Embargoed Until Delivery
10:00 a.m. November 4, 2015

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Before

Oversight Subcommittee of House Committee on Ways and Means

Hearing on Iran Terror Financing and the Tax Code

November 4, 2015

Chairman Roskam, Ranking Member Lewis and members of the Subcommittee, thank you for inviting me to testify about terrorism-related provisions in U.S. tax law.[2] This issue is timely and important, since the Joint Comprehensive Plan of Action (or "JCPOA")[3] is supposed to ease *nuclear-related* sanctions on Iran, but not *terrorism-related* sanctions.[4] In announcing

[1] I am testifying in my individual capacity at the invitation of the Subcommittee. The views I am expressing are my own and do not reflect those of Columbia University or any organization with which I am affiliated.
[2] Section 901(j)(2)(A)(iv) (targeting nations that "repeatedly provid[e] support for acts of international terrorism").
[3] The JCPOA was negotiated among the Islamic Republic of Iran and the "E3/EU+3" (China, France, Germany, the Russian Federation, the United Kingdom and the United States, along with the High Representative of the European Union for Foreign Affairs and Security Policy). The JCPOA and appendices contain reciprocal commitments that outline a step-by-step framework, which is intended to limit Iran's nuclear program in exchange for the lifting of a range of UN Security Council, multilateral and national sanctions relating to Iran's nuclear program. The JCPOA is dated July 14, 2015. The JCPOA has five Annexes (I – V). *See* http://www.state.gov/e/eb/tfs/spi/iran/jcpoa.
[4] The JCPOA enumerates the nuclear-related sanctions that will be lifted if Iran honors its commitments. JCPOA, Annex II.B, para. 4 ("The United States commits to cease the application of, and to seek such legislative action as may be appropriate to terminate, or modify to effectuate the termination of, all nuclear-related sanctions as specified in Sections 4.1-4.9 below, and to terminate Executive Orders 13574, 13590, 13622 and 13645, and Sections 5-7 and 15 of Executive Order 13628, in accordance with Annex V."). The JCPOA explicitly provides that it does not lift sanctions other than those specifically listed in the agreement. *See, e.g.*, JCPOA, Annex II.B., para. 7.1, fn. 14 ("Unless specifically provided otherwise, the sanctions lifting described in this Section . . . is without prejudice to sanctions that may apply under legal provisions other than those cited in Section 4."). In paragraph 29 of the JCPOA, the U.S. and EU pledge to "refrain from any policy specifically intended to directly and adversely affect the normalisation of trade and economic relations with Iran," but this commitment is merely to refrain from such policies that are "inconsistent with their commitments not to undermine the successful implementation of this JCPOA."

the JCPOA, President Obama said that "we will maintain our own sanctions related to Iran's support for terrorism."[5]

Curtailing Iran's support for terrorism obviously is an important goal. While the tax law is not the only way to pursue this objective,[6] Congress can use the tax law to do so in two ways. First, Congress should discourage U.S. and other businesses from paying tax to Iran, since this revenue could be used to fund terrorism. Second, Congress should raise the tax cost of doing business with (or in) Iran or with Iranian businesses, since this commercial activity can strengthen extremist groups, such as the Revolutionary Guard.

Two provisions of the tax code pursue these goals under current law. I will explain how these provisions operate. Since both have significant gaps, I also will suggest ways to strengthen them.

I. Application of Section 901(j) and Section 952(a)(5)

The first provision, Section 901(j), raises the cost of paying taxes to Iran and other states that sponsor terrorism.[7] Ordinarily, when U.S. taxpayers pay tax to a foreign country, every dollar they pay of foreign tax reduces their U.S. tax by a dollar.[8] But taxes paid to states that sponsor terrorism are treated less favorably: a dollar of these taxes reduces U.S. tax by only 35 cents (for corporate taxpayers), instead of by a full dollar.[9] The reason is that Section 901(j) authorizes a deduction, instead of a credit.[10]

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[5] Statement by the President on Iran, July 14, 2015, www.whitehouse.gov; *see also* White House, The Iran Nuclear Deal: What You Need to Know About the JCPOA, https://www.whitehouse.gov/sites/default/files/docs/jcpoa_what_you_need_to_know.pdf ("we will continue to aggressively enforce sanctions against Iran's support for terrorism. . . ."); *Id*. ("Meanwhile, we will be keeping in place other unilateral sanctions that relate to non-nuclear issues, such as support for terrorism and human rights abuses.").

[6] Indeed, other policy instruments could be more effective in some circumstances, for instance, because they would be administered by government experts with more expertise about Iran's role in supporting terrorism.

[7] The Secretary of State has also designated Sudan and Syria as state sponsors of terrorism. http://taxmap.ntis.gov/taxmap/pubs/p514-004.htm#en_us_publink1000224444. These provisions also apply to U.S. taxpayers doing business in countries that do not have diplomatic relations with (or are not recognized by) the United States but, as a shorthand, I refer to nations covered by these provisions as "states that sponsor terrorism."

[8] For example, if U.S. taxpayers pay a $33 French tax, their U.S. tax bill usually is reduced by $33. Instead of paying a $35 U.S. tax on $100 of income in France, a U.S. corporation would pay only $2. For credits to have this effect, certain requirements need to be satisfied.

[9] Section 901(j) also imposes another tax cost on firms doing business in Iran: they cannot use income earned there to claim more credits for taxes paid to *other* nations. In general, having more foreign income allows U.S. taxpayers to use more foreign tax credits, but Section 901(j) prevents them from using income from Iran to do so. This is accomplished by creating a separate "basket" of income derived from 901(j) countries. *See* 901(j)(1)(B) ("subsections (a), (b), and (c) of section 904 and sections 902 and 960 shall be applied separately with respect to income attributable to such a period from sources within such country."). For example, assume an energy company earns $100 million in Iran (and pays a 25% tax of $25 million), and earns $200 million of income from Saudi Arabia (and pays a 40% income tax of $80 million). The U.S. generally allows foreign tax credits of up to 35% (the U.S. tax rate). If the firm can take into account the income from Iran in computing this limitation, it can claim a foreign

The second provision, Section 952(a)(5), accelerates U.S. tax when U.S. multinationals do business in states that sponsor terrorism. Usually, foreign earnings are not taxed until they are brought back to the U.S.[11] But if this money is earned in a state that sponsors terrorism, the U.S. taxes it right away.[12]

Both of these tax penalties are currently in effect, although the President has authority to waive them after giving Congress 30 days' notice.[13]

III. Gaps in These Provisions

While these provisions block some types of transactions, they have significant gaps. So I will now flag some of them and highlight a few possible solutions.[14]

A. Income "Derived From" States That Sponsor Terrorism

First, the rule forcing U.S. multinationals to pay U.S. tax immediately is porous. It applies to income "derived from" states that sponsor terrorism, but this "derived from" standard is imprecise.[15] This test should be satisfied when firms extract oil or have real estate in these countries.[16]

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tax credit for a total of .35*(300 million) or $105 million in foreign tax. However, because the Iranian income is in a separate "basket," the company can claim a credit for only .35* (200 million), or $70 million of the Saudi tax. In this example, putting the income from Iran in a separate basket prevents the taxpayer from claiming a credit for all the Saudi tax – and, in particular, the Saudi tax that is in excess of the U.S. tax. Note, however, that the separate Iranian basket actually is a *benefit* when firms have *losses* in Iran, since these losses do not reduce overall foreign income – and thus the general limitation – if they are in a separate basket. Since the goal here is to discourage firms from paying taxes and doing business in Iran, a tougher approach would be to source *losses* in the general basket, and to source only *net gains* separately.

[10] Section 901(j) expressly permits this deduction. Section 901(j)(3). As an example, assume a U.S. energy company (or its foreign subsidiary) earns $100 drilling for oil in Iran, and pays a $25 Iranian tax. With a foreign tax credit of $25, it would pay only $10 of U.S. tax. But if it deducts the $25 of Iranian tax from the $100 it earns in Iran, the company has only $75 of U.S. taxable income, and pays a 35% U.S. tax of $26.25. When added to the $25 of Iranian tax, the firm pays a total of $51.25 of tax on $100 of income, instead of a total of $35 of tax on $100 of income.

[11] Specifically, when foreign subsidiaries of these multinationals earn money abroad, the U.S. does not tax these foreign profits until they are distributed as a dividend to the U.S. parent.

[12] Section 952(a)(5) (defining as subpart F income "the income of such corporation derived from any foreign country during any period during which section 901 (j) applies to such foreign country").

[13] Section 901(j)(5).

[14] The goal of this testimony is to suggest options for Congress to consider, not to make a definitive recommendation.

[15] A somewhat different formulation – "income . . . from sources within such country" -- is used to describe income that has to be assigned to a separate basket for purposes of the foreign tax credit limitation. *See* 901(j)(1)(B) ("income attributable to such a period from sources within such country").

[16] *See generally* Section 862(a); Treas. Reg. 1.862-1.

Yet this penalty arguably can be avoided when a firm has no people or facilities "on the ground."[17] For example, income from the sale of property sometimes is treated as earned where *title passes*,[18] instead of where the property *ultimately is used*. So U.S. taxpayers may argue that income from selling goods to Iran is not "derived from" Iran – so no current U.S. tax is due – as long as title passes in international waters. Another strategy to avoid treating profits as "derived from" Iran is to sell to an intermediary (such as an independent agent) in another country, which then resells the property in Iran.[19]

To plug these gaps, Congress can direct Treasury to promulgate regulations that read "derived from" more broadly in this context,[20] or Congress can consider legislation. For example, the test should reach any property that is "sold for use, consumption or disposition" in states that sponsor terrorism if that country is "the ultimate destination of the property," regardless of where title passes.[21] "Derived from" also should reach any income of a subsidiary organized under the laws of a state that sponsors terrorism. Congress also can consider an anti-abuse rule to reach independent agents used as intermediaries to sell in states that sponsor terrorism.[22]

B. Expenses of Doing Business in States That Sponsor Terrorism

[17] This sort of argument draws strength from Treasury guidance indicating that general source rules should be used in interpreting this provision. *See* Treas. Reg. 1.863 – 6 ("The principles applied in sections 861 through 863 and section 865 and the regulations thereunder for determining the gross and the taxable income from sources within and without the United States shall generally be applied in determining the gross and the taxable income from sources within and without a particular foreign country when such a determination must be made under any provision of Subtitle A of the Internal Revenue Code, including section 952(a)(5).").

[18] *See* Treas. Reg. 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.")

[19] Section 901(j)(4) provides regulatory authority to treat income as "derived from" a country even if it was paid through "one or more entities" but, to my knowledge, there are no regulations on this issue.

[20] The Treasury has regulatory authority to prescribe specific rules for these provisions. *See* Section 901(j)(4).

[21] Similarly, services could be deemed to be performed in a state that sponsors terrorism where that state is the end product of the services, regardless of where the services are actually performed. These sorts of broad formulations are used in regulations on foreign base company sales income, *see* Treas. Reg. 1.954-3(a)(3), as well as in rules penalizing participation in certain international boycotts, *see* Treas. Reg. 7.999-1(b)(6). Likewise, H.R. 1 from the last Congress has a broad definition of when income should be treated as derived from the U.S. or abroad (for purposes of the deduction for net imputed intangible income).

[22] For example, the rule could reach "arrangements or understandings, including with independent agents, by which goods and services are resold" in states that sponsors terrorism. *Cf*. Treas. Reg. 1.954-3(a)(3) ("if at the time of a sale of personal property to an unrelated person the controlled foreign corporation knew, or should have known from the facts and circumstances surrounding the transaction, that the property probably would not be used, consumed, or disposed of in the country of destination, the controlled foreign corporation must determine the country of ultimate use, consumption, or disposition of the property or the property will be presumed to have been used, consumed, or disposed of outside the country under the laws of which the controlled foreign corporation is created or organized."). Although there would be challenges in enforcing this sort of anti-abuse rule, and it does not offer certainty to taxpayers, taxpayers would think twice about gaming the rule.

Taxpayers may try another way to shift income away from states that sponsor terrorism: not just by claiming the *revenue* comes from somewhere else, but also by stuffing deductible *expenses* into these countries, such as interest and royalties.[23]

To thwart these familiar "income stripping" strategies – and, more generally, to raise the costs of doing business in states that sponsor terrorism – Congress can consider stopping taxpayers from deducting these (and other) costs of doing business there. In other contexts, Congress has taken away deductions for bribes,[24] fines and penalties for violating the law,[25] and costs of trafficking in controlled substances.[26] Congress should consider the same treatment for costs of doing business in states that sponsors terrorism.

C. Treatment of Foreign Taxes

1. Third Country Taxes

Taxpayers can use income-stripping (and transfer pricing generally) not just to avoid U.S. tax, but also to avoid Iranian tax. At one level, this is good news, since Iranian taxes could fund terrorism. But the bad news is that these strategies can lower the cost of doing business in Iran, encouraging firms to be more active there. Unfortunately, Section 901(j) does not reach this situation, since it applies only to foreign taxes paid to *sponsors of terrorism*.[27] To cover taxes paid to other countries, Congress can consider broadening the provision to cover taxes on *profits earned* directly or indirectly from doing business with customers from countries that sponsor terror.

2. Deduction of Taxes Paid to States That Sponsor Terror

In any event, if Congress wishes to make taxes paid to *sponsors of terrorism* more costly, it can disallow not only the credit for these taxes, but also the deduction.[28] Then, the U.S.

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[23] Section 952(a) (last sentence) references deductions that taxpayers will use to reduce the income they otherwise would accelerate. *See* Section 952(a) ("For purposes of paragraph (5), the income described therein shall be reduced, under regulations prescribed by the Secretary, so as to take into account deductions (including taxes) properly allocable to such income." One way to read this language is that these deductions are not authorized absent regulations, but another is simply that Congress intended the Treasury to give guidance about deductions. Under either reading, Treasury has authority to impose some limits on these deductions.
[24] Section 162(c).
[25] Section 162(f).
[26]Section 280E. Similarly the IRS has asserted the right to deny other business deductions that are against public policy. While the Supreme Court curtailed the IRS' ability to do so without specific statutory authority*, see Commissioner v. Tellier*, 383 U.S. 687 (1966), the Court allows deductions to be disallowed when they would frustrate sharply defined national or state policies. 383 U.S. at 694. Footnote 10 of the *Tellier* decision lists other circumstances where Congress has enacted specific legislation denying deductions that violate public policy.
[27] For example, if the Swiss subsidiary of a U.S. firm earns money in Iran – but pays tax to Switzerland, instead of Iran – a foreign tax credit is still available for the Swiss tax, since Section 901(j) reaches only Iranian tax.

[28] Section 901(j)(3) expressly allows the deduction under current law. Notably, for some taxpayers, a deduction actually can be more value than a credit. For example, an energy company paying taxes that are higher than the U.S. rate will be limited in its ability to use more credits, but can still use a deduction.

Treasury would no longer shoulder 35% of these taxes (as it does now when the tax is paid by a U.S. corporation).[29]

D. Foreign Multinationals

Finally, perhaps the most daunting gap is that these rules do not reach foreign multinationals. Since these firms do not pay U.S. tax on foreign earnings, they are immune to the costs imposed by these provisions: after all, these firms have no need for a U.S. foreign tax credit, and no U.S. tax (on foreign earnings) to accelerate.

Although these provisions do not reach foreign multinationals, they still can weaken states that sponsor terrorism. By reducing the number of firms willing to do business with them, these rules reduce these countries' bargaining power, so they may get less favorable terms.

Nevertheless, these rules would be much more effective if they reached foreign multinationals. To do so, a potential lever is that these firms *do* pay U.S. tax on earnings *in the U.S*. Therefore, an extra tax can be imposed on the *U.S. earnings* of firms that do business in countries that sponsor terrorism.[30] The size of this extra tax should depend on how much a firm earns in these countries.[31] To avoid discriminating against foreign firms, this extra tax should apply to U.S. firms as well.

E. Conclusion

To sum up, Section 901(j) and 952(a)(5) raise the cost of paying tax in Iran and doing business there. While these rules have useful effects in their current form, Congress should consider strengthening them, for instance, with a broader definition of income "derived from" Iran, limits on deductions for costs of doing business there, as well as rules that reach foreign multinationals.

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[29] A credit, by contrast, would reduce U.S. tax by $100.

[30] For instance, some U.S. deductions or treaty benefits can be disallowed, or a withholding tax or higher rate can apply to a portion of their income. *Cf*. Section 891 (doubling the tax rate on citizens and corporations from nations that apply discriminatory tax rates to U.S. taxpayers).

[31] There are administrative challenges in determining how much they earn in these countries. Firms would have to report how much this income is, and guidance (and strict penalties) would be needed to discourage misleading reporting (*e.g*., which relies on creative sourcing of income, independent agents, and so forth).