

**THE DUAL PURPOSE OF THE AMERICAN
JOBS CREATION ACT OF 2004**

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I. ENACTMENT OF THE AMERICAN JOBS CREATION ACT OF 2004

A. The Dual Purpose of the American Jobs Creation Act of 2004

This article examines the dual purpose of the American Jobs Creation Act of 2004 and the means by which the dual purpose is fulfilled. Sections 402, 404, 422 and 801 of The American Jobs Creation Act of 2004 (AJCA 2004) create Internal Revenue Code adjustments that stimulate the United States economy and bring the United States tax system in line with international trade obligations. This article examines the United States' response to International economic pressures by facilitating changes in U.S. economic policy through tax reform. The enactment of the American Jobs Creation Act of 2004 is an example of how the United States can create economic change through a modification of international and domestic tax policies. The Act is also an example of how a change in domestic tax policy can create conformity with U.S international trade obligations while simultaneously attempting to stimulate the domestic economy.

Part I of this article is an introduction to the American Jobs Creation Act of 2004. Part II explores international claims that illegal trade subsidies provide an unfair competitive advantage to the U.S. in the international marketplace. Included is a review of International rulings concerning past objections to U.S. tax policies, the attempts by the U.S. to conform its tax practices to remedy international imbalances and the International community's response to the AJCA 2004. Part III examines the removal of illegal trade subsidies through Sections 402 and 404 of the AJCA 2004. Part IV examines the U.S.'s attempt to increase domestic productivity through Sections 801 and

402 of the AJCA 2004. Finally, Part V of this article will conclude by examining the U.S.'s response to the enactment of the AJCA.

B. Introduction to the American Jobs Creation Act of 2004

The American Jobs Creation Act of 2004 (AJCA) balances the need to increase productivity in the United States job market on one hand, and on the other, to fulfill U.S. international trade obligations. Prior to the enactment of the AJCA, The United States' treatment of Foreign Sales Corporations (FSCs) was not in compliance with international trade regulations. Specifically, the U.S violated Articles 1 and 3 of The Agreement on Subsidies and Countervailing Measures (SCM Agreement) and Articles 1, 3, 9, and 10 of the Agreement on Agriculture (AA) because, for tax purposes, FSCs operated as subsidies that were contingent on a corporation's exporting performance. Subsidies that are contingent on export performance are prohibited by the SCM Agreement and AA.

The AJCA 2004 cures the subsidy non-compliance issue and at the same time attempts to stimulates domestic job growth. Specifically, sections 402, 404, 422, and 801 accomplish these tasks as follows. Sections 402, and 404 help increase the foreign tax credits that can be taken by the taxpayer without violating the SCM Agreement and AA thereby substituting illegal export subsidies through recharacterization of loss and reclassification of foreign "tax credit baskets." Section 422 helps to stimulate the U.S. economy by giving taxpayers incentives to reinvest in the United States. Section 801 also stimulates the U.S. economy by eliminating tax incentives of classifying domestic corporations as foreign subsidiaries.

Furthermore, section 402 eliminates double taxation on domestic and foreign income. It allows a taxpayer to recharacterize a portion of overall domestic loss as foreign income, which in turn increases foreign tax credits. Prior to section 404, foreign

source income was classified into nine different categories, which would create nine different tax credit amounts. These different categories or “baskets,” offset each other effectively offsetting the amount of the tax credit. Section 404 reduces the number of baskets from nine to two, which decreases the chance of the categories offsetting the credit amounts and, in turn, increases the amount of allowable foreign tax credits.

Section 422 allows a taxpayer to take an 85% dividend deduction for amounts received during the tax year by the shareholder from a CFC, if that amount is reinvested in the United States. Lastly, Section 801 limits the tax benefits created by inversion transactions, which turn domestic corporations into a subsidiary of a foreign corporation. An inversion transaction allows income produced by the subsidiary to be classified as foreign source income and receive a tax break through foreign tax credits. Section 801 limits this tax benefit in an effort to disincentivize the transformation of a domestic corporation into foreign subsidiary and in theory, brings corporate operations back into the domestic sphere.

II. INTERNATIONAL RESPONSE AND SANCTIONS TO THE UNITED STATES' NONCONFORMITY WITH GLOBAL TAX OBLIGATIONS

A. Illegal Subsidies

A subsidy is a monetary assistance granted by a government to a person or group in support of an enterprise regarded as being in the public interest.¹ Normally, a subsidy is given by a governmental entity to encourage a certain activity or function.

Specifically, in the international trade community, subsidies are regulated to balance the needs of importing and exporting of goods from one country to another. The regulation of subsidies is essential to the global economy because they prevent a country from

¹ American Heritage Dictionary, 4th Ed. (2000), Houghton Mifflin Company.

rewarding its citizens by encouraging exporting and dissuade importing. A country cannot solely depend on imports without the exportation of goods as this would result in an increase of cash flow exiting the country and little cash flow entering the country. For example, if subsidy regulations did not exist, then a country could grant subsidies to its citizens encouraging exportation of goods, which would increase the individual country's economy through income derived from exports while crippling the importing country's economy.

Two significant international Agreements that regulate subsidies are the Agreement on Subsidies and Countervailing Measures² (ASCM) and the Agreement on Agriculture³ (AA). A country that has ratified either of these two Agreements must abide by the subsidy regulations set forth within the documents. The United States has ratified both the ASCM and the AA and is therefore, required to abide by the terms of both Agreements.⁴ Specifically, the ASCM and AA prohibit members of the Agreements from granting subsidies that are dependent or contingent upon export performance. The international community accused the United States of granting prohibited subsidies through its tax treatment of Foreign Sales Corporations. The persistent objections of the international community led to an examination of U.S. foreign tax policy by international dispute settlement bodies.

² Agreement on Subsidies and Countervailing Measures, opened for signature Apr. 15, 1994 (entered into force Jan. 1, 1995), 1869 U.N.T.S. 14, [hereinafter ASCM].

³ Final Act Embodying the Results of the Uruguay Round of Multilateral Trade Negotiations, Office of the U.S. Trade Representative Executive Office of the President, Agreement on Agriculture, December 15, 1993, [hereinafter AA].

⁴ ASCM, *supra* note 2; AA, *supra* note 3.

B. International rulings; U.S.'s non-conformity to International Trade Obligations

1. International Agreements Violated Through the U.S.'s Tax Treatment of FSCs

With its tax treatment of Foreign Sales Corporations the United States violated its trade obligations because the Agreement on Subsidies and Countervailing Measures⁵ and the Agreement on Agriculture⁶ prohibited the tax treatment afforded to FSCs to the extent that it created illegal export trade subsidies. The European Community accused the United States of creating illegal trade subsidies by giving FSCs a tax incentive to increase exports through FSC treatment in sections 921-927 of the IRS Code and the United States Foreign Sales Corporation replacement, the Extraterritorial Income Act of 2000.

The Internal Revenue Code section 7701 defines foreign corporations "as all corporations that are not incorporated in one of the fifty states or the District of Columbia".⁷ The United States generally taxes any income earned by foreign corporations within the territory of the United States. However, the U.S. does not tax income that is earned by foreign corporations outside the United States, even if the corporation earns income domestically. The test as to whether income is earned within the United States, and therefore taxable under the IRS Code, is determined by classifying the income as income "effectively connected with conduct of a trade or business within

⁵ ASCM, *supra* note 2.

⁶ AA, *supra* note 3.

⁷ Internal Revenue Code § 7701a(4) (2004).

the United States”.⁸ Whether the corporation’s income is effectively connected income, and, therefore, foreign source income depends upon a factual inquiry.⁹

Generally, a domestic parent corporation is only subject to taxation on income earned by its foreign subsidiary when such income is transferred to the United States parent corporation in the form of a dividend.¹⁰ The period between the subsidiary earning income and the transfer by dividend to the parent corporation is known as a tax deferral.¹¹

The United States foreign tax rules and deferral provisions are altered by the Foreign Source Corporation measures. FSCs are foreign corporations responsible for certain sales-related activities in connection with the sale or lease of goods produced in the United States for export outside the United States.¹² Foreign trade income of FSCs are “foreign trading receipts” generated in qualifying transactions.¹³ Qualifying transactions involve the sale or lease of “export property” or the performance of services “related” to such sale or lease. Pursuant to United States tax policy, the amount of foreign source income (FSI) from qualifying transactions is exempt from taxation if the foreign corporation is “effectively connected with the conduct of a trade or business within the United States”.¹⁴ Thus, the Internal Revenue Code provides an incentive for subsidiaries of domestic parent corporation to increase foreign source income through

⁸ I.R.C. § 882(a) (2004), [hereinafter IRC 882].

⁹ CCH, *infra* note 39.

¹⁰ *See Infra* note 50.

¹¹ *Id.*

¹² I.R.C. §§ 922, 297(e)(3) (2004).

¹³ I.R.C. § 924 (2004).

¹⁴ I.R.C. 882, *supra* note 8, at (a)(2).

qualifying transactions, which includes export property.¹⁵ The more FSI a taxpayer reports, the larger foreign tax credit available to the domestic taxpayer.¹⁶ If a corporation continues exporting then the income from this exporting is classified as FSI that qualifies as tax credit decreasing the taxpayer's tax liability. The European Union argues that this type of incentive in effect, creates an illegal export subsidy.

The European community's objection to the United States' FSC tax policy is grounded in The Agreement on Subsidies and Countervailing Measures, specifically Article 3.1.¹⁷ Article 3.1 states,

Except as provided in the Agreement on Agriculture, the following subsidies, within the meaning of Article 1, shall be prohibited (a), subsidies contingent, in law or in fact, whether solely or as one of several other conditions upon export performance, (b) subsidies contingent whether solely or as one of several other conditions, upon the use of domestic over imported goods.¹⁸

2. *International Rulings*

On November 18, 1997, The Permanent Delegation of the European Commission sent communications to the Permanent Mission of the United States and to the Dispute Settlement Body¹⁹, objecting to the apparent lack of conformity of Sections 921-927 of the Internal Revenue Code with the obligations the United States of America under the SCM Agreement.²⁰ The European community argued that the FSC exemptions violate

¹⁵ I.R.C. § 901 (b)(1) (2004).

¹⁶ *Id.*

¹⁷ ASCM, *supra* note 2, at article 3.1.

¹⁸ *Id.*

¹⁹ World Trade Organization, Dispute Settlement Body, WT/DS108/1, 28 November 1997, available at <http://docsonline.wto.org>; The United States is subject to the review of the Dispute Settlement Body pursuant to Article 4 of the Understanding on Rules and Procedure Governing the Settlement of Disputes, Article XXIII: 1 GATT 1994, and Article 4 of the Agreement on Subsidies and Countervailing Measures.

²⁰ *Id.*

the agreement by offering an incentive for United States corporations to decrease imports and increase exports by allowing for a tax exemption using tax credits.

On February 24, 2000, the Appellate Body of the Dispute Settlement Body agreed with the European community and held that those incentive based sections of the IRS code were in direct conflict with the Agreement on Subsidies and Countervailing Measures.²¹ In addition, the Dispute Settlement Body held that the United States' treatment of FSCs was a violation of Article 3.3 of the Agreement on Agriculture.²²

Article 3.3 states,

Subject to the provisions of paragraph 2(b) and 4 of Article 9, a member shall not provide export subsidies listed in paragraph 1 of Article 9 in respect of the agriculture products or groups of products specified in Section II of Part IV of its schedule in excess of the budgetary outlay and quantity commitment levels specified therein and shall not provide such subsidies in respect of any agriculture product not specified in that Section of its Schedule.²³

Further, relevant parts of Article 9 states: “The following export subsidies are subject to reduction commitments under this Agreement,

[T]he provisions by governments or their agencies of direct subsidies, including payments-in-kind, to a firm, to an industry, to producers of an agriculture product, to a cooperative or other association of such producers, or to a marketing board, contingent on export performance.²⁴

On October 5, 2000, the United States and the European Community submitted a resolution to the Dispute Settlement Body entitled: “Agreed procedures under Articles 21 and 22 of the Dispute Settlement Understanding and Article 4 of the SCM Agreement

²¹ WTO, Report of the Appellate Body, United States Tax Treatment For “Foreign Sales Corporations, Report of the Appellate Body, WT/DS108/AB/R, February 24, 2000.

²² *Id.*

²³ AA, *supra* note 3, at article 3.

²⁴ *Id.* at art. 9(1)(a).

applicable in the follow-up to the United States Tax Treatment of “Foreign Sales Corporations” WTO dispute”.²⁵ Pursuant to this understanding, the United States Congress agreed to pass legislation to replace the then existing foreign sales corporation provisions of the Internal Revenue Code.²⁶ By November 1, 2000, the U.S. failed to comply with this stipulation.²⁷ As a result, the European community requested authorization from the DSB to take appropriate countermeasures and to suspend concessions pursuant to Article 4.10 of the SCM Agreement and Article 22.2 of the DSU in the amount of \$4.043 million per year.²⁸ The United States requested and was allowed an extension by the DSB to conform to its ruling of February 24, 2000.

On November 15, 2000, the President of the United States signed into law the “FSC Repeal and Extraterritorial Income Exclusion Act of 2000” (ETI)²⁹ to bring the U.S. into compliance with the DSB recommendations and rulings in case WT/DS108.³⁰ In response, the European Community argued that the U.S. had yet to comply with the DSB ruling and was still in violation of the SCM and Agreement on Agriculture. The European Community claimed the ETI merely replicated the violations of the WTO Agreement found in the original dispute.³¹ The ETI’s treatment of FSCs still created a

²⁵ World Trade Organization, Dispute Settlement Body, United States Tax Treatment For “Foreign Sales Corporations, WT/DS108/12, October 5, 2000.

²⁶ *Id.*

²⁷ *Id.*

²⁸ WTO, Dispute Settlement Body, United States Tax Treatment For “Foreign Sales Corporations, WT/DS108/13, November 17, 2000.

²⁹ WTO, Dispute Settlement Body, United States Tax Treatment For “Foreign Sales Corporations, WT/DS108/14, November 21, 2000.

³⁰ *Id.*

³¹ *Id.*

tax incentive for export property which violates the SCM Agreement and AA. The EU repitioned the Dispute Settlement Body to declare that the U.S. tax treatment of FSCs was a prohibited subsidy practice pursuant to Articles 1 and 3 of the SCM and Articles 1, 3 and 9 of the Agreement on Agriculture.³² The DSB agreed with the EU.

The Report of the Appellate Body, 2001, affirmed the DSB’s findings concerning the U.S. Tax treatment of FSCs through the use of the ETI.³³ The Appellate Body further held that “the ETI measures included subsidies “contingent”...upon export performance within the meaning of Article 3.1(a) of the SCM Agreement”.³⁴ The Appellate Body also held that “the ETI measure involves export subsidies inconsistent with the United States’ obligations under Article 3.3, 8, and 10.1 of the Agreement on Agriculture.”³⁵ The Appellate Body agreed with the European Community by stating, “The United States of America has not fully withdrawn the subsidies under Article 3.1(a) of the SCM Agreement, and that the United States has, therefore, failed to fully implement the recommendations and ruling of the DSB”.³⁶ The U.S. was still providing a tax incentive by allowing for a foreign tax credits contingent on exports.

The Appellate Body’s ruling forced the United States to reanalyze its tax treatment of FSCs. The U.S. responded with the American Jobs Creation Act, specifically, Sections 404, 402, 801, and 422.

³² WTO, Dispute Settlement Body, United States Tax Treatment For “Foreign Sales Corporations”, WT/DS108/16, December 8, 2000.

³³ WTO, Dispute Settlement Body, United States Tax Treatment For “Foreign Sales Corporations”, WT/DS108/AB/RX. January 14, 2002.

³⁴ *Id.*

³⁵ *Id.*

³⁶ *Id.*

C. International Response to the AJCA

Initially, the international community was unyielding in its position that the Extraterritorial Income Act was an illegal export subsidy barred by the Agreement on Agriculture (AA) and The Agreement on Subsidies and Countervailing Measures (SCM). The international response to the American Jobs Creation Act has been more than positive. Upon enactment, the European Union Trade Commissioner Pascal Lamy stated, “I am extremely pleased that this Bill now has become law. It is a victory for multilateralism and for the rule of law in foreign affairs and I want to thank leaders of the U.S. Congress...for their efforts in this respect. Obviously, I am very pleased that our efforts have been rewarded after 5 years, right before the end of the mandate of the current European Commission.”³⁷ It is imperative that the international community is satisfied because prior to the AJCA, the WTO authorized the EU to increase customs duties to the level of 100% for a total of \$4 billion on U.S. trade.

The AJCA’s aligns U.S. tax treatment of Foreign Source Corporations with the Agreement on Agriculture and the Agreement on Subsidies and Countervailing Measures. The international community, although still waiting for WTO reports of full compliance with the AA and SCM, is extremely pleased with the U.S. changes to FSI tax treatment. It is an indication that 33 years of resistance to U.S. tax policy has resulted in a victory for international export. The U.S. tax policy no longer violates export subsidies and therefore, in the eyes of the international community, helps increase the export performance of foreign countries. The AJCA favorably eliminates an export advantage by replacing it with federal tax policies in conformity with international obligations.

³⁷ European Union Press Release No. 147/04, Foreign Sales Corporation (FSC): EU Welcomes U.S. Repeal of Illegal Export Subsidies- UU to Lift Sanctions and Ask for Check on WTO Compatibility, October 25, 2004, available at <http://www.eurunion.org/news/press/2004.200200147.htm>.

III. THE UNITED STATES' ATTEMPT TO REMOVE ILLEGAL SUBSIDIES

A. Section 404 of the AJCA 2004

1. Changes Made by Section 404

The AJCA, in theory, increases foreign tax credits without violating international agreements. The change was simple, a taxpayer may conduct the same type of foreign business as it did before the enactment of the AJCA but now, U.S. tax liability is not dependent upon exporting performance but rather upon foreign income classification.

Section 404 of the AJCA 2004 changes foreign income classification by reducing the amount of foreign tax credit baskets from nine to two. Under prior law, to report a foreign tax credit, the taxpayer first classified the yearly income earned in one of nine separate baskets. These nine baskets included: (1) passive income, (2) high withholding services income, (3) financial services income, (4) shipping income, (5) certain dividends received from noncontrolled section 902 foreign corporations, (6) certain dividends from a domestic international sales corporation (DISC), (7) taxable income attributable to certain foreign trade income, (8) certain distributions from a foreign sales corporation, and (9) general basket income, which is other income not described in items (1) through (8).³⁸ The significance of the this system is that the total amount of foreign tax credit available to the taxpayer for the tax year in each basket is limited to its portion of U.S. tax liability allocated to that basket.³⁹ This means that an excess credit for one basket cannot

³⁸ I.R.C. § 904(d) (2004).

³⁹ American Jobs Creation Act, Law, Explanation and Analysis (2004) Congressional Clearing House, INC., (2004), [hereinafter CCH].

be used to offset U.S. tax liability in another.⁴⁰ Each basket is calculated based on its own entries and not as an aggregate of the baskets.

However, the AJCA 2004 reduces the number of baskets from nine to two: passive category income and general category income. The passive category income is defined as passive income and specified category income which includes: (1) dividends from a Domestic International Sales Corporation (DISC) or former DISC; (2) taxable income attributable to foreign trade income under Code Section 923(b); and, (3) distributions from FSC or former FSC, out of earnings and profits attributable to foreign trade income.⁴¹ The general category includes income other than passive category income, which includes financial service income.⁴²

2. *The Effects of Section 404*

This reduction directly impacts the tax calculations for each tax basket. Before the AJCA, the amount of foreign tax credit was calculated by subtracting from the amount of foreign income taxes paid, the amount of foreign income taxes deemed paid under Section 960.⁴³ While Section 960 remains affected by the AJCA 2004, it is a constant when calculating the foreign tax credit. The AJCA changes the characterization of the amount of foreign income taxes paid because the tax credit baskets that classified foreign income were reduced. Hence, the amount of foreign taxes paid in the remaining

⁴⁰ *Id.*

⁴¹ American Jobs Creation Act 2004, R. 4520, 108th Cong. (2004), Text of H.R. 4520 as passed by the House on October 7, 2004 and the Senate on October 11, 2004, Congressional Clearing House, INC., (2004), [hereinafter AJCA 2004].

⁴² CCH, *supra* note 39.

⁴³ I.R.C. § 960 (2004).

two baskets will increase, as more income will be included in fewer baskets. In some transactions the tax treatment is more beneficial.

For example, consider a taxpayer who has the following classifications of income with a 10% foreign tax rate: financial services income of \$100.00; certain dividends from a domestic international sales corporation (DISC) of \$50.00; and passive income of \$200.00. For that same year, the taxpayer has \$10.00 of Section 960 foreign taxes deemed paid. Before the AJCA, all three of the classifications were separate baskets and the foreign tax credit was calculated for each individual basket. Thus, the foreign tax credit available for the financial services income basket would be 0, $(\$100(10\%) - \%10)$. The foreign tax credit available for the dividends from the DISC would result in U.S. tax liability of \$5.00, $(\$50(10\%) - \$10)$. The foreign tax credit available for the passive income basket would equal \$10, $(\$200(10\%) - \$10)$. This results in a foreign tax credit of \$10 in the passive income basket and a \$5 tax liability in the dividends form DISC basket.

Now, consider the same situation using the AJCA's reduction of foreign tax baskets. The general category income consists of the passive income (\$200) and the financial services income (\$100). This results in a \$20 foreign tax credit $([\$200(10\%) + \$100(10\%)] - \$10)$. The passive category income results in U.S. tax liability of \$5 $(\$50(10\%) - \$10) = \$5$. Therefore, instead of a \$5 tax liability for the DISC basket there is a \$5 tax liability in the passive category. The \$5 tax liability is still present however, there is a \$20 credit in the general category instead of only a \$10 credit in the passive category. Section 404 results in an increase in the total available credit equal to \$10.

Hence, the \$25 of foreign taxes paid generates a \$20 tax credit versus the \$10 tax credit available before the enactment of Section 404.

B. Section 402 of the AJCA 2004

1. The Purpose of Section 402

Section 402 was enacted because the changes made under Section 404 may result in a taxpayer being unable to receive a foreign tax credit due to an overall domestic loss. Section 402 allows a taxpayer to benefit from the changes made in Section 404, even if the taxpayer generates an overall domestic loss that results in the taxpayer missing out on otherwise accepted foreign tax credit.

The IRC taxes worldwide income of domestic corporations. Congress first enacted the foreign tax credit to prevent double taxation, as foreign investors would be required to pay taxes to foreign countries as well as the U.S for foreign investments. The foreign tax credit allows U.S. taxpayers to reduce their U.S. tax liability on foreign-source income by the amount of foreign taxes paid on the income.⁴⁴ Foreign tax credits are subject to limitations. These limitations are found in IRC Section 904. Section 904 states: “[T]he total amount of the credit taken under section 901(a)⁴⁵ shall not exceed the same proportion of the tax against which such credit is taken which the taxpayer's taxable income from sources without the United States (but not in excess of the taxpayer's entire taxable income) bears to his entire taxable income for the same taxable year.⁴⁶ This

⁴⁴ CCH *supra* note 39, at ¶ 420.

⁴⁵ I.R.C. § 901 (2004); “If the taxpayer chooses to have the benefits of this subpart, the tax imposed by this chapter shall, subject to the limitation of section 904, be credited with the amounts provided in the applicable paragraph of subsection (b) plus, in the case of a corporation, the taxes deemed to have been paid under sections 902 and 960. Such choice for any taxable year may be made or changed at any time before the expiration of the period prescribed for making a claim for credit or refund of the tax imposed by this chapter for such taxable year. The credit shall not be allowed against any tax treated as a tax not imposed by this chapter under section 26(b).” Section 901(a) IRC. The

overall limitation is created so that the foreign tax credit of a taxpayer cannot exceed the amount of U.S. tax imposed on foreign-source income.⁴⁷ As discussed above, Section 904 requires that a taxpayer compute its foreign tax credit limitation separately for nine various categories, which are known as “baskets”.⁴⁸

Under section 402, “a portion of the taxpayer’s domestic-source income for each succeeding tax year is recharacterized as foreign-source income in an amount equal to the lesser of: (1) the amount of the unrecharacterized overall domestic losses for years prior to such succeeding year, or (2) 50 percent of the taxpayer’s U.S.-source income for such succeeding tax year”. Section 402 pertains to losses incurred in tax years beginning after December 31, 2006. Any and all domestic source income that is recharacterized as foreign source income is allocated among and increases the separate income categories in proportion to the domestic source loss previously allocated to those income categories.⁴⁹ Put another way, any domestic source income that is recharacterized as foreign source income is allocated to one of the two foreign source income baskets described above in Section 404.

In the example described in the above section, the taxpayer in year 1 generates \$350 of foreign source income resulting in a \$5 tax liability in the passive category and a \$20 credit in the general category. Assume that in year 1 the taxpayer generates a \$100 domestic source income loss along with the \$350 foreign source income. Since the

⁴⁶ Section 904 IRC.

⁴⁷ CCH *supra* note 39, at ¶ 420.

⁴⁸ *Id.*

⁴⁹ RIA Checkpoint, ¶ 0-4720-1, Recharacterization of overall domestic loss of foreign tax credit purposes: tax years starting after December 31, 2006, available at <http://checkpoint.riag.com/servlet/com> [hereinafter Recharacterization].

taxpayer has no taxable income in year 1, no foreign tax credit can be claimed in year 1 for the \$25 of foreign taxes paid. If the taxpayer then earns \$100 of U.S. source income and \$100 of foreign source income in year 2, the \$100 of domestic source income is recharacterized as foreign source income to reflect the fact that the previous year's \$100 domestic source loss reduced taxpayer's ability to claim the \$20 foreign tax credit.

Essentially, section 402 of the AJCA assures that the foreign tax credit is available to the taxpayer. Section 404 increases foreign tax credits through a mechanism that is not in conflict with international obligations such as the SCM Agreement and the AA.

IV. THE UNITED STATES' ATTEMPT TO INCREASE DOMESTIC INVESTMENT

A. Section 801 of the AJCA

1. Inversion Transactions

The United States tax treatment of a multinational corporate group depends significantly on whether the parent corporation of the group is domestic or foreign.⁵⁰ If a corporation is incorporated under the laws of the United States or of any State, the corporation is treated as a domestic corporation.⁵¹ All other corporations are treated as foreign.⁵² If a domestic parent corporation earns income through a foreign subsidiary the income is subject to U.S. tax when the income is distributed as a dividend to the domestic

⁵⁰ COMREP ¶ 78,741.099, Tax treatment of expatriated entities and their foreign parents, American Jobs Creation Act of 2004, 108-357, 10/22/2004, [hereinafter Commission Report]; I.R.C. § 7874(a)(1) (2004), as added by the American Jobs Creation Act 2004.

⁵¹ *Id.*

⁵² *Id.*

corporation.⁵³ The time period between the earning of the income by the foreign subsidiary to the time of dividend distribution to the domestic parent is referred to as the deferral period, because no tax liability arises during this period.

When the subsidiary distributes the dividend to the parent corporation the income is classified as foreign source income, as described in the sections above, and is also subject to an 85% dividend deduction, which will be discussed later in this article.⁵⁴ After the income is distributed to the parent corporation it is then classified into one of the two foreign source income baskets. The available foreign tax credit is then calculated pursuant to AJCA Section 404.

One type of inversion transaction, and the most common, is a corporate stock inversion transaction. For example, a U.S. corporation forms a foreign corporation. Thereafter, the foreign corporation forms a domestic merger subsidiary.⁵⁵ The domestic merger subsidiary then merges with the U.S. corporation, leaving the domestic a subsidiary of the new foreign corporation in existence.⁵⁶ To avoid U.S. tax, the old U.S. corporation may then transfer some or all of its assets to the newly formed foreign parent corporation.⁵⁷

Inversion transactions are taxable events, subject to immediate U.S. tax liability. For example, the U.S. stockholders in stock inversion transactions generally recognize a

⁵³ *Id.*

⁵⁴ The 85% dividend deduction was created by the enactment of AJCA Section 422.

⁵⁵ Commission Report, *supra* at note 50.

⁵⁶ *Id.*

⁵⁷ *Id.*

gain under section 367(a) of the IRS Code.⁵⁸ The gain is based on the difference between the fair market value of the foreign corporation and the adjusted basis⁵⁹ of the domestic corporation stock exchange.⁶⁰ However, the income is foreign source income as the transaction represents the acquisition of stock of a foreign corporation. Therefore, any recognizable gain can be reduced or eliminated through the use of foreign tax credits. The use of inversion transaction avoids U.S. tax liability and, through foreign tax credits, any U.S. tax liability for the recognized gain on the transaction is reduced or eliminated.

Inversion transactions are symptomatic of larger issues characterizing the U.S.'s current uncompetitive system for taxing American-based global business and are also indicative of the unfair advantage that our tax laws provide for foreign ownership.⁶¹ The policy of the AJCA is to prevent domestic corporations from gaining tax incentives through inversion transactions where the change in corporate structure bolsters offshore investments, hurting domestic productivity. By eliminating the incentives associated with inversion transactions, the policy is aimed at curtailing offshore investments and increasing domestic investment.

2. *Effects of Section 801 on Inversion Transactions*

Section 801 limits tax benefits created by inversion transactions, which converts a domestic corporation into a subsidiary of a foreign corporation. This transaction allows

⁵⁸ I.R.C. § 367(a) (2004); Transfers of property from the United States; General rule. If, in connection with any exchange described in section 332, 351, 354, 356, or 361, a United States person transfers property to a foreign corporation, such foreign corporation shall not, for purposes of determining the extent to which gain shall be recognized on such transfer, be considered to be a corporation.

⁵⁹ Adjusted basis is defined by I.R.C. §§ 1011 and 1012 (2004).

⁶⁰ Commission Report, *supra* at note 50.

⁶¹ Commission Report, *supra* at note 50.

income produced by the subsidiary to be classified as foreign source income and receive a tax break through foreign tax credit without losing its status as a domestic company. Section 801 limits this tax benefit, decreasing the tax incentives associated with the transformation of a domestic corporation into foreign subsidiary and in theory, brings corporations back to the United States.

Under Section 801, in an inversion transaction in which the former shareholders of the U.S. corporation hold 80% or more of the stock of the foreign incorporated entity after the transaction, the foreign corporation is treated as a domestic corporation for U.S. tax purposes.⁶² In addition, section 801 provides that in corporate inversion transactions in which the former shareholders of the U.S. corporation hold at least 60% but less than 80% of the stock of the foreign incorporated entity after the transaction, the benefits of inversions are limited by barring corporate level “toll charges” from being offset by tax attributes.⁶³

Section 801 reduces offshore investment therefore; it is logical to conclude that Section 801 is inconsistent when viewed in conjunction with Sections 402 and 404. Sections 402 and 404 of the AJCA act as changes to the IRS Code, which generate an incentive for offshore investments. Section 801 does the opposite. Section 801 discontinues a tax policy that was granting incentives to taxpayers who invest in foreign corporations rather than domestic corporations. When analyzing Section 801 in conjunction with Sections 402 and 404, the dual purpose of the AJCA is evident. Section 801 disincentivises offshore investments while Sections 402 and 404 incentivise offshore investments. This inconsistency results in a dual purpose of the AJCA that remains a

⁶² Commission Report, *supra* at note 50.

⁶³ *Id.* at I.R.C. § 7874(a)(1), as added by the American Jobs Creation Act 2004.

cohesive tax policy. The dual purpose is to: (1) appease the international community by disallowing an increase in foreign tax credits through illegal subsidies; and, (2) to increase domestic productivity. Sections 402 and 404 advance the first purpose while Section 801 advances the second. However, Section 801 alone is not enough to help increase domestic productivity.⁶⁴ Section 422 also helps effectuate the AJCA's purpose of bolstering the U.S. economy.

B. Section 422 of the AJCA 2004

One purposes of the AJCA is to encourage corporations to reinvest foreign earnings in the United States. Section 422 of the American Jobs Creation Act encourages corporations to reinvest foreign earnings in the U.S. by temporarily providing that certain dividends received by a U.S. corporation from a CFC are eligible for an 85% dividend-received deduction provided the dividend is reinvested in the United States.⁶⁵ The taxpayer may elect to receive the deduction either during the taxpayer's last tax year beginning before October 22, 2004 or during the taxpayer's first tax year that begins during the one-year period beginning on October 22, 2004.⁶⁶

⁶⁴ AJCA Section 401 also aids domestic investment. It allows an affiliated group of corporations to make a one-time election to determine foreign source taxable income of the group by allocating and apportioning interest expense of the domestic members of a worldwide affiliated group on a worldwide group basis. The amount of foreign tax credits available is "capped". The calculation that is used to effectuate this cap is as follows: $\text{Maximum Credit} = (\text{Taxable Income from Foreign Sources} / \text{Worldwide Taxable Income}) \times \text{U.S. Income Tax on Worldwide Income}$. When foreign source income increases then the numerator of the equation increases and so does the maximum credit available. The tax planning technique to increase the maximum credit is to increase the taxpayer's foreign source income. In addition, the taxpayer will attempt to source deductions as domestic rather than foreign. Section 401 allows a taxpayer to increase the number in the numerator by allocating interest expenses on a worldwide basis which alleviates the need to source deductions as domestic rather than foreign. This, in theory, will aid the domestic economy because the need for domestic deductions is no longer necessary.

⁶⁵ RIA Checkpoint ¶ 1006, Estimating the State Tax Cost of Receiving Foreign Dividends from Subsidiaries and Developing Plans to Minimize Those Costs, available at <http://checkpoint.riag.com/servlet/com> [hereinafter State Tax Cost].

⁶⁶ *Id.*

Section 404 of the AJCA creates IRC Section 965 that allows for the 85% deduction. The 85% deduction stimulates foreign corporations to make additional dividend distributions to domestic subsidiaries.⁶⁷ In theory, this will bring offshore investments back to the United States and, therefore, help fulfill the AJCA's economic policy goals. However, not all states have incorporated Section 965 of the IRS Code as part of State and local taxation.

The effectiveness of Section 965 depends, in part, on the state adopting parallel state tax incentives. States have either: (1) adopted IRS Section 965⁶⁸, (2) not adopted IRC Section 965 but allow a deduction of between 70% to 100% of the dividends received⁶⁹; or, (3) do not allow for any foreign dividend deduction or allow for a much more limited deduction.⁷⁰ States that have adopted a parallel tax scheme to Section 965 do so because they start calculating taxable income with federal taxable income and do not require an addback of the dividend deduction.⁷¹ These states do not impede the purpose of the AJCA. In theory, Section 965 encourages domestic corporations to bring offshore investments back to the United States. States that allow a deduction between 70% to 100% of the dividends received also aid the purpose of the AJCA. However,

⁶⁷ *Id.*

⁶⁸ States that have adopted parallel tax provisions to I.R.C. § 965: Alabama, Alaska, Colorado, Delaware, Florida, Georgia, Iowa, Illinois, Indiana, Kansas, Maryland, Montana, North Carolina, Nebraska, New Mexico, Oklahoma, Oregon, Rhode Island, South Carolina, Texas, Virginia, Vermont and West Virginia.

⁶⁹ States that have adopted a dividend reduction that is between 70% to 100% of I.R.C. § 965: Arizona, California, Connecticut, Hawaii, Massachusetts, Michigan, Minnesota, Ohio and Pennsylvania.

⁷⁰ State Tax Cost, *supra* note 65. Selected states that have not allow for a deduction or allow for a much more limited deduction: Arkansas, District of Columbia, Idaho, Maine, Mississippi, New Hampshire, New Jersey, New York, North Dakota, Tennessee, Utah and Wisconsin.

⁷¹ State Tax Cost, *supra* note 65.

these states only assist the AJCA's purpose to a certain degree, as Section 965 is limited, in some jurisdictions, to only 70% deduction of foreign dividends received.

The states that allow for a much more limited deduction or no deduction at all certainly do not help carry out the AJCA's purpose. In the state of New York, a 100% deduction received from dividends of a foreign subsidiary are allowed only if the taxpayer directly holds more than 50% of the stock of the subsidiary corporation. In this instance, the purpose of IRS Section 965 is significantly restricted. The taxpayer in New York will not be affected by the incentive to reinvest foreign dividends in the United States unless the taxpayer holds more than 50% of the stock of the foreign subsidiary. While on its face, Section 965 fulfills the purpose of the AJCA, its effectiveness ultimately depends upon parallel state provisions.

V. CONCLUSION

Domestic support for the AJCA 2004 has been mixed. Organizations such as Americans for Tax Reform (ATR)⁷² have repeatedly supported the enactment of the AJCA. ATR representative Grover Norquist endorsed the AJCA as a proper remedy to bring the U.S. into compliance with WTO rulings while reforming international tax law.⁷³ The ATR believes the American Jobs Act will cut the corporate tax rate, allow for repatriation, and put America in compliance with the WTO rulings to prevent a worldwide trade war.⁷⁴ As well as the ATR, the bill received outstanding Congressional

⁷² ATR was founded in 1985 by Grover Norquist at the request of President Ronald Reagan. ATR fights to continue to bring tax relief to Americans and work to stop unjust taxation, such as Streamlined Sales Tax Proposals and Internet Taxation. They are a nonprofit lobbying organization who believes in a simplification of the tax system.

⁷³ Americans for Tax Reform, Letter to U.S. Senate Representatives, June 15, 2004, available at www.art.org.

support as it was accepted by a vote of 69 to 17.⁷⁵ The Republic Senator from Idaho, Larry Craig, proclaimed the bill as, “yet another accomplishment by this President and this Congress to save, restore, and create jobs for American workers, the bill will help U.S. employers and workers compete in tough international markets”.⁷⁶ Many supporters view the law as a jump-start to the U.S. economy and a collection of incentives that will persuade corporations to invest in the United States.

Critics of the law, such as Senator Edward M. Kennedy, have ridiculed the AJCA as being “a missed opportunity to ensure that good-paying jobs stay in this country”.⁷⁷ Senator Kennedy, along with 17 other members of Congress, believes “Congress should act at the next opportunity to close down the tax provisions in this law that actually provide for incentives for corporations to move facilities overseas”.⁷⁸

International tax reform, such as the enactment of the AJCA 2004, is a necessity. The United States cannot afford to ignore WTO rulings and international pressure. Without international tax reform the U.S. risked billions of dollars in WTO sanctions. The U.S. used international tax reform as a tool to align itself with international obligations. Sections 404 and 402 of the AJCA were implemented to help the U.S. conform to international trade obligations. However, the appeasement of the

⁷⁴ *Id.*

⁷⁵ Conference Report, Senate Roll Call No. 211, 108th Congress, 2nd Session, 10/11/04, available at www.congress.org.

⁷⁶ *Id.*

⁷⁷ Congressional Record Article 6, Senator Edward M. Kennedy, The 108th Congress and Missed Opportunities to Support Working Families, November 20, 2004, available at www.congress.org.

⁷⁸ *Id.*; Other members of Congress who have voted against the AJCA 2004 include: Barbara Boxer (D-CA), Dianne Feinstein (D-CA), Christopher Doss (D-CT), Joseph Biden (D-DE), Thomas Carper (D-DE), Daniel Akaka (D-HI), Richard Durbin (D-IL), Paul Sarbanes (D-MD), Susan Collins (R-ME), Carl Levin (D-MI), Judd Gregg (R-NH), Jon Corzine (D-NJ), Mike DeWine (R-OH), Jack Reed (D-RI), Robert Byrd (D-WV), John Rockefeller (D-WV).

international community through international tax reform may result in a decline of the domestic economy. Understanding that tax reform may lead to a drop in the domestic economy, the United States implemented Sections 801 and 422 of the AJCA to lure offshore investment back into the U.S.

The AJCA is a response to international trade violations, as well as a recognition of the possible negative effect that U.S. violations of international trade obligations may have on the domestic economy. To ensure that the U.S. economy would not decline and that international obligations would be met, the AJCA needs to balance both competing interests. Sections 404 and 402 are prime examples of how the AJCA helps accomplish the need to meet international obligations. Sections 801 and 422 are prime examples of how the AJCA helps accomplish the need to stimulate the U.S. economy. When viewed in conjunction, Sections 404, 402, 801, and 422 illustrates how the AJCA helps accomplish the dual purpose of the Act.