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Toward a Negative Definition of Tax Incentives

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Viewpoints

Toward a Negative Definition of Tax Incentives

by Martin B. Tittle

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When Tax Analysts' round-table discussion on tax incentives opened on April 7, 2006, Ken Kies, the first speaker, began by asking for a show of hands from those who would like to see all tax incentives removed from the tax code, and those who would oppose such a move. There was an immediate objection that he needed to define what a tax incentive is, but he waved off that protest, saying that, for his purpose (which was just to demonstrate that there was support for both positions), it wasn't important.

As a disclaimer, I admit that I raised my hand as one of those who would not want all tax incentives removed because I can't think of a worse move than for the United States to rescind the tax holiday for portfolio interest earned by nonresident aliens and foreign corporations.[1] The United States would be better off if that particular giveaway had not been adopted in 1984 because it started a race to the bottom for source-country taxation of inbound portfolio investments around the world. Rescinding it now, however, would be unthinkable and, practically speaking, irresponsible.

To get back to my point, the round table began without defining what a tax incentive is. Many of the provisions that were discussed were clearly incentives — for instance, the deductions for home mortgage interest and charitable giving. However, when one participant said that two of the worst incentives were the remnants of the extraterritorial income exclusion (ETI)[2] and the title passage rule,[3] my ears perked up. Although I can agree that ETI was/is a tax incentive, I'm not so sure that the title passage rule is, and if it isn't, the reasons it isn't may be the beginning of a negative definition of tax incentives — that is, a definition of what they are not.

The title passage rule is a sourcing rule that determines whether the income from an international sale of inventory property is foreign or domestic.[4]

[1]*See* IRC sections 871(h), 881(c).

[2]*See* American Jobs Creation Act of 2004, P.L. 108-357, sections 101(a), (d), (f) (repealing IRC section 114 but allowing a two-year transition period for 2005-2006 and grandfathering binding contracts "in effect on September 17, 2003, and at all times thereafter").

[3]*See* Treas. reg. section 1.861-7(c).

[4]The title passage rule may also be used to determine the source of sales activity when inventory property is produced

(Footnote continued on next page.)

That's important because if the income is foreign-source, it can increase a taxpayer's ability to take credit for foreign taxes against its U.S. tax liability.[5]

At the risk of oversimplifying, the title passage rule usually allows taxpayers to choose, for each transaction, the place where title to goods passes from seller to buyer.[6] That elective flexibility has been criticized as allowing taxpayers to "manipulate" the amount of their foreign-source income,[7] but the title passage rule was nevertheless left untouched in the Tax Reform Act of 1986 because of concern that its repeal "would create difficulties for U.S. businesses competing in international commerce."[8]

> ***The presence of an antiabuse rule may be an indicator that a particular provision is not a tax incentive.***

Now, one reason the title passage rule might not be considered a tax incentive is that it's paired with a fairly strong antiabuse rule, and has been since 1947.[9] That rule says that if "the primary purpose" for the taxpayer's title passage decision was avoidance of tax, that decision can be set aside, and the government can substitute the place of the "substance of the sale," as determined by all the factors of the transaction.[10] Tax incentives usually imply or say outright, "We, the government, want you to do X, and if you do, here's the tax benefit you'll get." I can't think of a tax incentive that says, "We want you to do X, and if you do, there's a tax benefit, but if you do it for the primary purpose of the tax benefit, all bets are off, and we get to reconstruct the transaction to your detriment." The presence of an antiabuse rule like this one may be an indicator that a particular provision is not a tax incentive.

Another reason the title passage rule might not be a tax incentive is that its adoption was not a choice made by the government. It was, as one of the round-table participants pointed out in 1949 when he was a new associate at Covington Burling, a capitulation to the decisions of the courts.[11]

The Revenue Act of 1921 set the stage for the title passage rule by saying that taxability was determined by the place where goods were sold.[12] The regulations interpreting the act explained that "[t]he word 'sold' . . . ordinarily means the place where marketed."[13] Both the courts and the Bureau of Internal Revenue interpreted the act and its circular explanation in the regulations to mean "the place where ownership passe[s] to the buyer."[14]

Then, in 1930, the bureau, relying on the Supreme Court decision in *Compania General*,[15] decided to change the rule in GCM 8,594 and base taxability on the place where the contract of sale was completed.[16] The courts, however, continued to apply the old rule,[17] and finally, 17 years later, the bureau capitulated, rescinded the GCM, and returned to the title passage rule in a statement

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in whole or in part in the United States and sold outside the United States, or vice versa. *See* Treas. reg. sections 1.863-3(a)(1), (b)(1)(i), (c)(2).

[5]*See generally* IRC section 904.

[6]*See supra* note 3.

[7]*See, e.g.*, H.R. Rep. No. 426, 99th Cong., 2d Sess. 360 (1985).

[8]*See* Staff of Joint Committee on Tax'n, 100th Cong., 1st Sess., "General Explanation of the Tax Reform Act of 1986," 918 (1987).

[9]*See* Treas. reg. section 1.861-7(c); *cf.* GCM 25,131, 1947-2 C.B. 85 (1947). GCM 25,131 was declared obsolete by Rev. Rul. 69-45, 1961-1 C.B. 313.

[10]*See supra* note 3.

[11]*See* Donald C. Alexander, "Where Is a Sale Made?" 27 *Taxes* 133 (1949).

[12]*See* Revenue Act of 1921, ch. 136, section 217(e), 42 Stat. 227, 244 (stating, regarding nonresident alien individuals, that "[g]ains, profits and income" from the sale of personal property "shall be treated as derived entirely from the country in which sold"), section 233, 42 Stat. 227, 254 (stating, regarding corporations, that "the term 'gross income' means the gross income as defined in sections 213 and 217," and that "[i]n the case of a foreign corporation, gross income means income from sources within the United States, determined . . . in the manner provided in section 217"). Earlier tax statutes had referred to the "source" of income, defined as "the place of origin of the income," but they had not specifically linked source and sales. *See, e.g.,* Revenue Act of 1916, ch. 463, section 10, 39 Stat. 756, 765; Revenue Act of 1917, ch. 63, section 1206(1), 40 Stat. 300, 333-34; Treas. reg. 33, art. 66 (1918) (defining the term "source").

[13]*See* Regulations 62, art. 323 (1922).

[14]*See* Alexander, *supra* note 11, at 133.

[15]*Compania General de Tabacos de Filipinas v. Collector of Internal Revenue*, 279 U.S. 306 (1929).

[16]*See* GCM 8,594, 9-2 C.B. 354 (1930).

[17]*See, e.g.*, *East Coast Oil Co., S.A. v. Comm'r*, 31 B.T.A. 558 (1934), *aff'd*, 85 F.2d 322 (5th Cir. 1936), *cert. den.*, 299 U.S. 608 (1936), *nonacq.* 14-1 C.B. 27 (1935), *nonacq. withdrawn and acq.*, 1947-2 C.B. 2; *Hazleton Corp. v. Comm'r,* 36 B.T.A. 908 (1937), *nonacq.*, 1938-1 C.B. 50; *Ronrico Corp. v. Comm'r*, 44 B.T.A. 1130 (1941), *nonacq.,* 1941-2 C.B. 22, *nonacq. withdrawn and acq.*, 1944-1 C.B. 24; *The Exolon Co. v. Comm'r*, 45 B.T.A. 844 (1941), *limited acq.*, 1942-1 C.B. 6, *partial nonacq., id.* at 22, *limited acq. and partial nonacq. withdrawn and acq.*, 1947-2 C.B. 2.

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almost identical to the formulation of that rule today.[18,19]

Is there any way that an interpretation imposed by U.S. courts could be considered a tax incentive? It doesn't seem likely. Near the end of the round table, Jim Halpern reminded the participants that Boris Bittker had questioned whether it was possible to identify tax expenditures[20] in the absence of agreement on what constitutes a "pure tax" model.[21] But even in an expansive view of tax incentives, can a capitulation to a view espoused over and over by the courts be considered a tax incentive? If so, then perhaps we should say that any rule that is not always consonant with economic reality is an incentive. I don't object to that definition as long as we all agree that is what we mean when we try to talk about tax incentives.

If we were to adopt that definition, however, it wouldn't necessarily mean the title passage rule was a tax incentive. Fifteen years ago Linda Galler argued persuasively that, to the extent risk of loss passes with title (as it usually does), the title passage rule is completely consonant with economic reality. Here's her case in a nutshell:

> The title passage rule had its genesis in the law of commercial sales. Judicial opinions that initially adapted the title passage rule from commercial law regarded risk of loss as the major ingredient of the title concept. The title passage rule thus evolved as a risk of loss passage rule. If the term "title" is understood as connoting risk of loss rather than mere legal title, then the title passage rule does reflect economic substance, and any tax advantages resulting from application of the rule may be justified by the economic risks assumed by the taxpayer. (Footnotes omitted.)[22]

Of course, risk of loss need not necessarily accompany title passage.[23] However, when it does not, the government has an extensive array of case-law ammunition to use if it wishes to disregard the nominal title transfer and recharacterize the transaction based on the time when and location where risk of loss was finally transferred to the buyer.[24]

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[18]*See* GCM 25,131, *supra* note 9:

> [F]or the purpose of determining the source of income attributable to the sale of personal property, a sale is consummated at the place where the seller surrenders all his right, title, and interest to the buyer. In cases in which the bare legal title is retained by the seller, the sale will be deemed to have occurred at the time and place of the passage to the buyer of the beneficial ownership and the risk of loss. However, in any case in which the sales transaction is arranged in a particular manner for the primary purpose of tax avoidance, the foregoing rules will not be applied. In such cases, all factors of the transaction, such as negotiations, the execution of the agreement, the location of the property, and the place of payment, will be considered, and the sale will be treated as having been consummated at the place where the substance of the sale occurred.

Cf. Treas. reg. section 1.861-7(c):

> For the purposes of part I (section 861 and following), subchapter N, chapter 1 of the Code, and the regulations thereunder, a sale of personal property is consummated at the time when, and the place where, the rights, title, and interest of the seller in the property are transferred to the buyer. Where bare legal title is retained by the seller, the sale shall be deemed to have occurred at the time and place of passage to the buyer of beneficial ownership and the risk of loss. However, in any case in which the sales transaction is arranged in a particular manner for the primary purpose of tax avoidance, the foregoing rules will not be applied. In such cases, all factors of the transaction, such as negotiations, the execution of the agreement, the location of the property, and the place of payment, will be considered, and the sale will be treated as having been consummated at the place where the substance of the sale occurred.

[19]There were other flip-flops by the government in the years between 1947 and today, but in the end, the title passage rule was retained. *See* Linda Galler, "An Historical and Policy Analysis of the Title Passage Rule in International Sales of Personal Property," 52 *U. Pitt. L. Rev*. 521, 545-554 (1991).

[20]Tax expenditures are sometimes equated with tax incentives, but "it ain't necessarily so." *See* Martin Sullivan, "Tax Incentives and Economists," *Tax Notes Int'l*, Apr. 10, 2006, p. 96 (dividing tax expenditures into three categories — pure incentives, quasi-incentives, and pure subsidies — with examples of each).

[21]*See, e.g.,* Boris I. Bittker, "Accounting for Federal 'Tax Subsidies' in the National Budget," 22 *Nat'l Tax J.* 244, 247-48, 258 (1969). ("[T]he lack of an agreed conceptual model makes it impossible to say whether a large number of structural features of the existing federal income tax laws are, or are not, 'tax expenditures.' ")

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[22]*See* Galler, *supra* note 19, at 524.

[23]*See, e.g.*, TAM 200539026 (Sept. 30, 2005) (deciding that passage of title outside the U.S. combined with retention of risk of loss by the seller was sufficiently similar to a CIF ("cost, insurance, and freight") sale to generate foreign-source income). It's hard to tell whether that conclusion was correct because the shipping term "CIF" has had different meanings in different countries, both today and throughout the 20th century when the cases on which the IRS relied were decided.

[24]*See Abraham B. Johnson v. Comm'r*, 7 B.T.A. 820, 824 (1927) (stating that "when delivery has not been effected, title has not been transferred and *the benefits and burdens of ownership remain with the vendor,* we fail to see how there can be any question that a sale has not yet been completed" (emphasis added)); *East Coast Oil Co., S.A. v. Comm'r*, 31 B.T.A. 558, 561 (1934), *aff'd,* 85 F.2d 322 (5th Cir. 1936), *cert. den.*, 299 U.S. 608 (1936) (stating that "[u]nder [CIF] contracts, the seller has performed his part when he has loaded the goods on the carrier, secured the insurance, and forwarded to the purchaser the proper shipping documents. *At*

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To sum up, I find it hard to accept the title passage rule as a tax incentive for three reasons. First, as Galler said, it began as a reflection of the allocation of rights and risk already present in the commercial law of sales.[25] To the extent that title passage is now less important in commercial law than transfer of risk of loss,[26] the title passage rule may be anachronistic, but that alone doesn't make it a tax incentive. Second, it's an interpretation of the "place where goods are sold"[27] that was imposed by the courts. Third, it's accompanied by an antiabuse rule that allows it to be set aside when a transaction is structured for the primary purpose of gaining a tax benefit. I don't know whether those are factors that will be helpful in thinking about tax incentives in general, or whether they'll end up being specific only to the title passage rule. I do know that the further we travel away from the mortgage-interest and charitable-giving center of the tax incentives world, the more we need some structure for defining tax incentives. Thinking about what they are not may be a starting point. ◆

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that time, and at the place of shipment, title passes to the purchaser; thereafter the goods, and the risks, are his." (Emphasis added.)); *Elston Co., Ltd. v. Comm'r*, 42 B.T.A. 208, 215 (1940) (noting that "after delivery of the bonds to the [Canadian] dealers they understood that the risk of loss was to fall on them and not on petitioners"); *Ronrico Corp. v. Comm'r*, 44 B.T.A. 1130, 1134-35 (1941) (finding, and quoting *East Coast Oil* to establish, that in CIF sales, "title to the goods and the risk involved pass to the buyer at the point of shipment," and citing six authorities for the principle that reservation of title for security purposes by a CIF seller "does not prevent the passage of beneficial ownership and risk in the goods to the buyer at the point of shipment"); *Amtorg Trading Corp. v. Higgins*, 150 F.2d 536, 539-40 (2d Cir. 1945) ("Under the Sales Act and mercantile usage, a presumption arises that when goods are contracted for F.O.B., the property passes to the buyer at the time they are delivered on board the carrier. And what we consider the better authority indicates that the fact that the seller takes the bill of lading to his own order does not indicate a contrary intention, since [quoting the Uniform Sales Act] 'the seller's retention of ownership is merely for the purpose of security, and the beneficial interest as well as the risk of loss is on the buyer.' "); *Barber-Greene Americas, Inc. v. Comm'r*, 35 T.C. 365, 387 (1960) ("The real issue is whether the petitioners' retention of title was a sham. In retaining ownership they undertook real responsibilities, *risks*, and obligations, quite at variance with those involved in the case of sales where title would pass in the United States." (Emphasis added.)); *Pan American Eutectic Welding Alloys Co., Inc. v. Comm'r,* 36 T.C. 284, 284 (1961) ("The agreement between the petitioner and the distributor provided that the petitioner should retain title and risk of loss until the goods reached the foreign port of delivery. . . . Here, as was true in *Barber-Greene Americas, Inc.*, *supra*, the petitioner undertook real responsibilities, risks, and obligations in retaining title until delivery of the goods to the foreign port and its retention of title was real."); *Comm'r v. Hammond Organ Western Export Corp.*, 327 F.2d 964, 966 (7th Cir. 1964) ("It is well established by many court decisions that the place of sale is where the title and risk of loss passed from the seller to the buyer."); *Babson Bros. Export Co. v. Comm'r*, T.C. Memo. 1963-144 (1963) ("[Plaintiff] intended to and did assume the risk of loss and retain the title and beneficial ownership of its merchandise until the goods reached their foreign destination. . . . There was no sham in Export's title retention. The substance of what happened is exactly the form it took. Export intended to and did assume the risk of loss and retain title to its merchandise until the goods reached their foreign destination."); *Comm'r v. Pfaudler Inter-American Corp.*, 330 F.2d 471, 475 (2d Cir. 1964) ("It is clear that Pfaudler's sales were no mere shams; retention of title carried with it the risk of loss or damage to the goods prior to ultimate delivery as well as the benefits linked to reservation of control over the goods while in transit."); *Otis Elevator Co. v. U.S.,* 618 F.2d 712, 727 (Ct. Cl. 1980) ("Prior to the change, title to the components passed to plaintiff at the port of embarkation in the country of manufacture. The sale occurred at that time. Risk of loss also at that point shifted to plaintiff. If the components were damaged or destroyed while in transit to whichever of plaintiff's branches needed the components, the sale had nevertheless still occurred and plaintiff had to bear whatever loss there may have been. Subsequent to the

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change, New Jersey bore the risk of loss from the port of embarkation until transfer of title to plaintiff at the point of entry in the country of plaintiff's branch which needed the components. If the components were lost or damaged while in transit, New Jersey would have to bear this loss. In addition, if for some reason the components failed to arrive at the point of delivery, then no sale to plaintiff would occur."); *Miami Purchasing Service Corp. v. Comm'r*, 76 T.C. 818, 826 (1981) ("In interpreting the above regulation [Treas. reg. section 1.861-7(c)], cases have focused on the place where title to the goods and risk of loss passes from the seller to the buyer. [Citations to *Pfaudler* and *Hammond Organ* omitted]. . . . We have already found that use of the F.O.B. shipping term indicated the point at which the shipper's risk ended and the buyer's risk began."); *Kates Holding Co. v. Comm'r*, 79 T.C. 700, 700, 706, 707 (1982) ("*Held*, when the Uniform Commercial Code art. 2 applies, both passage of title and risk of loss determine where a sale occurs for purposes of sec. 922, I.R.C. 1954. . . . He [the commissioner] contends that a sale occurs within the United States when title or risk of loss passes from seller to buyer within the United States. . . . Because the U.C.C. has been enacted in New York, Connecticut, and Pennsylvania, and was so enacted during the year in issue, we will look to its provisions to determine the passage of title and risk of loss."); *Liggett Group, Inc. v. Commissioner,* T.C. Memo. 1990-18 (1990) ("Paddington and its customers also understood and agreed that F.O.B. British Isles meant that ownership and risk of loss passed from Paddington to the customer when J&B, at Paddington's direction, loaded the J&B Rare aboard the ship of the specified carrier in a timely fashion in the British Isles. As one of Paddington's principal customers explained, 'We own the goods at the moment the merchandise passes the rail of the ship. . . . [W]hen those goods are put on the ship, I become the owner and therefore it is my responsibility to insure it.' ").

[25]*See supra* note 22 and accompanying text.

[26]*See* Galler, *supra* note 19, at 555.

[27]*See supra* note 12.

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