves a variety of purposes. Our study has as its focus tax disincentives to repatriation of the foreign earnings of the CPCs of USMNs. Accounting for tax purposes, both foreign and domestic, is not at all the same as accounting for the purpose of preparing financial statements according to generally accepted accounting principles (GAAP), nor is net income according to GAAP at all the same as the total funds available for disposition by a USMN. And, a financial statement presented to the shareholders of USMNs will be evaluated entirely differently than the same statement evaluated by lenders to the USMN, or by the marketplace when new equity capital is sought.
The consideration of these differences is fundamental to the resolution of our topic, because in it the weight that ought to be assigned to the tax position or problem of USMNs can be better determined. Accordingly, we briefly discuss the objects of each type of accounting and the purpose to which each result is put.

Tax accounting, from the point of view of the USMN or any reporting component of it, such as a CFC, has as its object both the short-term and long-term minimization of tax burden. Tax accounting, from the point of view of the taxing jurisdiction, has as its object the raising of revenues and, often, the behavioral modification of affected taxpayers. By behavioral modification we mean such things as incentive to invest (as through the granting of Investment Tax Credit by the U.S.), or to export (DISC), or to employ targeted individuals, etc. The incentives work because they match the desires of taxpayers to defer or minimize tax burden.

The fundamental difference in tax accounting (to arrive at taxable income) and financial accounting is that timing differences are available to postpone the reporting of taxable income and accelerate the reporting of deductions. Financial reporting, on the other hand, strives to match income and expenses in the period to which they properly relate. Almost all differences may be understood in terms of timing. Accelerated depreciation methods (direct expensing in some jurisdictions), cash receipts and disbursements (instead of accrual basis)
bookkeeping, and the completed contract (instead of percentage of completion) method of reporting long-term contracts are all generally familiar examples.

A survey of the 1980 annual reports of the top 250 Fortune industrial companies found the unweighted average of deferred taxes was 26 percent of stockholders equity, up from only 9 percent ten years earlier. Assuming a 50 percent tax rate the deferred tax account represents only about half the deferred income accounts that arise from timing and deferral opportunities. More recently, a survey of the 100 largest industrial companies in the U.S. showed deferred taxes of 14 percent of stockholders equity. These figures are offered only to show the relative significance of the differences in tax and financial accounting and not as a quantification applicable to all USMNs.

The difference in tax and financial accounting (and, later discussed, fund flow accounting) is one of the primary sources of disincentive to a USMN to remit the profits of a CFC in certain circumstances. When a CFC files its tax return in the local foreign jurisdiction it is according to the local tax accounting allowed, which generally provides deferral. However, deferral or timing differences are often removed under U.S. tax law in evaluating whether or not a remittance to the USMN parent is a dividend or a return of capital. Incomes of CFC are recalculated to reflect, essentially, financial reporting standards applicable to domestic corporations when determining the source, in time and character, of the remittance. For
example, direct expensing provisions of local foreign law are not allowed and are replaced by depreciation deductions according to IRS regulations. The IRS tables are considerably less favorable than most foreign law.

It is thus possible, in an extreme example, to have a CFC report no local foreign taxable income and thereby pay or accrue no local foreign tax. Upon remittance to the USMN parent, however, to the extent the CFC has its income recalculated to show 'earnings and profits,' taxable income accrues and U.S. tax is due. But no offsetting Foreign Tax Credit is available. Naturally, USMNs have the ability to plan in avoidance of this possibility in that it is at their discretion as to when to remit. However, it can be seen that a difficulty for them exists and the simple way out of it is to not remit.

The deferred tax accounts reported by USMNs are used by us to infer the size of the deferred income accounts of USMNs, which are both domestic and foreign.

The provisions of U.S. tax law requiring distributions to be accounted for in terms of the U.S. definition of Earnings & Profits (E&P) were enacted to avoid the prospect of U.S. shareholders arranging to receive tax free dividends. However, the clear effect in the statements of USMNs in a position to make such decisions, is that remittance will not be made unless an undue consequence of it can be ameliorated through offsetting circumstances.

On this difficult point we note that while U.S. tax regulations recast distributions to more realistic financial
accounting standards for the purpose of arriving at the U.S. tax, no corresponding adjustment is made on account of the foreign taxes that will accrue to the local jurisdiction upon the same restatement. Obviously, if a CFC is allowed a direct expense deduction in its local return, resulting in no taxable income, it will in future years have higher incomes because no depreciation will be allowed in each future year in respect of the asset that was expensed. U.S. law replaces the direct expensing with the depreciation deduction but does not give effect to an immediate Foreign Tax Credit in respect to the two different accounting methods used to arrive at taxable income in each jurisdiction.

One directed task of our study was to examine how accounting relationships between a USMN parent and its foreign subsidiaries are manipulated to defer income to future years. This idea, too, needs to address the three types of accounting. From a tax point of view the answer is straightforward. Income is almost always deferred to the future for tax reporting purposes regardless of the jurisdiction collecting the tax. If a substantial second tax might accrue from the remittance of foreign earnings to the U.S., a USMN has a choice of timing since, generally, tax does not accrue until the dividend is remitted which is to some extent controllable by the parent. Thus, the parent will wait to try to minimize any tax impact arising from remittance, if it has not planned for the cost.
Our research shows that USMNs do plan for the cost that arises from remittance to the extent that such remittance is planned.

Some attention in the past has been given to the characterization of fund flow between parent and foreign subsidiary. For example, funds might flow back as interest, rents, royalties, service charges, management fees, inventory purchases, etc. In all of these areas there is little opportunity under U.S. or foreign tax law to misprice with a view to deferring income to the future. That is effectively precluded by the use of Subpart F, and IRC Sec. 482 or its foreign equivalent; the so called 'arms-length' rule.

We will offer that most of our significant trading partners allow arms-length flows of funds for the things listed, above, between a parent and subsidiary without imposing a withholding tax or disallowing a local tax deduction. Some jurisdictions impose a withholding tax on interest and royalties to a modest extent.

We will at this point reiterate the basic point that USMNs think in terms of GAAP income, which is reported to shareholders, and invest according to fund flow accounting. Tax accounting or manipulation arises only because some tax jurisdiction offers an incentive in its locale. A USMN will almost always take advantage of the offer. The incentives are almost always the 'timing' differences previously discussed which result in deferral of income for tax purposes to the future. But these
deferrals are fully accounted for as ultimate costs in the audited GAAP statements of companies. They are not considered as deductions in the fund flow statements.

Thus, we say, there is no such thing as a deferral to the future of incomes by reason of accounting manipulations of a USMN except in the very narrow area of local tax accounting to local jurisdictions. The only deferral, if there is one, is in the remittance of profits back to the USMN. The reason such profits might not be remitted has nothing to do with accounting manipulations between home office and foreign subsidiary but is almost entirely due to tax law. But, to reiterate, the materiality of the disincentives to remittance is not what drives the jobs or investment export with which we are concerned.

In deciding the question of how and why a USMN makes its investment decisions, we rely heavily on fund flow accounting to support the statements the USMNs have made to us. Fund flow accounting is relatively new as a statement that auditors express an opinion on, and therefore, one on which we can rely. When such statements are read in connection with footnotes to the statements dealing with income taxes and geographical data, one may determine quite clearly what large scale employment of available funds have been made. By relating increase or decrease in net assets employed in foreign jurisdictions to foreign earnings and to other sources of investment funds, it is made clear whether or not remittances are being made or if profits are being 'parked'. To illustrate this point we again will use
the audited reports of IBM Corporation. The information in the following table has been recast from data found in the 1982 IBM annual report. It is offered as being representative of the information generally available about all USMNs.
TABLE II

INFORMATION FROM IBM CORPORATION

1982 ANNUAL REPORT (5)

(in millions)

<table>
<thead>
<tr>
<th></th>
<th>1982</th>
<th>1981</th>
<th>1980</th>
</tr>
</thead>
<tbody>
<tr>
<td>NON-U.S. OPERATIONS:</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Revenues ................</td>
<td>$15,336</td>
<td>$13,982</td>
<td>$13,787</td>
</tr>
<tr>
<td>Earnings before taxes ....</td>
<td>3,226</td>
<td>2,664</td>
<td>2,772</td>
</tr>
<tr>
<td>Income taxes ............</td>
<td>1,577</td>
<td>1,123</td>
<td>1,035</td>
</tr>
<tr>
<td>Net income .............</td>
<td>1,649</td>
<td>1,541</td>
<td>1,737</td>
</tr>
<tr>
<td>Net assets employed .....</td>
<td>8,008</td>
<td>7,690</td>
<td>7,674</td>
</tr>
<tr>
<td>Untaxed foreign earnings.</td>
<td>7,538</td>
<td>6,565</td>
<td>5,943</td>
</tr>
</tbody>
</table>

| ALL OPERATIONS:          |        |        |        |
| Income before taxes ......| 7,930  | 6,260  | 5,723  |
| Income taxes ............ | 3,521  | 2,650  | 2,326  |
| Net income ............. | 4,409  | 3,610  | 3,397  |
| Non-cash deductions &    | 5,049  | 4,000  | 3,438  |
| working capital changes  |        |        |        |
| Net new financing .......| 62-    | 752    | 168    |
| Capital raised .......... | 613    | 423    | 62-    |
| Funds available ..........| 10,009 | 8,785  | 6,941  |
| Dividend requirement .....| 2,053  | 2,023  | 2,008  |

Notes:

(1) U.S. & foreign taxes on incomes.
(2) Equivalent to 'net worth'.
(3) Not intended to be repatriated.
(4) Does not include fund balances on hand at the beginning of each period.
(5) The IBM statements, as most other USMNs, exclude the credit or finance subsidiaries. In many cases (but not in the case of IBM) deferred tax benefits are reported or reside mainly in such subsidiaries.
The information presented brings the activities of IBM clearly into perspective. For year 1982, foreign operations earned 1.649 billions. Total new funds available for deployment during the year were 10 billions. The relationship gives the relative significance of the two ways of looking at income. While foreign earnings before taxes represented about 41 percent of combined income, what remained after taxes was only about 16 percent of total fund flow.

The question of repatriation can be decided on the basis of the information presented. Untaxed foreign earnings (balance at the end of each period) increased 973 millions from 1981 to 1982 compared to earnings of 1,649 millions after taxes. However, net assets employed in the business (also as at the end of each period) increased only 318 millions. Thus, net assets in the foreign business became increasingly financed by accumulated untaxed foreign profits and other kinds of capital have been remitted or used to reduce general corporate borrowings. Perhaps the most significant trend shown is the relatively steady amount of net assets employed in the foreign business segment at the same time as untaxed foreign earnings are increasing substantially.

It is also clear that, even allowing for dividend requirements, IBM had cash flow sufficient to undertake major domestic investment without resorting to the capital it has accumulated to finance its foreign activities.
It is also clear, because net income after taxes is greater than the annual increase in untaxed foreign earnings, that IBM has, in fact, repatriated considerable foreign earnings.

Elsewhere in the annual report is disclosed a summary balance sheet for foreign operations. Our review of it shows that the foreign operations are not unduly liquid. Undue liquidity would indicate profit 'parking'.

A final comment about IBM is that it is unusual in only one regard; the deferred tax account consists only of investment credits that are being amortized over the useful life of the underlying assets. It appears that timing differences are not material in the case of IBM, while our review of other USMNs discloses that the deferred tax account is usually significant.

The importance of fund flow accounting and fund flow statements cannot be over-emphasised. IBM Corporation, based on its general credit-worthiness as evidenced by its debt service ability reflected in the fund flow statement, can raise large amounts of capital in the U.S. or off-shore without pledging the shares of its foreign operations. The effect is to liberate, in one way of looking at it, the accumulated foreign earnings of its off-shore operations without the need to repatriate. And, in fact, the IBM statement indicates this has been done to an extent.

At the end of 1982 total shareholders equity was about 20 billions of which foreign net worth was about 8 billions. Yet, long term debt at year-end was far more lopsided. Foreign
long term debt was about .6 billion while total debt was almost 3 billions. These figures are also not representative of all USMNs because IBM is so well capitalized with equity. However, the ratio of borrowings that are obtained on the general credit-worthiness of a company to domestic and foreign net worth is very significant. A USMN may easily access its foreign retained earnings without repatriation, and without running up against U.S. rules taxing the increase in earnings of CFCs invested in U.S. property, so long as it does not require the guarantee or pledge of assets of a CFC, or so long as it does not directly or indirectly pledge the CFC shares as collateral.

The fund flow statement of a USMN is one of the primary statements used by lenders in evaluating the general credit worthiness of borrowers because it reflects the quality of income; that is, how much of it is cash or the equivalent or how much arises from accounting conventions that are not available to service debt during the accounting cycle.

A USMN, however, is under no constraint in supplying the funds thus borrowed to its CFCs and requiring them to repay it. Nor is the USMN parent constrained from guaranteeing the debt of its CFC.

We were advised by USMNs directly, that they possess the financial resources to undertake any investment they might contemplate, domestically, without accessing the accumulated foreign earnings of their CFCs at a rate greater than they otherwise would. We were also advised that, among the limited
sample interviewed, there has never been a decision to not undertake a domestic opportunity because of the tax consequences of repatriation. Our survey of the statements of USMNs, while admittedly not a statistically valid sample, generally supports their contention of available resources.

Our final comment on the matter of accounting is that the quality of reliable information on the topic of USMN activity in financing its foreign operations is quite good, and it is quite current. Audited financial statements, including the appended footnotes, as presented in annual corporate reports and filings with the SEC are surely a much better source of information than data compilations of tax return information previously employed by others in evaluating similar topics. Both sources provide historical data. But annual reports are current, generally available within a few months after the end of the year, while tax return data is commonly many years old. Further, the amount of information that is 'tied together' in audited reports is very great. Forms filed with the IRS, which cannot be obtained on an individual company basis, cannot be related to other meaningful data, such as fund flow statements or balance sheets.

**TAX MATTERS**

Tax options available to a USMN cannot be fully separated from the other options, organization structure, finance, and accounting, because each of these things have tax consequences
in and of themselves. All are naturally related and intertwined. In general, however, we may say that the basic premise of U.S. tax law is to tax a U.S. corporation on its worldwide income currently, as earned, and to allow a credit against the U.S. tax for income taxes paid to a foreign jurisdiction.

However, should a USMN own shares in a foreign corporation it will generally not report income to the U.S. in respect of the earnings of the CFC, in whatever form, until receipt of a dividend.

At the time of receipt of the dividend, it is 'grossed up' in the tax return of the parent to include the underlying income tax paid and any further withholding tax imposed. The USMN then reports the full underlying foreign earnings and receives a credit against the U.S. tax liability for the foreign taxes paid.

The first CFC may, in turn, own shares in lower tier CFCs and the same process obtains; that is underlying incomes and taxes are imputed up the chain to the parent for inclusion in its return and credit against its tax. In U.S. law such imputation is available down to the third tier of CFC; beyond that no credit is available for foreign taxes though dividend income from a lower tier will find its way up the chain and into U.S. taxable income.

We reviewed the organizational structure of USMNs and they clearly observe the U.S. requirement. One will rarely observe a chain of ownership descending below the third foreign tier.
One result of the U.S. system is that it generally concedes taxation to the extent of the U.S. rate, or the foreign rate if that is higher, to foreign jurisdiction. Thus it can be seen that if the foreign rate is higher than the U.S. rate it is likely no U.S. tax will ever be paid on the foreign income. It is also possible that some foreign rates will be less than the U.S. rate, in which case the excess taxes paid a high-rate country can offset the reduced taxes of the low-rate country.

U.S. corporations must figure the foreign tax credit (FTC) on an overall basis and not on a country by country basis. If the effective foreign tax rate, all countries considered, is lower than the U.S. rate, some U.S. tax would generally be payable on receipt of a dividend.

Since tax rates, both income and withholding, and income source rules vary quite widely from country to country, and the manufacturing, sales, licensing, and financing activities of USMNs are often complex and in a large number of jurisdictions, it is normal to incorporate in a number of foreign countries, which incorporations include holding companies and base companies.

In the past tax haven jurisdictions were used to receive and redeploy foreign earnings, avoiding remittance of a dividend to, and tax by, the U.S. However, Subpart F of the Internal Revenue Code effectively precludes this practice and a number of others thought of as abusive.

Under Subpart F, a U.S. parent company is subject to tax on a 'deemed' distribution or dividend arising from certain
activities. It is still possible, under present rules, to use foreign earnings for local expansion without developing a deemed dividend. Thus, the current preferred practice of USMNs is not to have a tax-haven subsidiary at the apex of the ownership hierarchy, but for the U.S. company to own the shares of each subsidiary operating in a foreign country. It is often possible that a holding company will, however, result in the reduction of foreign withholding taxes on some types of remittances through the operations of tax treaties.

A holding company is often used when a USMN has several subsidiaries located in the same foreign country to take advantage of local consolidated return rules.

We again refer the reader to Appendix A, the IBM organization chart, which illustrates a very typical structure.

Even though considerable discretion resides in a USMN parent about the timing of dividend and other remittance flow, and thus when a taxable event is to occur, a number of kinds of income are taxed currently. The two most important are Subpart F income and the 'increase in earnings (of CFCs) invested in U.S. property'.

Subpart F income, in turn, has four main elements:

1. Foreign Base Company Income;
   a. Personal holding company income.
   b. Sales company income.
   c. Services income.
   d. Shipping income.
e. Oil related income.

2. Income from the insurance of U.S. risks;
3. International boycott income;
4. Foreign bribes.

The main intended effect of Subpart F is to tax passive investment income and artificial income arising from intercompany transaction such as purchase of sales of property or service between affiliates or between a member of the affiliated group and an unrelated party. The element dealing with shipping income reaches earnings that are not reinvested in shipping operations. Oil related income reaches virtually all income after extraction unless further processing or sale of crude or processed product occurs in the country of extraction. We do not treat boycott or bribe elements of Subpart F on the basis that they are not material to the topic.

If a CFC invests its earnings in U.S. property, including shares of a U.S. Corporation, such investment is deemed income to a U.S. shareholder to the extent of earnings and profits of the CFC. Intercompany loans and receivables are considered to be an investment as is the guarantee by a CFC of an obligation of a USMN parent. A variety of complex and detailed rules exist, all of which seek to deny to the parent the accumulated earnings of a CFC without the reporting of such use as a dividend. Several exceptions exist, which are significant, including investment in obligations of the U.S. government, bank deposits with a banking institution, and property (inventory
or capital goods) that will be exported or used in foreign countries. Any such assets, money deposit and securities in particular, however, may not be indirectly pledged in support of an obligation of the domestic parent.

Foreign base company sales income develops whenever a sale of personal property is made through a CFC to or from a related party and the property is both produced and sold for use outside the domicile of the CFC. This encompasses the so called reinvoicing practices that parked profits off-shore in the past. There is no Subpart F income arising from true third country trading activities not involving a related party. Nor does Subpart F income arise if the sales activity is domiciled either in the country of origin or ultimate use.

Foreign base company services income reaches technical, administrative, and similar services performed for a related person in a country other than the country of base company domicile.

It should be noted that foreign base company sales and service activities are commonly used. The only import of Subpart F in this area is to tax any profits derived on a current basis. Most jurisdictions, including the U.S., permit intercompany transactions to stand, tax wise, so long as the arms-length rule is observed. It can be an advantage to centrally locate support operations, or distribution facilities, in one locale or another rather than have multiple facilities, for each country. However, the artificial creation of profit
in one locale at the expense of another violates the arms-length rule of the U.S. and many other countries and has significant adverse tax consequences.

Perhaps the single most powerful section in the Internal Revenue Code is the single sentence of Section 482 which allows the allocation of gross income, deductions, credits and allowances among related businesses (domestic or foreign) for the purpose of the clear reflection of (taxable) income. Given the power, and frequent use, of Section 482, one can only say that if abuse in this area occurs, then, "Shame on me".

The foreign personal holding company income element of Subpart F reaches passive incomes such as interest, rents, royalties, and dividends, but with significant exceptions.

Subpart F does not reach rents or royalties from an unrelated person derived from the active conduct of a trade or business. Nor does it reach dividends from related persons organized and operating in the same foreign country. Similarly, it does not reach rents or royalties from an affiliate in the same domicile. Another significant exception is that it does not reach interest received from a related person if the recipient is in the banking or finance business and the business of both parties is mainly with unrelated parties.

A substantial departure from the treatment accorded CFCs of USMNs appears in the treatment of Domestic International Sales Corporations. We have said that DISC, under U.S. tax law, is artifice. By that we mean it does not need to meet the
ordinary tests of substance that apply to all other artificial entities. For tax purposes, DISC may exist only on paper. Most importantly, Section 482 does not effectively apply to transactions between DISC and its parent. Profits may be attributed to DISC that are entirely artificial, or unearned.

DISC is an extremely effective tax-sparing device for USMNs that export because it, in effect, allows a portion of the sale price of an export to be parked in a DISC (which must be a domestic corporation) that otherwise would be earned by an off-shore corporation, or taxed by the U.S. if earned by an ordinary domestic corporation. This profit is determined according to several quite liberal rules, which can be summarized as allowing a profit not in excess of the greater of:

1. 4 percent of export receipts plus another 10 percent of DISCs export promotion expenses; or

2. 50 percent of the combined taxable income of DISC and its related export property supplier plus 10 percent of DISCs export promotion expenses; or

3. Traditional taxable income based on Sec. 482 and the actual price charged and costs incurred in manufacturing.

In fact, the only constraint in the application of rules 1 and 2 is that they may not result in a loss to the related supplier (which will always be domestic).

The profits allocated to DISC are not taxable. Instead, the parent of DISC is 'deemed' to receive a distribution of a portion of DISCs profits annually, according to a formula. The present formula defers recognition of 42.5 percent of the
profit arising from the increase in exports over a base period amount. Because of inflation and the fact that the base period average is determined for a base period several years in the past, quite a large share of profits are available for deferral even if no physical increase in unit export volume develops.

The profits that are not fully deferred, about 57.5 percent, are given a further timing deferral. If the DISC tax year ends one month after the tax year end of the parent, the portion that is taxable in effect receives an eleven month deferral. This long lead time aids a USMN in determining its annual tax position and aids substantially in planning. Being able to artificially determine the profits of DISC in advance by paying a set artificial commission also aids in planning.

The most beneficial aspect of DISC is that the profits that are parked in it are available to the parent by permissibly borrowing them back by calling the borrowing a 'producers loan'. This is substantially different than the circumstance of borrowing the accumulated profits of a CFC, which results in full and immediate taxation.

Our review of tax structure of our USMN sample revealed considerable use of DISC. Experience also indicates it is most important to the tax planning of exporting companies. While we do not have reliable, current data about the scope of DISC tax deferral, simply imagining 4 percent of total USMN qualified exports convinces one of the significance. The IRS does compile statistics about DISC operations, but no separate accounting is
generally available from companies in their annual reports on a consistent basis.

Perhaps the area that is most complex for USMNs, in reviewing the tax options available to them, is in understanding the tax treaties that are available. We have already said that the Foreign Tax Credit (FTC) is the basic mechanism by which double taxation is avoided. FTC is a simple concept, subject to relatively few complications. Tax treaties, however, go beyond the FTC in attempting to avoid double taxation of activities. Tax treaties allocate certain types of income to a particular country and reduce the withholding tax on certain types of income that would apply in the absence of a treaty.

Since there is a limit on the amount of foreign tax, income or withholding, that can be absorbed in the U.S. tax rate, utilization of tax treaty provisions to reduce withholding taxes is vital to USMNs. Tax treaties exist between the U.S. and all major industrial countries.

Each treaty is negotiated separately and all, as one would suppose, are different to a greater or lesser degree. Treaties are continually adjusted through negotiation and are further interpreted by Treasury Rulings and court cases.

The main area of concern of our topic is in the level of withholding taxes that apply to flow of funds back to a USMN parent. Most treaties address withholding taxes on dividends, interest, and royalties. It is common for treaties to reduce withholdings from the statutory rates (in the U.S. the rate is
30 percent on most payments) to as little as 5 to 15 percent on dividends and, often, nothing at all on interest and royalties.

If there does exist a disincentive to USMNs to repatriate their profits it is first found in the imposition of withholding taxes. This is true if for no other reason than it is a discretionary event to a large degree. If, further, the earnings to be repatriated come from a low (income) tax country it is possible further U.S. tax will be due. On the other hand, if treaties provide for no withholding taxes on royalties, interest, or home office charges, and such expenditures of the CFC are at arms-length rates and are deductible for computing local income taxes, these kinds of payments will be preferred.

We note, however, that such types of payments do not enter into our problem; those funds will have been repatriated. Our concern is with what is left after all deductible (for local tax purposes) expenses have been paid out.

The tax rates on income of most industrialized foreign countries that are important to USMNs approximate the U.S. rate or are higher. When withholding taxes are figured, worldwide effective tax rates are mostly greater than the U.S. rate. It can easily be seen, then, that the larger the proportion of foreign activity to U.S. activity the greater a problem a USMN is likely to encounter in recouping all of its foreign tax expense. It is not at all difficult to see why so many USMNs, then, intend to finance their off-shore investments with off-shore earnings.
Another aspect of this problem is that foreign countries such as Ireland attempt to acquire 'inward' investment by offering tax incentives to locate in their locale. U.S. tax law, in effect, often taxes away such incentives. If a foreign country grants a tax holiday to the CFC of a USMN, earnings of the CFC are fully taxed at U.S. rates upon remittance.

On this point, the suggestion has been advanced that the way out of the problem is world-wide current taxation. This theory fails because even though it might raise U.S. tax revenues (not at all assured) it could not require remittance of a dividend. A dividend may be needed by the USMN in order to meet its tax obligation, but one cannot show how that would aid in resolving the problem. It would simply put off-shore activities on a par with domestic activities, tax-wise, without addressing the reason the activity went off-shore in the first place. It would reduce the capital of USMNs by increasing foreign and domestic taxation.

The opposite point of view is to remove all such barriers to remittance by imposing no U.S. tax at all on any remittance of profits. It would be the same as present tax law, only the U.S. impediment to repatriation is removed. It is fairly clear, given a usual range of available choices, a USMN, if it desires to remit profits, will do so from the CFC that results in the lowest cost. Why should the U.S. inhibit the flow of such earnings back to the U.S. simply because some foreign country elects not to impose a tax on income earned in its jurisdiction? We recall the power of Section 482 in preventing abuse.
Given the importance of tax withholding rates it should not be surprising for us to learn that such treaties can be used to reduce withholding taxes and income taxes. So called 'treaty shopping' involves constructing a transaction or organizational structure that directs taxable events to occur in the country desired or according to the law of the country desired. We earlier mentioned the treaty shopping practice used by U.S. corporations in selling obligations through a Netherlands Antilles capital corporation for the purpose of avoiding the U.S. withholding tax being imposed on the interest paid off-shore investors; thereby reducing the interest cost to USMNs. There is nothing abusive in the idea; about 28 percent of the 1982 Eurofinancing of U.S. corporations was accomplished this way. In the same way differing rules across 'tax frontiers' can be used to reduce costs, of which income taxes are but one.

A point to be made is that tax rules, and thus, tax options, rarely deal in the concept of net income. Instead, they tend to address very specific elements that enter into the calculation of taxable income. These rules are often significantly different across tax frontiers. We give but one example; cross-country leasing of equipment.

When the use of equipment is transferred under a lease that, for all practical purposes, delivers effective economic ownership to the lessee but retains actual title in the lessor, the arrangement can be thought of as a financing lease or, even, a conditional sales contract. When the lessor, on the
other hand, retains ownership the lease is thought of as an operating lease.

Differences exist, between countries, about which party is considered to be the owner of the property for tax purposes, when a financing lease exists. In the United States, Japan, and Germany (and others), for example, the lessee is considered to be the owner. The lessee is entitled to account for the asset on his tax return as though he were the owner. The lease payments are accounted for as payments of debt service with an interest element. Detailed rules exist in most countries to determine the differences between finance and operating leases, and these rules, too, differ across tax frontiers.

But other countries always treat the actual owner of the property as the owner for tax purposes. Some countries, such as the United Kingdom, decide either way depending on whether or not the lease contract has a purchase option.

It should be clear that the differing rules provide the chance for a taxpayer to 'have it both ways' in some cases. Some (foreign) rules do exist to avoid abuse, but planning opportunities abound, and are commonly used. Further, in the same way the United States offers Investment Tax Credits and accelerated depreciation as a capital allowance, so do many foreign countries. The differing rules of tax ownership can result in additional capital allowances which, in turn, reduce the cost to the lessee.
The tax benefits can often be transferred to a third country with a favorable treaty with the U.S., such as Switzerland, which also enjoys favorable treaties with other industrial countries. These and similar tax rules provide myriad specific opportunities for cash flow extraction or cost reduction.

The point to be made by the general example given is that a real knowledge of the tax practices of USMNs and their CFCs is difficult to gain by dealing in the simple concept of net income. We have made the point that it is fund flow that is the more essential thing to understand.

Though it appears to us that tax treaties probably have more to do with the avoidance of double taxation than does the Foreign Tax Credit, an understanding of the basic rules of the FTC is needed.

The FTC may be claimed by any U.S. taxpayer. We are concerned, here, with the foreign taxes paid by a CFC or by a U.S. domiciled corporation, including a branch. The income in respect of which the FTC may be claimed is quite broad. It may be the earnings of a foreign branch, dividends from a foreign corporation, including a CFC, interest or royalty payments, undistributed income arising under Subpart F, or from the actual or deemed distributions of a DISC.

A U.S. corporation has the option of deducting such taxes as an expense instead of taking credit against the tax; but may not do both in any one year. Normally a dollar for dollar credit against the U.S. tax is the most advantageous.
The taxes that may be claimed as a credit are income taxes paid to a foreign government, including withholding taxes on dividends, interest, royalties and other remittances.

A U.S. corporation may also take credit for taxes paid by a corporation in which it owns a 10 percent or more interest, such as a CFC, and in turn, for taxes paid by lower foreign tiers of ownership. Tax credit is available in respect of taxes paid by the third tier of ownership. We have previously presented how remittances and underlying earnings are grossed up to include the underlying tax paid; thus U.S. tax is figured on the entire underlying income.

In calculating the underlying tax of a subsidiary deemed paid by the recipient the following formula is used:

\[
\text{Dividends} \quad \frac{\text{Earnings & Profit}}{} \times \text{Foreign Tax}
\]

Thus, if less than all the annual income after taxes is paid out a FTC is computed that is proportionate, and not equal to the entire tax. The remainder is available in the future. For purposes of the deemed paid credit, earnings and profits are recalculated according to specific U.S. rules, some of which are elective and others that are mandatory, but which may not agree with local tax accounting procedures.

If the dividend paid in any year exceeds the earnings and profits for that year the dividend is treated as paid out of prior year earnings and profits on a last-in, first-out method. For U.S. tax purposes, a dividend paid within 60 days after the
end of the foreign corporation fiscal year is treated as being paid out of the fiscal year just ended prior to the dividend.

The FTC that thus develops is further limited according to the following general formula:

\[
\frac{\text{Foreign Taxable Income}}{\text{Global Taxable Income}} \times \text{U.S. Tax Liability}
\]

Since the formula contains the term 'taxable' income, it is necessary to allocate deductions to foreign source gross according to, again, detailed and complex rules. The essence of regulations, however, require that deductions that are definitely directly related to a particular item of gross income be charged against it. A proportionate share of all remaining deductions must be applied against foreign source income based on the ratio of foreign to global income.

In addition to the general rules, certain specific items have specific regulations on how the allocation is to be made. They are interest expense, research and development expense, income taxes, charitable contributions, legal and accounting costs, net operating losses, and stewardship expenses. There also exist rules relating to losses incurred in selling property used in the business.

A separate FTC limitation is found on a global basis for all foreign source interest income. The formula has several exceptions, the impact of which is to allow only interest arising in and out of the ordinary course of a foreign trade or business, or the banking or finance business to be included in
the FTC limitation rather than to be separately calculated. Foreign interest income is usually taxed at low rates and could be used to soak up excess credits arising from business operations and dividend receipts.

A number of rules preclude a tax subsidy in the form of credits against a foreign tax or indirect tax tradeoffs, such as loans or grants depending on income in a foreign jurisdiction, from being considered a credit against the U.S. tax. Rules also exist to prevent payments for an economic benefit, such as oil royalties, from being recast to the form of a tax on income and thereby become credits against the U.S. tax. These measures are not entirely successful, and it will be noted by readers of annual reports of USMNs that some industries seem to pay little or no U.S. tax rather consistently while at the same time reporting large incomes, according to GAAP. International Banking and resource based companies are familiar examples.
### EXHIBIT II

**PARENTS AND SUBSIDIARIES**

<table>
<thead>
<tr>
<th>Region</th>
<th>Subsidiary Name</th>
</tr>
</thead>
<tbody>
<tr>
<td>New York</td>
<td>Delaware</td>
</tr>
<tr>
<td>Delaware</td>
<td>100 (F)</td>
</tr>
<tr>
<td>Delaware</td>
<td>100</td>
</tr>
<tr>
<td>Delaware</td>
<td>100</td>
</tr>
<tr>
<td>California</td>
<td>50</td>
</tr>
<tr>
<td>Delaware</td>
<td>100</td>
</tr>
<tr>
<td>Australia</td>
<td>100</td>
</tr>
<tr>
<td>Canada</td>
<td>100</td>
</tr>
<tr>
<td>United Kingdom</td>
<td>100</td>
</tr>
<tr>
<td>Delaware</td>
<td>100</td>
</tr>
<tr>
<td>Bermuda</td>
<td>100</td>
</tr>
<tr>
<td>Delaware</td>
<td>100</td>
</tr>
<tr>
<td>Delaware</td>
<td>100</td>
</tr>
<tr>
<td>Austria</td>
<td>100</td>
</tr>
<tr>
<td>Finland</td>
<td>100</td>
</tr>
<tr>
<td>France</td>
<td>100 (B)</td>
</tr>
<tr>
<td>France</td>
<td>100 (B)</td>
</tr>
<tr>
<td>France</td>
<td>100 (B)</td>
</tr>
<tr>
<td>Germany (Federal Republic of)</td>
<td>90 (D)</td>
</tr>
<tr>
<td>Germany (Federal Republic of)</td>
<td>100 (F)</td>
</tr>
<tr>
<td>Germany (Federal Republic of)</td>
<td>100</td>
</tr>
<tr>
<td>Germany (Federal Republic of)</td>
<td>100</td>
</tr>
<tr>
<td>Ireland</td>
<td>100 (H)</td>
</tr>
<tr>
<td>Israel</td>
<td>100 (H)</td>
</tr>
<tr>
<td>Italy</td>
<td>100</td>
</tr>
<tr>
<td>Netherlands</td>
<td>100</td>
</tr>
<tr>
<td>South Africa</td>
<td>100</td>
</tr>
</tbody>
</table>

### International Business Machines, S.A.E.

- Spain 100
- Turkey 100 (A)
- United Kingdom 100
- United Kingdom (Continued)

<table>
<thead>
<tr>
<th>Region</th>
<th>Subsidiary Name</th>
</tr>
</thead>
<tbody>
<tr>
<td>Spain</td>
<td>100</td>
</tr>
<tr>
<td>Sweden</td>
<td>100</td>
</tr>
<tr>
<td>Switzerland</td>
<td>100</td>
</tr>
</tbody>
</table>

### IBM World Trade Americas/Far East Corporation

- Delaware 100

### IBM Europe/Middle East/Africa Corporation

- Bermuda 100
- Delaware 100
- Delaware 100
- France 100 (B)
- France 100 (B)
- France 100 (B)
- Germany (Federal Republic of) 100 (F)
- Germany (Federal Republic of) 100 (H)
- Germany (Federal Republic of) 100 (I)
- Ireland 100 (H)
- Israel 100 (H)
- Italy 100
- Netherlands 100
- South Africa 100

### IBM World Trade Europe/Middle East/Africa Corporation (Continued)

<table>
<thead>
<tr>
<th>Region</th>
<th>Subsidiary Name</th>
</tr>
</thead>
<tbody>
<tr>
<td>France</td>
<td>100 (A)</td>
</tr>
<tr>
<td>Costa Rica</td>
<td>100 (E)</td>
</tr>
<tr>
<td>Ecuador</td>
<td>100</td>
</tr>
<tr>
<td>Guatemala</td>
<td>100</td>
</tr>
<tr>
<td>Honduras</td>
<td>100 (B)</td>
</tr>
<tr>
<td>Hong Kong</td>
<td>100</td>
</tr>
<tr>
<td>Japan</td>
<td>100</td>
</tr>
<tr>
<td>Japan</td>
<td>100</td>
</tr>
<tr>
<td>Korea (South)</td>
<td>100</td>
</tr>
<tr>
<td>Mexico</td>
<td>100</td>
</tr>
<tr>
<td>New Zealand</td>
<td>100</td>
</tr>
<tr>
<td>New Zealand Product Distribution Company Limited</td>
<td>100</td>
</tr>
<tr>
<td>Panama</td>
<td>100</td>
</tr>
<tr>
<td>Peru</td>
<td>100</td>
</tr>
<tr>
<td>Philippines, Incorporated</td>
<td>100 (A)</td>
</tr>
<tr>
<td>Singapore PTE Ltd.</td>
<td>100</td>
</tr>
<tr>
<td>Taiwan Corporation</td>
<td>100</td>
</tr>
<tr>
<td>Thailand Company Limited</td>
<td>100</td>
</tr>
<tr>
<td>Uruguay</td>
<td>100</td>
</tr>
<tr>
<td>Venezuela</td>
<td>100</td>
</tr>
</tbody>
</table>

### IBM World Trade (Continued)

- (A) IBM World Trade Corporation is the nominee shareholder.
- (B) Minor percentage held by other shareholders subject to repurchase option.
- (C) IBM Eurocoordination is owned approximately 14% each by subsidiaries located in France, Germany, Italy and the United Kingdom and approximately 4% each by subsidiaries located in Austria, Belgium, Denmark, Finland, Ireland, Netherlands, Norway, Portugal, Spain, Sweden and Switzerland.
- (D) Remaining percentage owned by IBM World Trade Corporation.
- (E) Remaining percentage owned by IBM World Trade Asia Corporation.
- (F) Not consolidated.