NEW YORK UNIVERSITY SCHOOL OF LAW

COLLOQUIUM ON TAX POLICY
AND PUBLIC FINANCE
SPRING 2012

"INTERNATIONAL CORPORATE TAX REFORM AND A CORPORATE OFFSHORE EXCISE TAX"

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March 20, 2012 (Tuesday)
NYU School of Law
Vanderbilt Hall-208
Time: 4:00-5:50pm
Number 8

SCHEDULE FOR 2012 NYU TAX POLICY COLLOQUIUM

(All sessions meet on Tuesdays from 4:00-5:50p.m. in Vanderbilt Hall-208, NYU Law School)

1. January 17 – Michelle Hanlon, MIT, Sloan School of Management. "Taking the Long Way Home: Offshore Investments in U.S. Equity and Debt Markets and U.S. Tax Evasion." (with Edward L. Maydew and Jacob R. Thornock).

2. January 24 – Amy Monahan, University of Minnesota Law School. "Will Employers Undermine Health Care Reform by Dumping Sick Employees?" (with Daniel Schwarcz).

3. January 31 – Alex Raskolnikov, Columbia Law School. "Accepting the Limits of Tax Law and Economics."

4. February 7 – Victor Fleischer, University of Colorado Law School. "Tax and the Boundaries of the Firm."

5. February 14 – Heather Field, Hastings College of Law. "Binding Choices: Tax Elections & Federal/State Conformity."

6. February 28 – Daniel Shaviro, New York University School of Law. "The Financial Transactions Tax Versus (?) the Financial Activities."

7. March 6 – Edward Kleinbard, USC Gould School of Law. "The Sorry State of Capital Income Taxation."

8. **March 20 – Susan C. Morse, Hastings College of the Law. "International Corporate Tax Reform and A Corporate Offshore Excise Tax."**

9. March 27 – Stephen Shay, Harvard Law School. "Unpacking Territorial."

10. April 3 – Jon Bakija, Williams College Economics Department. "Jobs and Income Growth of Top Earners and the Causes of Changing Income Inequality: Evidence from U.S. Tax Return Date."

11. April 10 – Lane Kenworthy, University of Arizona Sociology Department. "Getting taxes right: What can we learn from the comparative evidence?"

12. April 17 – Yair Listokin, Yale Law School. "'I Like to Pay Taxes': Lessons of Philanthropy for Tax and Spending Policy." (with David Schizer).

13. April 24 – William Gale, Brookings Institution. "Fiscal Therapy."

14. May 1 – Rosanne Altshuler, Rutgers Economics Department, and Harry Grubert, U.S. Treasury Department. "A New View on International Tax Reform."

Draft 030512 – Preliminary draft, please do not cite or quote

INTERNATIONAL CORPORATE TAX REFORM AND A CORPORATE OFFSHORE EXCISE TAX

Susan C. Morse[*]

INTRODUCTION

The U.S. corporate income tax is trouble, and the international aspects of the tax significantly contribute to the problem. Rules meant only to carve out non-U.S. active business income from the corporate tax base instead allow U.S.-parented multinational corporations (MNCs) to shift to low-tax foreign

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[*] Associate Professor, UC Hastings College of the Law. My thanks for the many very helpful comments received at presentations at the Junior Tax Scholars' Workshop, Hastings Junior Faculty Workshop, Loyola Law School – Los Angeles, University of Toronto Law School, [and NYU (March 2012)].

jurisdictions income properly allocated either to the U.S. or to high-taxed foreign jurisdictions. These rules also encourage U.S.-parented MNCs to retain cash reserves offshore to avoid the U.S. tax that would be imposed on the repatriation, or payment of dividends, from non-U.S. subsidiaries to the U.S. parent.

Google, with its intellectual property-heavy, advertising-based business and market capitalization approaching $200 billion, has exploited the existing U.S. rules by directing the payment of non-U.S. advertising revenue to an Irish company, taxed at 12.5%. Google further erodes the Irish tax base with deductible payments to a Bermuda company, taxed at 0%, that nominally owns Google's non-U.S. IP.[1] The result: an effective tax rate on non-U.S. income of 2.4% in 2009.[2]

GE, which runs a large lending business and earns about $14 billion in profits annually, takes advantage of an "active financing exception" to rules that are supposed to require that passive income earned abroad by U.S.-parented MNCs is taxed in the U.S. While Google gets the advantages of offshored IP by using relatively obscure transfer pricing regulations, GE gets its tax breaks through high-profile lobbying for the periodic renewal of the active financing exception. The result is similar: GE's 2010 effective tax rate on non-U.S. income has been estimated at 0%.[3]

Some trading prices for non-U.S. businesses suggest an inflated value for non-U.S. businesses in U.S. hands because of a lower tax rate on non-U.S. income. Skype provides a good example. eBay bought Skype, an MNC with a corporate parent resident in Luxembourg, where the corporate tax is 0.4%, from a private equity consortium including Silver Lake Partners and from eBay in 2011.[4] The price was $8.5 billion. According to one estimate, Microsoft's ability to forecast a low tax rate for Skype profits and use offshore cash enabled it to pay $3 billion more than it would have been able to pay otherwise.[5]

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[1] *See* Edward D. Kleinbard, *Stateless Income*, 11 FL. TAX REV. 699, 707-14 (2011) (outlining Google's Double Irish Dutch Sandwich international planning).

[2] *See* Jesse Drucker, *Google's 2.4% Rate Shows How $60 Billion Lost to Tax Loopholes*, Bloomberg (Oct. 21, 2010), *available at* *http://www.bloomberg.com/news/2010-10-21/google-2-4-rate-shows-how-60-billion-u-s-revenue-lost-to-tax-loopholes.html*. [Note possible discrepancies actual tax rate/financial accounting.]

[3] *See* David Kocieniewski, *G.E.'s Strategies Let It Avoid Taxes Altogether*, N.Y. TIMES (Mar. 24, 2011). GE's low rate was due in part to net operating losses. [Note possible discrepancies actual tax rate/financial accounting.]

[4] *See* Richard Waters, Tim Bradshaw & Maija Palmer, *Microsoft in $8.5bn Skype Deal*, FIN. TIMES (May 10, 2011) (reporting profit of $5 billion for the investors who had purchased 70% of Skype 18 months before the announcement of the Microsoft deal).

[5] *See* Ronald Barusch, *Microsoft's Brilliant, Legal Tax Dodge*, WALL ST. J. DEALPOLITIK (May 11, 2011), *available at* http://blogs.wsj.com/deals/2011/05/11/dealpolitik-lesson-from-microsoftskype-congress-must-fix-corporate-tax-law/ (estimating deal price of $5.5 billion if "Skype had been a Delaware corporation run out of Silicon Valley" and Microsoft had used offshore cash).

Worldwide consolidation is one solution to concerns about the decreasing effectiveness of the U.S. corporate income tax. Worldwide consolidation would repeal deferral and include in the U.S. corporate income tax base all of the income earned by foreign subsidiaries of a U.S.-parented MNC, subject to a credit for foreign income taxes paid on such MNCs' foreign source income.[6] A worldwide consolidation system would not tax earnings upon repatriation, as they would already have been taxed when earned.

Worldwide consolidation contrasts with territorial corporate income tax systems, which limit tax jurisdiction over active business income to income sourced to the taxing jurisdiction. Most U.S. trading partners have territorial systems.[7] Moreover, the consensus view is that the existing U.S. corporate income tax system functions as a de facto territorial system, although it does not bear that label, and with the important caveat that the U.S. departs from the territorial model by imposing a tax on earnings repatriated to the U.S.[8] The adoption of a true territorial system, including the exemption of non-U.S. business earnings upon repatriation, is another possible avenue for U.S. international corporate income tax reform.

Literature exploring the choice between a worldwide consolidation international corporate income tax system and a territorial system for the U.S. includes five threads. These relate to the redistributive goals of the U.S. income tax system,[9] the deadweight loss of tax planning,[10] benefits-taxation-based fiscal

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[6] *See* Harry Grubert & Rosanne Altshuler, *Corporate Taxes in the World Economy: Reforming the Taxation of Cross-Border Income*, *in* FUNDAMENTAL TAX REFORM: ISSUES, CHOICES AND IMPLICATIONS 319, 329-330 (John W. Diamond & George R. Zodrow eds. 2008) (describing "constant burden worldwide taxation"); Edward D. Kleinbard, *Lessons of Stateless Income*, ___ TAX L. REV. ___, TAN 167 / Part VI.B (201[1]) (listing desired features of worldwide consolidation system including adoption of "'mind and management'" standard for corporate residence and thin capitalization rules to combat base erosion).

[7] *See* HUGH J. AULT & BRIAN J. ARNOLD, COMPARATIVE INCOME TAXATION 492-93 (3d ed. 2010) (providing chart comparing systems for taxing business income).

[8] *See* J. Clifton Fleming, Jr., Robert J. Peroni & Stephen E. Shay, *Worse Than Exemption*, 59 EMORY L. J. 79, 85 (2009) (summarizing argument that the imperfections of various U.S. international tax rules produce a system that is even more favorable to U.S.-parented MNCs than territoriality); Kleinbard, *supra* note 1 at 715-727 (arguing that the U.S. international corporate income tax system is an "ersatz territorial" system).

[9] *See* J. Clifton Fleming Jr., Robert J. Peroni & Stephen Shay, *Fairness in International Taxation: The Ability-to-Pay Case for Taxing Worldwide Income*, 5 FL. TAX REV. 299, 322-323 (2001) (arguing that the ability-to-pay feature of the U.S. federal income tax requires taxing corporations on their worldwide income).

[10] *See, e.g.*, Reuven Avi-Yonah, *The Structure of International Taxation: A Proposal for Simplification*, 74 TEX L. REV. 1301, 1329-30 (1996) (describing tax planning problem); Kleinbard, *supra* note 6, at 66/TAN 149 (contending that territoriality is unworkable because source rules are "unimplementable as a practical matter, and bankrupt

sovereignty concerns,[11] worldwide efficiency,[12] and national efficiency.[13] Worldwide consolidation appears to have the edge under many of these analyses, including under a worldwide efficiency outlook based on the theory of capital export neutrality.[14]

But a set of concerns stemming from ownership neutrality theory demonstrates that worldwide consolidation carries risks.[15] Ownership neutrality proponents argue that in a world where most other nations have territorial income tax systems, U.S. worldwide consolidation would cause U.S.-parented MNCs to face higher tax rates than non-U.S. investors under some territorial systems. The implicit tax, or

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as a conceptual matter").

[11] *See* Nancy H. Kaufman, *Fairness and the Taxation of International Income*, 29 L. & POL'Y INT'L BUS. 145, 169 (1998) (arguing that replacing the de facto territorial U.S. system with a worldwide consolidation policy would infringe the fiscal sovereignty of other nations, as it would prevent such nations from setting the income tax rate applicable to income earned by U.S.-parented MNCs and sourced in their jurisdictions below the rate set by the U.S.); Julie Roin, *Competition and Evasion: Another Perspective on International Tax Competition*, 89 GEO. L. J. 543, 603 (2001) ("Source countries should remain free to use tax policies to attract business investment, just as residence countries should have the right to tax their residents to support the social services . . . that they enjoy.").

[12] *See* DEP'T OF TREASURY, OFF. OF TAX POLICY, DEFERRAL OF INCOME EARNED THROUGH CONTROLLED FOREIGN CORPORATIONS: A POLICY STUDY 26-42 (December 2000) (summarizing capital export neutrality-based literature); Jane G. Gravelle, *International Corporate Tax Reform: Issues and Proposals*, 9 FLA. TAX REV. 479 (2009) (arguing that CEN trumps CON if capital is mobile).

[13] *See* Desai & Hines, *supra* note 17, at 496 (arguing that territoriality promotes national welfare by maximizing the productivity of U.S. firms, and that foreign investment in U.S. assets will flow into any space left by U.S. firms' decisions to invest abroad); Michael Graetz, *Taxing International Income: Inadequate Principles, Outdated Concepts, and Unsatisfactory Policies*, 54 TAX L. REV. 261, 280-82 (2001) (supporting national welfare, rather than worldwide efficiency, as a policy goal); Peggy B. Musgrave, *Combining Fiscal Sovereignty and Coordination: National Taxation in a Globalizing World*, *in* THE NEW PUBLIC FINANCE: RESPONDING TO GLOBAL CHALLENGES (2006) 167, 178 ("[U]nder what may be called a 'national' view of taxpayer equity the foreign tax is treated as a deduction from foreign source income (in effect, a cost of doing business), and the residence country's corporate tax is applied to foreign earnings net of foreign tax."); Daniel Shaviro, *Why Worldwide Welfare as a Normative Standard in U.S. Tax Policy?*, 60 TAX L. REV. 155, 164-65 (2007) (contending that even if worldwide welfare improves national welfare by encouraging cooperative behavior, unobserved defections should improve national welfare).

[14] *See* DEP'T OF TREASURY, OFF. OF TAX POLICY, DEFERRAL OF INCOME EARNED THROUGH CONTROLLED FOREIGN CORPORATIONS: A POLICY STUDY 26-42 (December 2000) (summarizing capital export neutrality-based literature).

[15] Mihir A. Desai & James R. Hines Jr., *Evaluating International Tax* Reform, 56 NAT'L TAX J. 487, 494 (2003) ("The United States would reduce world welfare by taxing foreign income . . . , since such as system encourages American firms to purchase assets in high-tax countries and foreign firms to purchase assets in low-tax countries.").

asset pricing,[16] consequences of such a rate discrepancy could cause U.S.-parented MNCs to lose bidding wars for such assets even if the U.S.-parented MNCs could make more productive use of the assets.[17] This could translate not only to lower productivity for U.S. firms, but also to an increased incentive for U.S. firms to expatriate and for portfolio investors to move their investments away from U.S. firms and toward non-U.S. firms.[18]

Under either worldwide consolidation or territoriality, lowering the U.S. tax rate so that it is more in line with the tax rates of U.S. trading partners is a key part of the reform. Existing proposals for worldwide consolidation[19] and territoriality[20] reforms include a top federal corporate income tax rate of at most 25%.[21] A rate of 25% would be substantially less than the current top U.S. federal rate of 35% and would bring the combined federal and state U.S. rate much closer to the OECD average and to the prevailing tax rates among U.S. trading partners.[22]

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[16] *See* MYRON S. SCHOLES ET AL., TAXES AND BUSINESS STRATEGY: A PLANNING APPROACH 91-100 (2d ed. 2002) (explaining implicit taxation mechanism).

[17] *See* Daniel Shaviro, *The Rising Tax-Electivity of U.S. Corporate Residence*, 64 TAX L. REV. 377, 394 (2011) (describing clientele effects that could produce "asset swaps" between U.S. and non-U.S. investors upon the imposition of a worldwide tax).

[18] *See, e.g.* Roger H. Gordon, *Discussion of Corporate Taxes in the World Economy: Reforming the Taxation of Cross-Border Income*, *in* Fundamental Tax Reform: Issues, Choices and Implications 359, 367 (John W. Diamond & George R. Zodrow, eds. 2008) (noting that the possibility that worldwide consolidation will incent multinationals owned by U.S. investors to locate outside the U.S. or will incent U.S. investors to increasingly invest in non-U.S. corporations instead of U.S.-parented MNCs "introduces a serious question about the advisability of" a worldwide consolidation reform);

[19] *See, e.g.*, The Bipartisan Tax Fairness and Simplification Act of 2011 (sponsored by Senators Ron Wyden (D-Ore.) and Dan Coats (R-Ind.)) (proposing deferral repeal and the reduction of the corporate rate to 24%).

[20] For example, Representative Dave Camp made an international corporate tax reform proposal in October 2011 that featured a territorial tax system and included a transition rule that would deem the inclusion of a CFC's "accumulated deferred foreign income" in a U.S. shareholder's income upon enactment. Under the Camp proposal, the inclusion would be reduced by an 85% deduction, producing a rate of 5.25%; foreign tax credits would be allowed on a pro-rated basis, and U.S. shareholders could elect to pay the transition tax over up to eight annual installments. *See Camp Releases Technical Explanation of International Tax Reform Plan*, *available at* LEXIS, TAXTXT, 2011 TNT 208-28 Part A.3 (Oct. 26, 2011) (describing Section 303 of the discussion draft and proposed changes to Section 965 of the Code).

[21] *See also, e.g.*, Kleinbard, *supra* note 6 (suggesting a 25% rate); others who have suggested a 25% rate.

[22] The average statutory combined national and sub-national rate of the top five U.S. global trading partners weighted by percent contribution to total imports and exports is 29.0%. This figure is based on Census Bureau information about the five largest U.S. trading partners – Canada, China, Mexico, Japan and Germany – in November 2011. *See* U.S. CENSUS BUREAU, TOP TRADING PARTNERS – TOTAL TRADE, EXPORTS, IMPORTS, http://www.census.gov/foreign-trade/statistics/highlights/top/top1111cm.html#total. It is also based on OECD-reported combined tax rates. *See* MARTIN SULLIVAN, CORPORATE

Under worldwide consolidation, a smaller rate discrepancy reduces implicit taxation concerns about loss of value for U.S.-parented MNCs' non-U.S. assets and incentives to divest such assets, minimizes worries about U.S.-parented MNCs' decreased ability to bid for non-U.S. assets, and decreases the possibility that U.S.-parented MNCs will become disfavored business firm structures. Most fiscal sovereignty concerns likewise recede in the absence of a rate discrepancy. Under territoriality, a lower U.S. tax rate is important on the theory that a higher rate will reduce after-tax returns on U.S. assets relative to non-U.S. assets and discourage investment in the U.S.[23]

The choice between worldwide consolidation and territoriality need not be a binary choice.[24] Other options along the continuum include a hybrid system that taxes non-U.S. business income at a lower rate than U.S. business income.[25] Such a hybrid reform, so long as it also featured the repeal of the existing U.S. tax upon the repatriation of profits from non-U.S. subsidiaries to U.S. parents, would raise the transition question that is the focus of this Article.

This Article considers the question of what transition tax, if any, on pre-enactment offshore earnings should be imposed upon enactment of an international tax reform that includes the repeal of the existing repatriation tax. It labels such a transition tax on pre-enactment offshore earnings a "corporate offshore excise tax," or COET. The question of a COET arises under either a worldwide consolidation reform or a territoriality reform.

A COET-like tax, at an effective rate of 5.25%, is included in a widely discussed U.S. territorial corporate income tax reform proposal floated in 2011. It appears that this tax is intended to help fund the proposed corporate tax rate reduction.[26] Such revenue has particular importance in a political climate where it is far easier to enact tax reform within the four corners of the corporate tax, without resorting to, for example, higher rates applicable to high-income individuals or a value-added tax (VAT).[27] Nevertheless, this Article seeks to

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TAX REFORM: TAXING PROFITS IN THE 21ST CENTURY 50 (2011) (giving rates for OECD countries); Appendix A *infra* (same).

[23] *See* Mihir A. Desai, C. Fritz Foley & James R. Hines Jr., *Domestic Effects of the Foreign Activities of U.S. Multinationals*, 1 AM. ECON. J.: ECON. POL'Y 181 (2009).

[24] *See* Graetz, *supra* note 13, at 282 (contending that promoting domestic investment or, conversely, foreign investment may best support U.S. interests depending on the circumstances)

[25] *See* Shaviro, *supra* note 13.

[26] *See* JOINT COMMITTEE ON TAXATION, ESTIMATED REVENUE EFFECTS OF S. 3018 (Nov. 2010) (giving a "very preliminary" ten-year cost estimate of the Wyden-Coats "corporate flat tax" as $1.1 trillion). *See* Martin A. Sullivan, *Testimony Before the House Ways & Means Committee*, Nov. 17, 2011, part VI, *available at* LEXIS, TAXTXT file, 2011 TNT 23-35.

[27] Possible revenue sources include base-broadening reforms that would repeal or cut

evaluate a COET, and analyze whether it would be sensible and at what base and rate it would be sensible, as a matter of theory and not simply realpolitik.

This Article considers five COET design constraints: revenue, Constitutionality, tax treaty compliance, tax avoidance exposure, and the risk of giving corporate taxpayers incentives or messages with unfortunate results. It argues that these constraints support a COET base equal to U.S.-parented MNCs' permanently reinvested earnings as recorded for accounting purposes.[28] It then considers rates ranging from 0% to 35%. Rates considered include a 5.25% rate, which would equal the effective rate imposed during the repatriation tax holiday of 2004-05, at a 15% rate, intended as a proxy for a 35% or 25% rate with a rough-justice adjustment to account for foreign tax credits. Design constraints offer opposing pros and cons for these rates, as the risk of tax treaty challenge and tax avoidance strategies, as well as the revenue opportunity, increase with the applicable rate.

The most challenging design constraint is the risk of giving corporate taxpayers incentives or messages with unfortunate results. The idea is that a COET could influence taxpayers' expectations about future policy changes,[29] including their expectations about whether Congress might impose harsh or unexpected tax changes in the future. This constraint includes the concern that an excessive COET, like a harsh worldwide consolidation policy, could have the

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back business tax benefits, such as accelerated depreciation and the domestic production activities deduction. *See generally* CONGRESSIONAL BUDGET OFFICE, REDUCING THE DEFICIT: SPENDING AND REVENUE OPTIONS (March 2011) (providing revenue estimates). But existing revenue estimates appear to be overly optimistic.

[28] Amounts may be recorded as permanently reinvested earnings, and thus support the recognition of the benefit of deferring U.S. tax on non-U.S. income, when "management represents that "repatriation will be . . . postponed indefinitely." Julie H. Collins, John R. M. Hand & Douglas A. Shackelford, *Valuing Deferral: The Effect of Permanently Reinvested Earnings on Stock Prices*, *in* International Taxation and Multinational Activity (James R. Hines Jr., ed) 143, 143-44 (2000) (citing APB no. 72 (1973) UPDATE). The PRE feature of the COET seeks to take advantage of firms' incentive to maximize their permanently reinvested earnings and thus minimize firms' incentive to plan to reduce the tax base. *See* Daniel Shaviro, *The Optimal Relationship Between Taxable and Financial Accounting Income: Analysis and a Proposal*, 97 GEO. L.J. 423, 484 (2009) (proposing "a 50% adjustment of taxable income towards financial accounting income for large, publicly traded companies"); *see also* Wolfgang Schoen, *The Odd Couple: A Common Future for Financial and Tax Accounting?*, 58 TAX L. REV. 111 (2005) (recounting Germany's history with a "one-book" system). Unlike a proposal to conform tax and accounting income measures on a steady-state basis, *see* Shaviro, *supra*, at 471-72, the use of an accounting measure for a one-time tax may not raise a significant risk that the politicized process used to set measures of taxable income will degrade the quality of the accounting rules.

[29] *See* DANIEL SHAVIRO, WHEN RULES CHANGE: AN ECONOMIC AND POLITICAL ANALYSIS OF TRANSITION RELIEF AND RETROACTIVITY 19-25 (2000) (outlining the importance of taxpayers' expectations about future policy changes).

results of encouraging businesses to avoid the U.S.-parented MNC form. The magnitude and uncertainty of this risk is very difficult, perhaps impossible, to quantify. In addition, it is possible that this risk does not follow a linear relationship relative to the tax rate, but rather that it is mediated by heuristics and norms that may move between equilibria in a more abrupt fashion.

Given the risk presented by this design constraint, one relatively safe option is to stay within the bounds of taxpayers' likely expectations about transition tax policy. Taxpayers have reason to expect a modest transition tax, such as a 5.25% transition tax. Such a modest tax also comports with existing law, relevant in the event that corporate taxpayers have anchored on existing law instead of predicting future policy, in that it represents a rough justice trade for the benefit of not taxing the current accumulation of untaxed offshore earnings at any point in the future.

A higher tax faces a higher risk of unfortunate results. Yet it could be defended under the theory that it would properly incent taxpayers to expect retroactive transition taxes under certain circumstances. The objection that taxpayers would not have enough information to predict when transition taxes might be imposed is minimized by the circumstances that support a transition tax in this case, including the repeal of deferral and the partial trade of an implicit tax for an explicit tax.

Part I discusses the framing of the choice of U.S. worldwide consolidation as opposed to U.S. territoriality in the existing literature and uses a numerical example to demonstrate objections raised by adherents of capital ownership neutrality theory to a lower U.S. corporate tax rate. Part II describes COET design constraints, including revenue, Constitutionality, tax treaty compliance, minimizing tax avoidance, and avoiding giving corporate taxpayers incentives or messages with unfortunate results. Part II contends that the financial accounting measure of permanently reinvested earnings is the right base for a COET and considers a range of tax rates, from 0% to 35%. Part III considers the relationship between rational expectations and the possibility that a COET would produce unfortunate results such as increased incentives for expatriation. It defends a COET at a modest rate of 5.25% and develops an argument for a higher-rate COET.

I. INTERNATIONAL CORPORATE TAX REFORM CHOICES

A. Worldwide Consolidation vs. Territoriality

Under current U.S. law, a U.S.-parented MNC is taxed on the income of its foreign subsidiaries only to the extent such income falls into the definition of "subpart F income."[30] Subpart F, together with sourcing,[31] transfer pricing,[32]

[30] *See* I.R.C. §§ 951 et seq. (defining subpart F income and providing for its current taxation).

foreign tax credit[33] and other rules, is supposed to protect the U.S. corporate tax base. These rules, roughly speaking, are supposed to ensure the inclusion in the U.S. corporate income tax base of (1) income economically attributable to the U.S., (2) foreign-source passive and mobile income, and (3) foreign-source active income upon its repatriation to the U.S.[34] However, the rules do not work very well, as others have explained.[35]

The existing rules are so flawed and open to tax planning that the U.S. international corporate tax system more closely resembles the territorial systems adopted by other countries[36] rather than a system of worldwide consolidation. In fact, it has been persuasively argued that the U.S. system is worse than a territorial system, because it motivates more tax planning[37] and collects less revenue.[38] Either a worldwide consolidation reform or a territorial reform could improve upon the existing system.[39] Importantly, either would remove the current rule that taxes dividends repatriated from non-U.S. subsidiaries to parent U.S. corporations.

"Worldwide consolidation"[40] means the current taxation of the income of a U.S.-parented multinational corporation, including the income of all of the MNC's foreign subsidiaries, on a current basis.[41] Its implementation would involve the

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[31] *See* I.R.C. §§ 861-865 (providing source rules).

[32] *See* I.R.C. § 482 and regulations thereunder (providing transfer pricing rules).

[33] *See* I.R.C. §§ 901-908 (providing foreign tax credit rules).

[34] *See, e.g.*, MICHAEL J. GRAETZ, FOUNDATIONS OF INTERNATIONAL INCOME TAXATION 217-18 (2003) (explaining the purpose of subpart F).

[35] *See* Fleming, Peroni & Shay, *supra* note 8, at 85 (summarizing article as an explanation of "how (1) the deferral privilege, (2) defective income-sourcing and cost-allocation rules, (3) generous and practically ineffective transfer-pricing rules, (4) largely unrestricted cross-crediting, and (5) the deduction of foreign losses against U.S.-source income combine to make the present U.S. international tax scheme worse than a conventional exemption system—at least with respect to active business income earned in low-tax foreign countries by U.S. resident corporations"); Kleinbard, *supra* note 1, at 729-38 (citing earnings stripping, transfer pricing and legal system arbitrage strategies to move income to low-tax jurisdictions).

[36] *See* AULT & ARNOLD, *supra* note 7, at 467-74 (3d ed. 2010) (discussing design issues arising under a territorial or "exemption" system and different countries' solutions).

[37] *See* Fleming, Peroni & Shay, *supra* note 8, at 110, 119-22, 132, 145-49 (describing planning related to expense allocation, transfer pricing, cross-crediting, and the deduction of foreign losses against U.S.-source income).

[38] *See* Rosanne Altshuler & Harry Grubert, *Where Will They Go if We Go Territorial? Dividend Exemption and the Location Decisions of U.S. Multinational Corporations*, 54 NAT'L TAX J. 787, 798, 800 (2001) (calculating an effective tax rate for income earned in low-tax countries of 3.3% for the existing system and 5.3% - 9.3% under a territorial system that included expense allocation rules) .

[39] STAFF OF THE JOINT COMMITTEE ON TAXATION, BACKGROUND MATERIALS ON BUSINESS TAX ISSUES 53-54 (2002) (describing worldwide, territorial and mixed systems).

[40] *See* Kleinbard, *supra* note 1, at 774 (referring to "worldwide tax consolidation").

[41] Subpart F grew out of a worldwide consolidation proposal made by the Kennedy administration. See Special Message to the Congress on Taxation, 1 PUB. PAPERS 290,

replacement of the subpart F provisions that attempt to identify currently taxable income as the passive and mobile income of foreign subsidiaries with provisions that required the current taxation of all income of foreign subsidiaries to U.S. parent corporations. Worldwide consolidation would include a foreign tax credit mechanism to avoid double taxation, and as a result it still requires the identification of foreign source income as to which a foreign tax credit will be allowed. Thus the sourcing and transfer pricing rules are still necessary, and solutions to them, including partially formulary solutions, still have relevance.[42]

The alternative to worldwide consolidation is the clarifying reform of adopting an explicitly territorial U.S. system.[43] Territoriality in theory suggests that each country only taxes the income that is sourced within that country.[44] But as used by U.S. trading partners,[45] territoriality generally only limits the taxation of business income to income sourced in the taxing country.[46] It is possible to link the exemption of business income to a treaty relationship, to condition it on the application of foreign income tax at a certain rate, or to simply define business

___ (Apr. 20, 1961) (proposing "[e]limination of tax deferral privileges in developed countries and 'tax haven' deferral privileges in all countries"**)**. John Kerry made a worldwide consolidation proposal during the 2004 presidential campaign. His plan would have repealed subpart F and used "$12 billion in annual savings" to cut the corporate tax rate by 5%. *See Kerry Plan Would Reform Corporate Tax System*, TAX NOTES TODAY, March 29, 2004, *available at* LEXIS, TAXTXT file, 2004 TNT 60-46. Most recently, a 2011 bill proposed by Senators Wyden and Coats would repeal deferral and reduce the corporate tax rate to 24%. *See supra* . . .

[42] If adopted by all nations, formulary apportionment could entirely replace the full spectrum of international tax rules and become the only source of law dividing jurisdiction to tax for business firms. *See* Susan C. Morse, *Revisiting Global Formulary Apportionment*, 29 VA. TAX REV. 593, 600-601 (2010). But in the realistic situation where an individual nation uses formulary apportionment to incrementally reform their tax rules, formulary apportionment is best described as a tool to improve the sourcing and/or transfer pricing rules imposed by that jurisdiction. *See, e.g.*, Reuven Avi-Yonah & Ilan Benshalom, *Formulary Apportionment, Myths and Prospects -- Promoting Better International Tax Policy and Utilizing the Misunderstood and Under-Theorized Formulary Alternative*, Oct. 16, 2010, *available at* http://ssrn.com/abstract=1693105 (proposing the application of formulary rules to allocate the residual portion of an MNC's income).

[43] Representative Camp made such a proposal in 2011. *See Camp Releases Technical Explanation of International Tax Reform Plan*, *supra* note 20.

[44] *See* AULT & ARNOLD, *supra* note 7, at 447 ("[I]nternational double taxation can also be avoided by exempting from domestic tax certain classes of foreign-source income, thus ceding exclusive taxing jurisdiction to the country of source.").

[45] *See* AULT & ARNOLD, *supra* note 7, at 492-93 (providing chart comparing systems for taxing business income and showing that Australia, France, Germany and the Netherlands rely mainly on territoriality, that the UK uses territoriality, and that Canada, Japan and the United States rely on the foreign tax credit).

[46] *See* AULT & ARNOLD, *supra* note 7, at 447 ("In the systems here considered, exemption is usually limited to specific categories of foreign income – most typically, active business or employment income – that are likely to be subject to a level of foreign tax comparable to that which would have been applicable in the residence country.")

income as a matter of domestic law.[47] In contrast, territorial systems do not generally exclude foreign-source passive income from the tax base,[48] although they do permanently exclude dividends received from subsidiary companies, at least to the extent such dividends are drawn from active income.[49]

The debate between worldwide consolidation and territoriality in the U.S. includes at least five threads. These include support for the larger project of the U.S. federal income tax system, including its distributive objectives; incentives for wasteful taxpayer planning; nations' fiscal sovereignty; worldwide economic productivity, or efficiency; and national economic efficiency.[50]

The first thread is the relationship between the worldwide consolidation or territoriality question and the broader U.S. income tax system.[51] Under certain

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[47] *See, e.g.*, Michael Graetz & Paul Oosterhuis, *Structuring an Exemption System for Foreign Income of U.S. Corporations*, 54 NAT'L TAX J. 771, 774 (2001) (listing design options for defining business income). For example, Germany limits business income exemption to income earned in treaty countries while France employs a statutory definition. *See* AULT & ARNOLD, *supra* note 7, at 467-69 (describing exemption structures in countries including Germany and France). [also Robert Peroni, "Designing an Exemption System for Foreign Income When the Treasury is Empty"]

[48] Michael Graetz and Paul Oosterhuis have suggested that the current U.S. definition of foreign personal holding company income under subpart F would provide a natural starting point for the definition of passive income under a U.S. territorial system; foreign base company income, they propose, might be classified as business income. *See* Graetz & Oosterhuis at 774-76 (exploring the possible definition of business income, including the issue of sourcing gain on sale). In another study, Harry Grubert assumed that foreign base company income would continue to be subject to current U.S. tax. *See* Harry Grubert, *Enacting Dividend Exemption and Tax Revenue*, 54 NAT'L TAX J. 811, 813 (2001). A U.S. territorial system would likely retain a foreign tax credit mechanism for the purposes of relieving double taxation in the case where foreign-source passive income is subject to foreign income tax. *See* Graetz & Oosterhuis at 776-77 , 782-83 (considering the design of a territorial foreign tax credit system, including the question of whether it might have only two categories of income, "exempt income and income currently taxed").

[49] Each system struggles with the problem of how to ensure that business (rather than passive) income supports profits distributed as dividends. *See* AULT & ARNOLD at 476-77 (describing "CFC rules" intended to distinguish between dividends deriving from business and passive income under territorial systems). Territorial systems typically require the inclusion in income of interest and royalties paid by foreign subsidiaries to domestic corporations. Kleinbard, *supra* note 1, at [22] (describing a typical territorial system as applied to MNC featuring permanent exemption for distributed dividends but inclusion of interest and royalties paid by foreign subsidiaries to domestic corporations on the grounds that such interest and royalty payments would have been deducted abroad). *See* Terrence R. Chorvat, *Ending the Taxation of Foreign Business Income*, 42 ARIZ. L. R. 835 (2000).

[50] Tax revenue is missing from this list in an attempt to permit this brief comparison of the two systems from a revenue-neutral perspective. *Cf.* LOUIS KAPLOW, THE THEORY OF PUBLIC ECONOMICS ___ (201_). In addition, revenue neutrality within the corporate tax system comports with a common discussion framework for corporate tax reform.

[51] Note difficulties with global distributive justice theory and international tax.

relatively reasonable assumptions, worldwide consolidation does a better job than territoriality at supporting the U.S. income tax system. A key design feature of the U.S. income tax base is the inclusion of capital income;[52] collecting tax on income earned by corporations is essential to this task;[53] and a territorial corporate tax system fails to accomplish this with respect to the non-U.S. business income of U.S. firms.[54] It fails to accomplish the goal not only because the U.S. does not collect tax on such non-U.S. income under a territorial system,[55] but also because a territorial system incents other countries to lower their tax rates in an effort to attract capital[56] and because U.S. firms can shift income from their U.S. tax base to low-taxed non-U.S. countries.[57] The view that worldwide consolidation is a necessary part of the U.S. income tax system is particularly strong under the assumptions that (1) the U.S. will retain an income tax, i.e. will not replace that tax with a consumption tax;[58] (2) U.S. shareholders own, and will continue to own, U.S.-parented MNCs;[59] (3) the incidence of the U.S. corporate tax falls on owners of capital;[60] and (4) U.S.-parented MNCs will not expatriate in significant

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Benshalom, Christians.

[52] *See* SIMONS 50 (1938).

[53] *See, e.g.*, DANIEL N. SHAVIRO, DECODING THE CORPORATE TAX [Chapter 1] (2009) (articulating efficient collection and comprehensive tax base reasons for the existence of the corporate income tax).

[54] *See* J. Clifton Fleming Jr., Robert J. Peroni & Stephen Shay, *Fairness in International Taxation: The Ability-to-Pay Case for Taxing Worldwide Income*, 5 FL. TAX REV. 299, 322-323 (2001) (arguing that the ability-to-pay feature of the U.S. federal income tax requires taxing corporations on their worldwide income).

[55] In an explicitly territorial system, non-U.S. business income would be explicitly exempted. In the de facto territorial system that the U.S. now has, U.S. firms decline to repatriate income earned abroad, so that U.S. tax collections from non-U.S. business income are extremely small. *See* Kleinbard, *supra* note 1, at 723-25 (reporting "almost trivially small revenues" from taxation of foreign income of U.S.-parented MNCs).

[56] *See* Reuven Avi-Yonah, *Globalization, Tax Competition, and the Fiscal Crisis of the Welfare State*, 113 HARV. L. REV. 1573, 1586-92 (2000) (explaining race-to-the-bottom phenomenon in which source countries often lower their tax rates in an effort to attract capital and arguing that multinationals do not face a reduction in government benefits as a result of their decision to make foreign direct investments in low-tax jurisdictions).

[57] *See* Yariv Brauner, *Value in the Eye of the Beholder: The Valuation of Intangibles for Transfer Pricing Purposes*, 28 VA. TAX REV. 79, 157-59 (2008) (summarizing the tax advantages enjoyed by multinationals as a result of their ability to manipulate the pricing of intangibles); Kleinbard, *supra* note 1, at 725-26 (describing domestic base erosion strategy based on leverage).

[58] *See* Julie Roin, *Competition and Evasion: Another Perspective on International Tax Competition*, 89 GEO. L. J. 543, 579-80 (2001) (describing as "far from devastating" the possibility that tax competition will force countries to replace income taxes with consumption taxes).

[59] *See, e.g.*, Gordon, *supra* note ___, at 366-67 (arguing that significant "cross=border portfolio investment" undermines the case for worldwide consolidation).

[60] The question of corporate incidence is famously intractable. For example, Kimberly Clausing has recently summarized and criticized theoretical and empirical work suggesting that labor bears 40-100% of the corporate tax burden in an open economy. She explains

numbers.[61]

The second consideration is the impact of the choice of worldwide consolidation or territoriality on tax planning behavior. Worldwide consolidation should reduce wasteful tax planning compared to territoriality. Harry Grubert and Rosanne Altshuler have written as follows with respect to the possibility of worldwide consolidation:

> There is no efficiency loss associated with repatriating income back to the United States since all subsidiary income is taxed currently. There is no incentive to engage in income shifting: eliminating deferral removes the benefit of moving income offshore and from high-tax to low-tax locations through transfer pricing. The benefits of offshore tax havens are no longer relevant. Effective tax rates for investment in tangible and intangible assets will not vary across locations. Tax considerations will no longer affect financing decisions. Companies do not have to make expense allocations. The tax system is simpler and less wasteful.[62]

Reuven Avi-Yonah, Kimberly Clausing and Michael Durst,[63] J. Clifton Fleming,

that important variables are left out of the studies and finds no capital outflow, the presumed causal mechanism for depressed wages as a result of increased corporate taxes, in the data she examines. *See* Kimberly Clausing, *In Search of Corporate Tax Incidence*, ___ TAX L. REV. ___ (forthcoming 2012).

[61] Worldwide consolidation would hinge on the country of residence of the U.S. parent corporation, and so if firms changed their country of residence in response to the reform, it would backfire. *See, e.g.*, Gordon, *supra* note ___, at 366-67. Currently corporate residence turns mechanically on the place where the corporation is organized, such as in the state of Delaware. I.R.C. § 7701. This rule would appear to permit corporations significant latitude to elect their residence status, but relatively few U.S.-headquartered firms appear to incorporate outside the U.S. at the startup stage. *See* Eric Allen & Susan C. Morse, *No Exodus Yet*. Moreover, I.R.C. § 7874 has quite effectively blocked the expatriation of existing firms. *See* Shaviro, *supra* note ___ at 409 (explaining that expatriation absent real merger and acquisition activity is extremely difficult). This could change in response to worldwide consolidation, of course, although measures such as amending the definition of corporation residence to refer to the substance of firms' connections with the U.S. would further guard against expatriation. *See* Kleinbard, *supra* note 6, at n. 158 and TAN 167 (recommending a 50% consolidation threshold and a "mind and management" residence standard).

[62] Grubert & Altshuler, *supra* note 6, at 346 (footnotes omitted). Grubert and Altshuler describe continued tax planning incentives for U.S. corporations in excess foreign tax credit positions, which would still face an incentive to locate taxable income in low-tax countries to permit them to access tax credits. *See id.*

[63]Avi-Yonah, Clausing and Durst have devoted significant attention to the prospect of a multilateral formulary apportionment system as a solution to the problem of taxpayer planning deadweight loss. *See, e.g.*, Reuven Avi-Yonah, Kimberly A. Clausing & Michael C. Durst, *Allocating Business Profits for Tax Purposes: A Proposal to Adopt a Formulary*

Robert Peroni and Steve Shay;[64] and Ed Kleinbard[65] are among the other commentators who agree that the removal of incentives to implement fiendishly complicated offshore tax planning structures must be a priority in corporate tax reform.[66]

Addressing the problem of tax planning is more difficult within the confines of a territorial system. Territoriality faces the very difficult problem of properly assigning jurisdiction over items of income and deduction.[67] Since business income sourced outside a taxing jurisdiction escapes that jurisdiction's tax base

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Profit Split, 9 FLA. TAX REV. 497, 502 (2009) (describing an "absurdly complex" system). Avi-Yonah has expressed qualified support for the repeal of deferral. *See* Reuven Avi-Yonah, *The Ingenious Kerry Tax Plan*, 103 TAX NOTES 477 (2004) (supporting Kerry proposal despite its incompleteness); Reuven Avi-Yonah, *The Structure of International Taxation: A Proposal for Simplification*, 74 TEX L. REV. 1301, 1329-30 (1996) (noting that ending deferral with respect to controlled foreign corporations only is an incomplete solution). Michael Durst has proposed reducing the corporate tax to 15%, eliminating deferral for income of controlled foreign corporations earned in countries "with effective corporate rates lower than 90 or 95 percent of the new U.S. rate," and offsetting the resulting revenue loss with an increase in the personal income tax. Michael Durst, *Radical Centrism and the Corporate Income Tax*, TAX NOTES, Aug. 4, 2011, *available at* Lexis, TAXTXT library, 2011 TNT 172-6; Michael C. Durst, *An Employment, Equity and Competitiveness Tax Act*, TAX NOTES, Sept. 26, 2011, *available at* Lexis, TAXTXT library, 2011 TNT 186-13.

[64] *See, e.g.*, Stephen E. Shay, J. Clifton Fleming Jr. & Robert J. Peroni, *Getting Serious About Curtailing Deferral of U.S. Tax on Foreign Source Income*, 52 SMU L. REV. 455, 492 (1999) (noting "inexorable" increase in complexity, including as a result of check-the-box rules).

[65] See Kleinbard, *supra* note 6, at 66/TAN 149 (contending that territoriality is unworkable because source rules are "unimplementable as a practical matter, and bankrupt as a conceptual matter").

[66] Numerical estimates of the cost of international tax compliance are difficult to come by. One 1993 survey showed an average cost of compliance for foreign operations of large multinationals of $4.66 million. [This figure has presumably grown significantly over time.] At that time, compliance costs attributable to international operations equaled 40-50% of total compliance costs, while the percentage of revenue from international operations was far less. *See* Marsha Blumenthal & Joel B. Slemrod, *The Compliance Cost of Taxing Foreign-Source Income: Its Magnitude, Determinants and Policy Implications*, 2 INT'L TAX & PUB. FIN. 37, 40-41 (1995) (citing data from authors' survey and survey by International Tax Policy Forum).

[67] Tax commentators in countries committed to territoriality, such as Germany and Australia, acknowledge the extreme difficulty of enforcing source rules, including transfer pricing rules, as a result of MNCs' tax arbitrage planning, valuation strategies, risk allocation and contracting out of numerous functions such as manufacturing. They propose remedies such as formulary profit splits, cooperative multinational enforcement, and expansion of treaty-based permanent establishment rules. *See, e.g.*, Wolfgang Schon, *International Tax Coordination for a Second-Best World* 1 WORLD TAX J. ___ (20__) [add second and third parts of article]; Richard J. Vann, *Taxing International Business Income: **Hard-Boiled** Wonderland and the End of the World*, 2 WORLD TAX J. 291, [ ] (201_).

forever, good source rules are key to the success of a territorial systems.[68] This includes not only robust transfer pricing rules but also deduction-sourcing rules that prevent MNCs from improperly allocating deductions away from foreign source income.[69] Territoriality proposals must devote considerable attention to the project of "base protection," or ensuring that the U.S. income and deduction sourcing rules would not permit the significant erosion of the U.S. corporate tax base under territoriality.[70]

The project of developing source rules that work may even prove impossible. It is crippled by the lack of any tractable connection between source of income and economic reality. [71] Hugh Ault and David Bradford have gone so far as to argue that the source rules are simply not an economic concept, because "[i]ncome . . . attaches to someone or something that consumes or owns assets[, and] does not come from some place."[72] Although this view does not attract a consensus, it is fair to say that the very difficult project of dividing jurisdiction to tax among different nations, which is the key fault line for international business tax planning, receives much more pressure under territoriality than under worldwide consolidation.

The third issue raised in the literature that compares worldwide consolidation and territoriality is fiscal sovereignty. Sovereignty theory includes both the old-fashioned idea that a nation-state has absolute power within its borders[73] and the

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[68] *See* AULT & ARNOLD, *supra* note 7, at 447-48 (noting the "great pressure . . . put on source rules" under a territorial system). If, for example, an item of income falls within the active business category and its source falls outside a taxing jurisdiction, it has forever disappeared from the jurisdiction's capacity to tax. This contrasts with system that taxes repatriated income subject to a foreign tax credit, under which (at least theoretically) the jurisdiction gets a second opportunity to tax the item of income as a residual matter under the foreign tax credit to the extent that the source jurisdiction does not in fact impose tax.

[69] Rosanne Altshuler and Harry Grubert have identified expense allocation as a key factor that would determine whether U.S. adoption of territoriality would increase corporate tax revenue. *See* Roseanne Altshuler & Harry Grubert, *Where Will They Go if We Go Territorial?*, 54 NAT'L TAX J. 787, 798, 801 (2001) (attributing existing low current effective tax rate of excess limitation MNCs to "tax minimizing repatriation behavior" and "ability to deduct overhead expense at the U.S. rate" and stating that "dividend exemption with expense allocation [that works] is likely to increase effective tax rates relative to the current system").

[70] *See, e.g.*, Sullivan, *supra* note ___ (noting that revenue estimates would vary greatly depending on the details of the interest expense allocation rules under the Camp territoriality proposal).

[71] *See* Kleinbard, *supra* note 6, at 66/TAN 149 (contending that territoriality is unworkable because source rules are "unimplementable as a practical matter, and bankrupt as a conceptual matter").

[72] *See* Hugh J. Ault & David F. Bradford, *U.S. Taxation of International Income*, *in* TAXATION IN THE GLOBAL ECONOMY ___, 30-31 (Assaf Razin & Joel Slemrod eds. 1990)

[73] *See* Diane Ring, *What's At Stake in the Sovereignty Debate*, 49 VA. J. INT'L L. 156, 160 (2009) (describing "core elements" of sovereignty concept as including the

more modern concept that legitimate sovereignty comes with a responsibility to meet certain basic needs and human rights standards.[74] As Diane Ring has explained, one way to describe the implications of sovereignty in the tax context is to acknowledge the importance of (1) capacity to raise revenue and (2) "fiscal sovereignty," or the power to choose a public finance system (including both taxation and spending) within a framework of macroeconomic, redistributive and other policy goals.[75] As described above in the discussion of the relationship between worldwide consolidation and the U.S. income tax system, worldwide consolidation generally supports an important part of the chosen U.S. public finance system, and thus it supports U.S. fiscal sovereignty.

Some argue that worldwide consolidation by the United States would violate non-U.S. nations' fiscal sovereignty. For example, Nan Kaufman writes that "the sovereign's general lack of power over wealth existing outside its borders makes benefit taxation of foreign source income illegitimate,"[76] and argues that fairness thus framed requires the allocation of more jurisdiction to source countries.[77] In contrast, a territorial approach to taxing business income, including the de facto U.S. system, derives at least in part from the benefits taxation concept of economic allegiance.[78] Territorial systems are consistent with the benefits taxation idea that each country should have "source" jurisdiction over items of active business income properly attributable to that country's economy.[79]

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requirements of "'territory, people and a government'" and the idea that "the state represents the supreme source of authority on internal matters") (quoting MICHAEL ROSS FOWLER & JULIE MARIE BUNCK, LAW, POWER & THE SOVEREIGN STATE 33 (1995) (citing among others ALAN JAMES, SOVEREIGN STATEHOOD 13, 228-29 (1986)).

[74] *See* Diane Ring, *What's At Stake in the Sovereignty Debate*, 49 VA. J. INT'L L. 156, 162-63 (2009) (explaining implications of expanding the concept of sovereignty to include "legitimacy and responsibility").

[75] *See* Diane Ring, *What's At Stake in the Sovereignty Debate*, 49 VA. J. INT'L L. 156, 167-70 (2009) (identifying revenue and fiscal sovereignty as the two "dominant functional reasons" why sovereignty is relevant for international tax policy).

[76] Nancy H. Kaufman, *Fairness and the Taxation of International Income*, 29 L. & POL'Y INT'L BUS. 145, 169 (1998).

[77] *See* Nancy H. Kaufman, *Fairness and the Taxation of International Income*, 29 L. & POL'Y INT'L BUS. 145, 198 (1998) (basing an internation equity analysis on the question of the "economic allegiance" of "income produced by international transactions"); Jinyan Li, *Improving Inter-nation Equity Through Territorial Taxation and Tax Sparing*, *in* GLOBALIZATION AND ITS TAX DISCONTENTS: TAX POLICY AND INTERNATIONAL INVESTMENTS: ESSAYS IN HONOR OF ALEX EASSON 117, 128 (Arthur J. Cockfield ed. 2010) ("[T]erritorial taxation of business profits would promote inter-nation equity . . . .").

[78] *See* Michael J. Graetz & Michael M. O'Hear, 46 DUKE L. J. 1021, 1077-78, 1080-81 (1997) (describing the 1923 League of Nations "economic allegiance" principle and also the allocation of more jurisdiction to source countries under a subsequent, "more practical" 1925 United Nations report).

[79] *See* Roin, *supra* note 58, at 603 ("Source countries should remain free to use tax policies to attract business investment, just as residence countries should have the right to tax their residents to support the social services . . . that they enjoy."). David Hasen, FLTXR (2012).

Advocates of benefits taxation-based territoriality might object to worldwide consolidation on the grounds that it usurps a non-U.S. country's right to decide whether to tax income properly allocable to the non-U.S. country and relatedly what public benefits to provide. But this argument is limited by the limited integrity of the source rules that determine how to allocate income. In particular, a tax haven country to which items of MNC income are allocated purely as a tax planning expedient cannot reasonably claim that it violates benefits taxation for the U.S. to tax items of income that have no economic connection to the tax haven country either.[80]

A U.S. trading partner with significant real economic connections to U.S.-parented MNC activity might have a stronger fiscal sovereignty-based objection to the U.S. adoption of worldwide consolidation. But such a non-U.S. trading partner should not currently object to the worldwide consolidation policy with a foreign tax credit except to the extent that the non-U.S. country prefers a corporate income tax rate that is lower than the U.S. rate adopted under worldwide consolidation.[81] Note also that a U.S. trading partner would find it easier to enact and/or enforce a robust corporate income tax if the U.S. did likewise. As Appendix A shows, OECD members, which include the largest U.S. trading partners, have stated combined national and subnational tax rates that average 25%. The weighted average statutory rate for the five largest U.S. trading partners is 29%.[82]

One caveat involves possible future tax policy developments. For example, what if future technology improvements permit an electronically enforced progressive consumption tax that does not require the filing of individual tax returns, permitted politically feasible negative tax distributive features, and supported near-perfect border controls?[83] In this situation, a country that formerly preferred a corporate income tax as part of a comprehensive income tax system may now prefer a progressive consumption tax, but will have little incentive to repeal its corporate income tax in favor of the consumption tax because the U.S.

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[80] *See* Kleinbard, *supra* note 1, at 753 (arguing that even if source rules were "economically rational," "stateless income tax planning" produces the result that "there can be no meaning at all to source").

[81] *Cf.* Kleinbard, *supra* note 6 at TAN 184 or p. 86 (noting that under worldwide consolidation there would exist "a circumscribed range of plausible corporate tax rates that a country might adopt").

[82] This figure is based on Census Bureau information about the five largest U.S. trading partners – Canada, China, Mexico, Japan and Germany – in November 2011. *See* U.S. Census Bureau, Top Trading Partners – Total Trade, Exports, Imports, http://www.census.gov/foreign-trade/statistics/highlights/top/top1111cm.html#total. It is also based on OECD-reported combined tax rates. *See* MARTIN SULLIVAN, CORPORATE TAX REFORM: TAXING PROFITS IN THE 21ST CENTURY 50 (2011) (giving rates for OECD countries).

[83] *Cf.* MICHAEL GRAETZ, ONE HUNDRED MILLION UNNECESSARY RETURNS: A SIMPLE, FAIR, AND COMPETITIVE TAX PLAN FOR THE UNITED STATES (2008).

will reclaim the ceded income tax jurisdiction.[84]

Worldwide efficiency, or the goal of maximizing global economic productivity, is the fourth factor in the debate between advocates of worldwide consolidation and advocates of territoriality. It is also the most prominent factor in the list. The theories of capital export neutrality (CEN) and capital ownership neutrality (CON) currently dominate the efficiency debate.[85]

Proponents of the theory of capital export neutrality (CEN) argue that worldwide consolidation maximizes worldwide economic welfare. This is because worldwide consolidation would result in the same tax burden on U.S. investment no matter what the investment location, thus promoting an efficient allocation of U.S. capital and in particular avoiding a situation where U.S. firms invest abroad rather than at home in part because of lower tax rates abroad.[86] The theory of capital export neutrality has particular force if the U.S. is the predominant source of global investment capital and the location of investment is flexible.[87]

CEN is weaker if non-U.S. investment capital tends to flow into the U.S. to fund investments that U.S. investment capital has not financed and/or if the supply of capital is sufficient to fund all worthwhile investments. Some empirical evidence demonstrates that non-U.S. investment capital does flow into the U.S. to offset capital flows out of the U.S. Some also argue that the supply of capital, especially if debt financing is available, does not limit firms' investment opportunities. Finally, there is empirical evidence that suggests that investments made by U.S. firms outside the U.S. tend to cross-pollinate or otherwise encourage investment opportunities inside the U.S.[88] If there exist vigorous cross-border flows of investment funds and/or sufficient funds to finance all worthwhile investments, the worldwide efficiency focus shifts away from CEN's concern with what investments will be funded and toward the question of who will own

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[84] [Insert cites re: historical examples: British income tax; French development of VAT (Ebrill et al for latter).]

[85] A third theory, that of capital import neutrality or CIN, argued that investments in a particular country should face the same tax rates in order to permit investors in that country to allocate their capital efficiently among investment choices. CIN supported territoriality. As described in the text, the current leading theory in support of territoriality is capital ownership neutrality. *See, e.g.*, Wolfgang Schoen, *International Tax Coordination for a Second-Best World*, 1 WORLD TAX J. 67, 80-82 (2009) (noting that "the concept of CIN is deeply rooted in the idea of a traditional unity of state, territory and market, which simply has evaporated over the decades" but that "[t]he CON concept has somehow reinvigorated the outcome of the CIN analysis).

[86] *See* DEP'T OF TREASURY, OFF. OF TAX POLICY, DEFERRAL OF INCOME EARNED THROUGH CONTROLLED FOREIGN CORPORATIONS: A POLICY STUDY 26-42 (December 2000) (summarizing capital export neutrality-based literature).

[87] *See* Jane G. Gravelle, *International Corporate Tax Reform: Issues and Proposals*, 9 Fla. Tax Rev. 479 (2009) (arguing that CEN trumps CON if capital is mobile).

[88] *See* Mihir A. Desai, C. Fritz Foley & James R. Hines Jr., *Domestic Effects of the Foreign Activities of U.S. Multinationals*, 1 AM. ECON. J.: ECON. POL'Y 181 (2009).

investment opportunities.[89]

The theory of capital ownership neutrality (CON) concerns itself with this question of ownership. CON proponents argue that U.S. adoption of territoriality would maximize worldwide economic welfare. This is because imposing the same rate of tax on returns on an asset located within a particular country regardless of the asset's owner would put U.S. firms on an even footing with other firms when bidding to buy such assets.[90] In contrast, worldwide consolidation could impose a higher U.S. tax rate on returns on non-U.S. assets relative to a lower tax rate on those same returns imposed for another prospective buyer subject only to territorial systems. A rate discrepancy produced by U.S. worldwide consolidation could thus permit non-U.S. investors to outbid U.S.-parented MNCs and purchase non-U.S. assets, even if the U.S. investors would make more productive use of the asset.[91] Relatedly, it could encourage firms to avoid the U.S.-parented MNC structure and/or incent portfolio investors to direct their capital away from U.S.-parented MNC firms.

The fifth thread in the debate between worldwide consolidation and territoriality concerns national efficiency. Commentators including Michael Graetz[92] and Dan Shaviro[93] have considered the question of why worldwide welfare, rather than national welfare, should be the standard by which U.S. business taxation policy is judged. The policy prescriptions under national efficiency theories do not necessarily follow the binary choice framework of

[89] *See, e.g.*, Desai, Foley, Hines, *Tax Policy and the Efficiency of U.S. Direct Investment Abroad*, 64 NATL TAX J 1055 (2011) (arguing that since returns on equity and debt investment from overseas exceed amounts invested overseas, US tax system does not unduly favor foreign investment).

[90] *See* Mihir A. Desai & James R. Hines Jr., *Evaluating International Tax* Reform, 56 NAT'L TAX J. 487, 494 (2003) ("The United States would reduce world welfare by taxing foreign income while permitting taxpayers to claim foreign tax credits, since such as system encourages American firms to purchase assets in high-tax countries and foreign firms to purchase assets in low-tax countries. These tax incentives distort the allocation of ownership away from one that is strictly associated with underlying productivity differences.")

[91] Desai and Hines state that CON would also be satisfied by all countries' adoption of worldwide consolidation systems with foreign tax credits. *See* Desai & Hines, *supra* note 90, at 494-95 ("CON requires that income is taxed at rates that, if they differ among investors, do so in fixed proportions").

[92] *See* Michael J. Graetz, *Taxing International Income: Inadequate Principles, Outdated Concepts, and Unsatisfactory Policies*, 54 TAX L. REV. 261, 280-82 (2001) (questioning why U.S. policymakers should focus on the welfare of all the world rather than prioritizing U.S. welfare).

[93] *See* Daniel Shaviro, *Why Worldwide Welfare as a Normative Standard in U.S. Tax Policy?*, 60 TAX L. REV. 155, 164-65 (2007) (explaining that worldwide welfare may improve national welfare by way of encouraging cooperative behavior, but adding that under this theory unobservable defections should also improve national welfare).

worldwide consolidation or territoriality.[94]

For example, the nationally-oriented cousin of CEN, national neutrality, predicts highest U.S. welfare under a U.S. worldwide consolidation system that denies a credit for foreign income taxes, and provides a deduction instead, in part under the theory that U.S. tax revenue is better than non-U.S. tax revenue.[95] At the same time, the goal of national welfare might sometimes support encouraging non-U.S. investment, perhaps through an explicitly lower tax rate on foreign income, if not through a foreign tax credit. For adherents of CON, however, the related national ownership neutrality theory predicts that territoriality will maximize national welfare just as it maximizes worldwide productivity, and by the same mechanism: directing investments, including investments by U.S. firms, to their highest and best use, which will improve the productivity and profitability of the U.S. firms and consequently the welfare of their shareholders, employees and consumers, assuming that these are predominantly U.S.[96]

B. Implicit Taxation and a Lower U.S. Corporate Tax Rate

Ownership neutrality theory provides the most well-developed set of objections to worldwide consolidation. One central concern of CON and its national ownership neutrality counterpart is that a higher worldwide consolidation U.S. tax rate compared to territorial tax rates prevalent in non-U.S. countries would cause U.S. firms to underbid for, and lose, investment opportunities in non-U.S. countries. The key concern of this argument stems from an assumed difference in rates. An ownership could: (1) depress the value of such non-U.S. investments in the hands of U.S. firms; (2) discourage cross-border investment and (3) encourage firm expatriation and (4) incent investors' migration to investments in non-U.S. rather than U.S. firms.

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[94] *See, e.g.*, Graetz, *supra* note 92, at 282 (contending that promoting domestic investment, as CEN emphasizes, or foreign investment, as CON emphasizes, may best support U.S. interests depending on specific circumstances and empirics).

[95] The CEN-based view of maximizing national welfare, in addition, recommends that foreign taxes receive less-generous deduction treatment, rather than supporting a foreign tax credit. *See* Peggy B. Musgrave, *Combining Fiscal Sovereignty and Coordination: National Taxation in a Globalizing World*, *in* THE NEW PUBLIC FINANCE: RESPONDING TO GLOBAL CHALLENGES (2006) 167, 178 ("[U]nder what may be called a 'national' view of taxpayer equity the foreign tax is treated as a deduction from foreign source income (in effect, a cost of doing business), and the residence country's corporate tax is applied to foreign earnings net of foreign tax.") [Add cites to earlier Musgrave/Richman books here and above.] *See also* Daniel Shaviro, *The Case Against Foreign Tax Credits*, 3 J. LEG. ANALYSIS 65, 66-68 (2011) (arguing that the important difference between tax collection by a non-U.S. country and tax collection by the U.S. merits mere deductibility of foreign income taxes).

[96] *See* Desai & Hines, *supra* note 90, at 496 (arguing that territoriality promotes national welfare by maximizing the productivity of U.S. firms, and that foreign investment in U.S. assets will flow into any space left by U.S. firms' decisions to invest abroad).

The sale of fixed assets by U.S.-parented MNCs to non-U.S.-parented MNCs upon the adoption of worldwide consolidation is one possible outcome predicted by ownership neutrality theory. It involves a transfer of value from U.S.-parented MNCs to non-U.S.-parented MNCs. Particularly if share ownership generally tracks corporate residence of parent corporations, this could translate to a transfer of value from U.S. citizens and residents to non-U.S. citizens and residents.

A second cost that ownership neutrality adherents might identify as a result of worldwide consolidation is the so-called clientele effect: the likely shifting of investment by U.S.-parented MNCs away from non-U.S. investments and toward U.S. investments. This is problematic, under the theories of capital ownership neutrality and national ownership neutrality, to the extent that it results in a decrease in the productivity of the investments at issue. Particularly for non-U.S. assets with a fixed non-U.S. location, ownership neutrality theory predicts that U.S. worldwide consolidation in the presence of non-U.S. territoriality would result in the ownership of a certain asset by an investor (presumably a non-U.S., lower-taxed investor) who cannot earn as much from the asset compared to the U.S. investor on a pre-tax basis, but earns more on an after tax basis. The idea is that this might reduce both worldwide efficiency and the real productivity of U.S.-parented MNCs.

The third and fourth possible costs suggested by ownership neutrality theory are presented by the possibility that decreased after-tax rates of returns on non-U.S. assets available to U.S.-parented MNCs, relative to those available to non-U.S.-parented MNCs, would provoke U.S.-based businesses to seek tax status as non-U.S. parented firms and/or would incent portfolio investors to sell ownership interests in U.S. firms and purchase ownership interests in non-U.S. firms, thus reducing the pool of capital from which U.S. firms could draw and presumably increasing the cost of that capital. As to the first, anti-inversion rules make it difficult for existing U.S.-parented MNCs to change their status absent a strategic or financial acquisition transaction.[97] Early-stage firms headquartered in the U.S. appear to generally choose U.S. incorporation, perhaps for reasons including substantive law preferences, market signaling, and path dependence relating to advisors' suggestions for firm organization.[98] And other laws turning on management and control or U.S. shareholder ownership thresholds might help preserve the tendency of firms that originate in the U.S. to incorporate in the U.S. Still, acquisition and initial organization decisions provide two paths that could

[97] *See* I.R.C. § 7874; Shaviro, *supra* note __ (re: rising electivity of corporate residence). It might be possible for some firms to change shift their location outside the U.S. to a place where they have a substantial business presence. E.g. Aon (January 2011 news – Chicago Tribune).

[98] *See* Eric J. Allen & Susan C. Morse, *Firm Incorporation Outside the U.S.: No Exodus Yet* (Oct. 2011), *available at* http://papers.ssrn.com/sol3/papers.cfm?abstract_id=1950760 (finding that only 47 firms in a sample of almost 3000 U.S. IPOs were headquartered in the U.S. and incorporated outside the U.S.).

drive firms outside the U.S.[99] Inversion with the cost of a shareholder-level tax into a structure parented by a corporation located in a jurisdiction where the firm has a material business is an option.[100] And nothing prevents portfolio investors from selling and buying stocks and bonds.

Implicit taxation analysis provides the key to understanding each of these concerns expressed by ownership neutrality theory. The idea that after-tax returns adjust to a single equilibrium rate drives implicit taxation. A tax applies to a certain type of asset initially decreases the asset type's after-tax return, but under the assumption that after-tax returns converge, the price of the taxed asset will decrease until the asset produces the equilibrium after-tax return.[101] Ownership neutrality theory would have particular force at the moment of adoption of worldwide consolidation, since most assets located outside the U.S. at that moment would have a more or less fixed location.[102]

The implicit tax analysis of a worldwide consolidation reform presented by ownership neutrality theory depends on assumptions about pre-enactment (ex ante) and post-enactment (ex post) corporate income tax rates imposed on non-U.S. business income earned by U.S.-parented MNCs compared to other firms. Under the reasonable assumption that the U.S. currently has a de facto territorial system, the pre-enactment rate of tax imposed on non-U.S. business income depends on the income tax imposed by non-U.S. countries.

Appendix A shows a table of tax rates of OECD countries in 2011. The U.S. combined national and local statutory rate is 39.2%.[103] The OECD average is 25%;[104] the average statutory combined national and sub-national rate of the top five U.S. global trading partners weighted by percent contribution to total imports and exports is 29.0%.[105]

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[99] Mihir Desai, *Decentering*; Shaviro, *supra* note __ (re: rising electivity). Note also Aon expatriation announced 2012 to UK.

[100] U.S.-based Aon Corporation announced such an inversion into a UK-parented structure in early 2012.

[101] *See* MYRON S. SCHOLES ET AL., TAXES AND BUSINESS STRATEGY: A PLANNING APPROACH 91-100 (2d ed. 2002) (explaining implicit taxation mechanism); add Graetz paper on municipal bonds.

[102] Even an asset like a customer service center or assembly plant or server farm that might initially have flexible location significantly affected by taxes will generally, once in place, be difficult and/or expensive to move.

[103] Given a top federal rate of 35%, this assumes a combined state and local corporate income tax rate of about 6.5%. Because the 6.5% tax paid to state and local governments is deductible for federal income tax purposes, the combined tax works out to 39.2%.

[104] *See* MARTIN SULLIVAN, CORPORATE TAX REFORM: TAXING PROFITS IN THE 21ST CENTURY 50 (2011) (giving rates for OECD countries).

[105] This figure is based on Census Bureau information about the five largest U.S. trading partners – Canada, China, Mexico, Japan and Germany – in November 2011. *See* U.S. CENSUS BUREAU, TOP TRADING PARTNERS – TOTAL TRADE, EXPORTS, IMPORTS, http://www.census.gov/foreign-trade/statistics/highlights/top/top1111cm.html#total. It is

However, some empirical studies indicate that the actual tax rate paid by U.S. multinationals with respect to foreign active business income is much lower than non-U.S. statutory rates suggest, in part because non-U.S. laws permit tax base erosion. Recent studies using Treasury and IRS data indicate that the rates in the mid-2000s were around 16%. This is a reduction from the 21% or so indicated in the mid-1990s.[106]

In addition, the use of existing average statutory rates of return is misleading. The effective tax rate could be substantially less than the statutory rate, and the gap between statutory and effective rates could be greater in non-U.S. countries than in the U.S. The importance of this concern is not clear. Some empirical evidence suggests that effective tax rates applicable to EU-parented multinationals are in the range of 27 – 31%, comparable to the U.S. effective rate.[107] And it may be more difficult for non-U.S. parented MNCs than for U.S.-parented MNCs to erode their non-U.S. tax bases.[108] But effective rates could vary significantly depending on the firm or the country; and it could be the case that the difference between statutory and effective rates is greater – i.e., tax planning to reduce the effective tax rate is easier – in some countries relative to others.

Moreover, some non-U.S. countries have significantly lower statutory corporate income tax rates. Ireland provides an OECD example, at 12.5%. And, it is possible that non-U.S. countries will reduce their corporate tax rates in response to a U.S. worldwide consolidation reform, for example in an effort to give their firms precisely the bidding edge that ownership neutrality predicts.

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also based on OECD-reported combined tax rates. *See* MARTIN SULLIVAN, CORPORATE TAX REFORM: TAXING PROFITS IN THE 21ST CENTURY 50 (2011) (giving rates for OECD countries). [Add cite to 2/2012 Administration Corp Tax Reform proposals, giving different calculation but with roughly consistent results.]

[106] *See* Harry Grubert, Foreign Taxes, Domestic Income, and the Jump in the Share of Multinational Company Income Abroad: Sales Aren't Being Globalized, Only Profits 11 (Dec. 11, 2009) (unpublished paper, *available at* http://web.gc.cuny.edu/economics/SeminarPapers/spring2010/Grubert_March16.pdf) (reporting an effective foreign tax rate for foreign subsidiaries of 21.3% in 1996 and 15.9% in 2004), *Controlled Foreign Corporations, 2006,* IRS Statistics of Information Bulletin, Summer 2010, _____ (reporting a 2006 effective rate of 16.4% for U.S.-parented MNCs' controlled foreign corporations).

[107] *See* Reuven Avi-Yonah & Yariv Lahav, *The Effective Tax Rates of the Largest US and EU Multinationals*, ___ TAX L. REV. ___ (forthcoming 2012) draft at 7-8, 16 (citing other studies and fresh empirical evidence).

[108] See Kleinbard, *supra* note 1.

Conforming the statutory U.S. combined rate of return to the statutory combined rate of return of major U.S. trading partners thus only partly addresses the concerns expressed by ownership neutrality theory. Table 1 illustrates these concerns based on the following assumptions:

- Ex ante combined tax rate, non-U.S. profits of U.S.-parented MNC = 16%[109]
- Ex post combined tax rate, non-U.S. profits of U.S.-parented MNC = 30%[110]
- Combined tax rate, non-U.S. profits of non-U.S. parented MNC = 29%[111]
- Combined tax rate, non-U.S. profits of non-U.S. parented MNC = 20%[112]
- After-tax rate of return = 10%

TABLE 1: IMPLICIT TAXATION RESULTS FOR NON-U.S. ASSETS OWNED BY U.S. MNCS ON ADOPTION OF WORLDWIDE CONSOLIDATION

	Pre-tax return	Ex ante after-tax return	Ex post after-tax return before investment shifting
Non-U.S. asset valued at 1000 ex ante held by U.S. MNC: ex ante rate = 16% ex post rate = 30%	119	100	83
Non-U.S. asset valued at 1000 if held by non-U.S. MNC with tax rate of 29%	119	84	84
Non-U.S. asset valued at 1000 if held by non-U.S. MNC with tax rate of 20%	119	95	95

Table 1 illustrates the concern about likely declines in the after-tax returns from non-U.S assets held by U.S. MNCs upon worldwide consolidation. Declines in after-tax returns from non-U.S. assets might translate to declines in the value of those assets in U.S. MNCs' hands and to an incentive to sell the assets or avoid the U.S.-parented MNC business firm form. If the U.S. worldwide consolidation

[109] This 16% rate is based on empirical findings, cited above, that existing U.S. MNCs appear to pay about this rate of tax on average on their non-U.S. earnings currently.

[110] A federal rate of 25% translates to a combined rate of about 30% assuming a state and local tax rate of 6.5% will almost eliminate this rate differential. This 6.5% rate is built into the OECD's current calculation of the U.S. combined rate of 39.2%.

[111] This 29% rate equals the weighted average statutory rate of corporate income tax for the five largest U.S. trading partners.

[112] This 20% is a placeholder rate intended to illustrate the implicit taxation results if the effective tax rate actually applicable to an important group of non-U.S. parented MNCs is significantly below the U.S. worldwide consolidation rate.

corporate income tax rate is close to the rate applicable to non-U.S. firms – if, for example, the U.S. combined rate is 30% and the non-U.S. combined rate is 29% -- the implicit taxation concerns of ownership neutrality theory are minimized. If the rates diverge, ownership neutrality concerns become more prominent.

In the stylized example above, the ex post after-tax return of 83 that the U.S.-parented MNC would obtain from the non-U.S. asset initially valued at 1000 is quite close to the after-tax return of 84 that a non-U.S. parented MNC taxed at 29% would earn from the same asset. But the same after-tax return of 83 for a U.S.-parented MNC is significantly lower than the after-tax return of 95 that a non-U.S.-parented MNC subject to a hypothetical tax rate of 20% could earn. This illustrates the concern of ownership neutrality theory that worldwide consolidation risks asset-shifting that is disadvantageous to U.S.-parented MNCs to the extent that relevant competitors face a corporate tax rate that is less than that imposed by worldwide consolidation.

The concerns described above derive from the premise of a high U.S. rate of corporate income tax imposed on non-U.S. business income relative to a low rate of corporate income tax imposed on non-U.S. business income by other countries, primarily U.S. trading partners. Since the objections of ownership neutrality theory decrease as the gap between the U.S. and non-U.S. tax rates decreases, worldwide consolidation looks less risky as the adopted U.S. corporate rate approaches the non-U.S. corporate income tax rate.[113] For example, if the target combined rate is about 30%, as is suggested by the statutory and effective rates reported for major trading partners, the federal rate should be about 25%, which translates to a combined rate of about 30% assuming a state and local tax rate of 6.5%.

C. Why 25%?

It might be argued that the right goal for the U.S. corporate rate is to reduce the corporate income tax rate as far as possible, or in any case to 16%, which is the level of the reported combined effective tax rate on offshore income earned by U.S.-parented MNCs.[114] Yet reducing the U.S. corporate income tax rate below the stated statutory rates of U.S. trading partners carries the risk of undermining those U.S. trading partners' tax policies. It is possible, for example, that even if German income earned by U.S. MNCs is in fact taxed at 16%, rather than the combined statutory German rate of 30.2%, Germany would prefer to counteract

[113] *See* Sullivan, *supra* note __, at 45-47 (explaining the argument for lowering the corporate rate rather than providing for targeted tax breaks).

[114] *See, e.g.*, Michael Durst, *Radical Centrism and the Corporate Income Tax*, TAX NOTES, Aug. 4, 2011, *available at* Lexis, TAXTXT library, 2011 TNT 172-6 (recommending 15% rate); Michael C. Durst, *An Employment, Equity and Competitiveness Tax Act*, TAX NOTES, Sept. 26, 2011, *available at* Lexis, TAXTXT library, 2011 TNT 186-13 (same).

base erosion and enforce its stated rate of 30.2%. If this is the case, the U.S. adoption of a federal rate of 25%, which produces a combined U.S. effective rate of 29.9%, would comport with and support German policy, while U.S. adoption of a federal rate of 16% might be viewed as tax competition.

In addition, the linear relationship between the marginal increase in the income tax rate applied to non-U.S. assets owned by U.S. MNCs and the predicted marginal reduction in an asset's after-tax return may have limited prediction power. It does not follow that there is a linear relationship between the income tax rate applied to non-U.S. assets and the magnitude of actual adverse results of loss in value for U.S.-parented MNCs, the shift in U.S.-parented MNCs' investment away from non-U.S. assets and toward U.S. assets, or the likelihood that U.S.-headquartered MNCs will start to incorporate outside the U.S. and/or that U.S. investors will sell U.S. stocks and bonds and buy non-U.S. investments. The actual relationship depends on the way in which the tax rate information is interpreted and used by the driver of a decision to sell an asset or make an investment decision.

This decisionmaker – for example, a corporate tax director – understands and models the decision based on his or her understanding and belief about what the corporate tax rate will be in different countries. The decisionmaker must balance tax and other concerns such as staffing, security, publicity, corporate governance, and transaction costs. He or she might use imprecise rules of thumb about the corporate tax rates in different countries, perhaps rounding the tax rate, using only the federal and not the combined rate, or using the statutory rate in some cases and a well-publicized effective rate in other cases.[115] The decisionmaker might be significantly influenced by advisor communities following rules of thumb developed on a consensus or imitative basis,[116] which may be subject to sudden or trend changes rather than smooth incremental changes.

It is relevant, for example, that pro-business figures have targeted 25% as the appropriate U.S. federal rate. Republican politicians including presidential candidate Mitt Romney and Representative Camp have proposed a 25% corporate rate. It may be that they understand from business leaders or predict from experience that a 25% federal rate would be a psychologically important level that conveys competitiveness and reduces tax-motivated planning as a result. This could be because a 25% federal rate is described as on a par with the OECD average, even though the OECD average relates to combined national and subnational rates and even if the OECD average describes statutory rates that differ from effective rates. In other words, it is possible that the resulting benefits of less

[115] I am not aware of empirical studies on this question of perceived or heuristic corporate tax rates.

[116] Corporate law literature has documented the impact of lawyers' habits on firms' decisions. *See, e.g.*, John Coates IV, *Explaining Variation in Takeover Defenses: Blame the Lawyers*, 89 CAL. L. REV. 1301 (2001); Daines, *The Incorporation Choices of IPO Firms*, 77 N.Y.U. L. REV. 1559-1661 (2002).

taxpayer planning – whether under a worldwide consolidation reform or a territoriality reform -- could be particularly material at a rate of 25% because of heuristics.

II. A CORPORATE OFFSHORE EXCISE TAX

A. Design Constraints

1. A Starting Point

The core idea of a COET is to impose a tax on the unrepatriated offshore earnings of U.S.-parented MNCs. Under current law, business income earned and retained offshore by a non-U.S. subsidiary of a U.S.-parented MNC is not taxed currently, assuming that the income does not fall into any category of taxable "subpart F" income,[117] which good planning typically can ensure.[118] Upon repatriation, the dividends received from a non-U.S. subsidiary are taxed to the U.S.-parented MNC at the prevailing corporate rate, subject to the foreign tax credit, which, very roughly, is intended to reduce the U.S. tax due by the foreign income tax previously imposed on the repatriated income, so long as that foreign income tax was not imposed at a rate higher than the U.S. rate.[119]

It is useful to set forth as a starting point the design a COET would take if it were intended to mimic the effect of a tax imposed on previously earned unrepatriated non-U.S. earnings of U.S.-parented MNCs as if worldwide consolidation had been the applicable corporate income tax rule all along. A tax like this might ask a U.S.-parented MNC to go back to each tax year of its non-U.S. subsidiaries and (1) determine the amount of taxable income earned by those non-U.S. subsidiaries; (2) subtract repatriated earnings and taxed subpart F income; (3) calculate a tentative tax at the rates in effect during each year, respectively; (4) reduce the tentative tax by foreign taxes paid (and not otherwise credited) that year, adjusted for relevant carryovers and carrybacks; and (5) apply an appropriate interest charge to the final tax bill.

2. Revenue

One goal of a COET is to raise revenue to help pay for corporate tax reform. Reducing the U.S. corporate tax rate to 25% in connection with a worldwide consolidation or territoriality reform requires revenue, perhaps about $1 trillion over the budget window of ten years.[120] Some revenue could be raised by familiar

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[117] I.R.C. §§ 951 et seq.

[118] E.g. Stephen E. Shay, *Plain Vanilla Subpart F Planning* ,TAXES (20__).

[119] I.R.C. §§ 901 – 904.

[120] *See* JOINT COMMITTEE ON TAXATION, ESTIMATED REVENUE EFFECTS OF S. 3018 (Nov. 2010) (giving a "very preliminary" ten-year cost estimate of the Wyden-Coats 24% "corporate flat tax" as $1.1 trillion).

base-broadening measures, such as the repeal of accelerated depreciation and the domestic production activities deduction,[121] in addition to the repeal of deferral itself.[122] But such existing revenue raisers appear insufficient to reduce the U.S. federal corporate tax rate to 25%.[123] Other measures, such as increasing income tax revenues or implementing a VAT could also provide revenue sufficient to permit a 25% corporate rate, but these face significant political obstacles.

3. Constitutionality

Even if the "modern Supreme Court" has not struck down a retroactive tax statute on Constitutional grounds,[124] and roundly dismisses challenges to retroactive taxes under the ex post facto clause[125] and the equal protection clause (absent a situation that calls for other than rational basis review)[126], it has taken some recent retroactive tax substantive due process claims seriously. In its 1994 *Carlton* case, for example, the Court upheld a retroactive statute against a due process challenge but emphasized the "modest" length of time – about one year --

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[121] *See* Memorandum from Thomas A. Barthold, Joint Committee on Taxation, Oct. 17, 2011 (citing "very preliminary" estimates provided in connection with Camp bill that show ten-year revenue of about $724 billion from repeal of accelerated depreciation; $164 billion from repeal of the domestic production activities deduction, $160 billion from repeal of R&D expensing, and $70 billion from repeal of LIFO accounting.

[122] *See* CONGRESSIONAL BUDGET OFFICE, REDUCING THE DEFICIT: SPENDING AND REVENUE OPTIONS 186 (March 2011) (providing a revenue estimate of about $114 billion); JOINT COMMITTEE ON TAXATION, ESTIMATED REVENUE EFFECTS OF S. 3018, THE "BIPARTISAN TAX FAIRNESS AND SIMPLIFICATION ACT OF 2010" (Nov. 2010) (providing a ten-year revenue estimate of $583 billion for deferral repeal together with the application of per-country foreign tax credit rules); *see also* Altshuler & Grubert, *supra* note 6, at 347 (reporting static calculation of burden-neutral 28% rate on foreign corporate income only under worldwide consolidation assuming no changes to domestic corporate income tax rules and no taxation of "the pool of previously unrepatriated income").

[123] *See* Jane G. Gravelle, *Reducing Depreciation Allowances to Finance a Lower Corporate Tax Rate*, 64 NAT'L TAX J. 1039, 1052 (2011) (arguing that repealing accelerated depreciation will not raise as much revenue as suggested outside the constraint of the budget window and pointing out that some suggested base broadening measures would also hurt unincorporated businesses); Jane G. Gravelle, *Practical Tax Reform for a More Efficient Income Tax*, 30 VA. TAX REV. 389, 402-06 (2010) (listing and evaluating different base broadening options, including deferral repeal); Martin A. Sullivan, *Testimony Before the House Ways & Means Committee*, Nov. 17, 2011, part VI, *available at* LEXIS, TAXTXT file, 2011 TNT 23-35 (arguing that existing revenue raisers in Camp plan would not provide sufficient room to reduce the corporate tax rate).

[124] Saul Levmore, *The Case for Retroactive Taxation*, 22 J. LEG. STUD. 265, 270 n. 12 (1993). *See* Charlotte Crane, *Constitutional Limits on the Power to Impose a Retroactive Tax*, *in* BLESSINGS OF LIBERTY: THE CONSTITUTION AND THE PRACTICE OF LAW 245, 248-49 (1988) (noting that the Court has invalidated only a few retroactive gift and other transfer taxes at "initial enactment," and at the height of the Court's substantive due process jurisprudence on the 1920s).

[125] The ex post facto clause limits changes in criminal, but not civil, statutory law.

[126] *See* Welch v. Henry, 305 U.S. 134, ___ (1938).

between the enactment of the statute and the retroactive amendment to the statute.[127] In a concurrence, Justice O'Connor suggested that more than one year's retroactivity would be problematic.[128] At least one state court has held that a retroactive tax violated the due process clause under the *Carlton* precedent because its retroactivity exceeded a "modest" length of time.[129] The *Carlton* Court also placed some importance on the fact that the retroactive amendment corrected an apparent mistake in the original statute.[130]

The Constitutional issue is not a significant obstacle to the imposition of some kind of tax that burdens unrepatriated non-U.S. earnings. But it affects the design of such a tax, perhaps encouraging a design that resembles a property or excise tax as well as a retroactive income tax. Policymakers' appetite for litigation also has relevance. A desire to avoid any exposure to a Constitutional claim that might progress beyond summary judgment could prompt a more cautious approach.

4. Tax Treaties

Even if U.S. federal courts dismissed out of hand any problems of Constitutionality or retroactivity for a COET under the income tax law, U.S. treaty partners could object. In its network of bilateral tax treaties, the U.S. enters into reciprocal undertakings to avoid double taxation of income.[131] The main tool used by the U.S. to fulfill this obligation is the foreign tax credit.

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[127] *See* United States v. Carlton, 512 U.S. 26, 35 (1994) (applying rational basis test and upholding one-year retroactivity for limitation of estate tax deduction for proceeds of sale of stock to employee stock ownership plan). *See also* Charlotte Crane, *Legitimate Expectations in Tax Transitions: Are Roth IRA Conversions Different?* (unpublished manuscript, *available at* http://papers.ssrn.com/sol3/papers.cfm?abstract_id=1505120) (manuscript at 33) (considering the possibility that a Roth IRA conversion is "tantamount to a contract").

[128] *See id.* at 38 (O'Connor, concurring) ("A period of retroactivity longer than the year preceding the legislative session in which the law was enacted would raise, in my view, serious constitutional questions."). *See also id.* at 42 (Scalia, concurring) ("[T]he critical event is the taxpayer's reliance on the incentive.").

[129] *See* Tesoro, 246 P.3d 211 (Wash. App. Div. 2 2010) (holding unconstitutional a Washington statute made retroactive for 24 years). *See also* Tate & Lyle, 87 F.3d 99 (3d Cir. 1996) (reversing Tax Court and upholding 6-year retroactive Treasury regulation in part because one-year retroactivity rule suggested in O'Connor concurrence should not apply with equal force to regulations); Garden City Medical Clinic, 137 P.3d 1058 (Kan. App. 2006) (overturning amendment to Kansas tax refund statute which reduced refund period from 3 years to 1 year on due process grounds); Oberhand, 22 N.J. Tax 55 (2005) (holding one-year retroactive New Jersey statute invalid under state "manifest injustice" equitable doctrine).

[130] Note passages in Carlton alluding to mistake, and also other line of cases distinguishing between curative and new tax.

[131] Last-in-time rule, BUT. Charming Betsy. Rebecca Kysar, *The Constitutionality of Tax Treaties* (2012); Caleb Nelson, 86 VA. L. REV. 225, Kesavan, 100 NW. L. REV., 99 COLUM. L. REV. around 2000; possibly useful cite is Breard v Greene, 523 us 371 (1988).

If a domestic corporation were to in fact repatriate all of its unrepatriated offshore earnings at the moment of enactment of a worldwide consolidation reform, the U.S. income tax due on those dividend distributions from non-U.S. subsidiaries to U.S. parents would be reduced by the so-called "deemed foreign tax credit" and also by credits attributable to dividend withholding taxes.[132] Consequently, U.S. treaty partners might object with good reason that the taxation of unrepatriated foreign earnings without allowance for a foreign tax credit violates U.S. treaty obligations. And despite the "last-in-time" rule that provides that later-enacted statutes trump treaties, sweeping disregard for one of the central principles of tax treaty practice would not be well-advised.

5. Exposure to Tax Avoidance

The ideal COET, like any other ideal tax, would be impervious to tax avoidance techniques.[133] In the case of a COET, these might include tax planning to erode the tax base, presumably without reducing other important profit measures, like those used for financial accounting.[134] Firms might also engage in close substitute transactions such as replacing ownership of non-U.S. subsidiaries with contractual relationships.[135]

A COET could make sure of at least two anti-tax-avoidance tools. The first is the element of surprise. (Though, as will be seen immediately below, some commentators do not believe in the possibility of surprise and others point out possible collateral damage from an unexpected transition tax.) For example, if a COET used earlier measurement dates, close to the time the idea was first proposed, taxpayers would have less latitude to plan. The second tool is the use of third-party-verified information, for example by tying the tax base to a financial accounting measure.

6. Risk of Giving Corporate Taxpayers Incentives or Messages with Unfortunate Results

Finally, a COET design must consider the risk that if the COET is too big, or surprising, or onerous, corporate taxpayers may take unfortunate actions in response. A transition tax that falls on existing wealth – like the COET – may appear optimal because it is imposed on a base fully formed by past decisions. But

[132] *See* I.R.C. § 902.

[133] *See, e.g.*, David M. Schizer, *Frictions as a Constraint on Tax Planning*, 101 COLUM. L. REV. 1312, 1323–25 (2001); David A. Weisbach, *Line Drawing, Doctrine, and Efficiency in the Tax Law*, 84 CORNELL L. REV. 1627, 1665–68 (1999) (defining marginal efficiency cost of funds as the ratio between the revenue from a tax change with no behavioral distortion and the actual—presumably lower but still positive—revenue including the impact of behavioral effects).

[134] David Walker

[135] Julie Roin, formulary apportionment paper.

this is a fallacy. First, corporate taxpayers may have priced in the risk of a COET when bidding to buy assets such as the stock of non-U.S. subsidiaries.[136]

Second, the enactment of a COET will likely affect future behavior of corporate taxpayers.[137] Possible future reactions include overinvestment of resources in handicapping, and planning for, the possibility of future similar transition taxes. In addition, corporate taxpayer might conclude that the enactment of a COET evidences an intolerable level of legislative tax policy risk in the U.S. This could prompt increased used of opt-out strategies, including expatriation.

This risk that a COET might prompt, for example, expatriation is not so different from the perceived risks of worldwide consolidation described by capital ownership neutrality theory. Even if there are few significant signs of such a trend at the moment of enactment, the possibility that corporations might simply leave is simply frightening. It is the more so because of the possibility that such a trend could be mediated by a sea change in advisors' stock advice to corporations[138] at relevant moments such as incorporation or acquisition.[139]

The balance of this Part II considers the design of a COET based on the five factors described above: revenue, constitutionality, tax treaties, exposure to tax avoidance, and the risk of giving corporate taxpayers incentives or messages with unfortunate results. Part III further explores the implications of corporations' rational expectations, or lack thereof, for the choice of a tax rate for a COET.

B. COET Base

Two candidates present themselves for consideration for the tax base of a COET: unrepatriated and untaxed offshore earnings as calculated for U.S. federal income tax purposes, and permanently reinvested earnings as recorded for financial accounting purposes. The record of post-1986 undistributed earnings and post-1987 accumulated profits on IRS Form 1118, for example, would support the tax item approach. These represent calculations performed according to U.S. tax

[136] *See* Michael Graetz, *Legal Transitions: The Case of Retroactivity in Income Tax Revision*, 126 U. PA. L. REV. 47 (1977); Louis Kaplow, *An Economic Analysis of Legal Transitions*, 98 HARV. L. REV. 509 (1986).

[137] *See* SHAVIRO, *supra* note 29, at 19-25 (outlining the importance of taxpayers' expectations about future policy changes). [expand to include availability bias point]

[138] Corporate law literature has documented the impact of lawyers' habits on firms' decisions. *See, e.g.*, John Coates IV, *Explaining Variation in Takeover Defenses: Blame the Lawyers*, 89 CAL. L. REV. 1301 (2001); Daines, *The Incorporation Choices of IPO Firms*, 77 N.Y.U. L. REV. 1559-1661 (2002).

[139] Incorporation and acquisition represent two moments of possibility for U.S. firms seeking to expatriate. Code Section 7874 effectively prohibits stand-alone expatriation to a tax haven parent structure, although the expatriation to the UK announced by Aon in 2012 demonstrates that expatriation to a structure parented by a non-U.S. country located in a significant business jurisdiction is still possible (albeit with a shareholder-level tax). *See supra* note 61.

rules that closely resemble the earnings and profits calculation undertaken by U.S. companies.

Post-1986 undistributed earnings and post-1987 accumulated profits support the calculation of deemed paid foreign income taxes brought up when a non-U.S. corporation pays a dividend to a U.S. corporation.[140] For post-1986 earnings, which take priority, the maximum foreign tax credit permitted is calculated as the dividend paid multiplied by a fraction whose numerator is post-1986 income taxes and whose denominator is post-1986 earnings. There has long been an incentive for U.S.-parented MNCs to reduce the denominator of post-1986 earnings in order to "supercharge" the so-called foreign tax credit limitation. Planning strategies include efforts to maximize depreciation by stepping up the basis of assets in non-U.S. subsidiaries for U.S., but not non-U.S. purposes.[141]

Financial statement reports would support the financial accounting item approach. Amounts may be recorded as permanently reinvested earnings, and thus support the recognition of the benefit of deferring U.S. tax on non-U.S. income, when "management represents that "repatriation will be . . . postponed indefinitely."[142] Because the financial statement reason for identifying PRE is to avoid recognizing the deferred U.S. tax liability that would result on the payment of dividends to the U.S., a close relationship exists between PRE and offshore earnings that have not yet been subjected to U.S. tax.[143] A widely cited estimate of total PRE is $1.3 trillion.[144]

Most of the design constraints favor the use of PRE as the base for a COET. First, PRE supports a more certain revenue estimate. This is because the PRE figure as of a certain date is known and audited, while unrepatriated earnings listed for tax purposes on firms' Forms 1118 tend to be mere estimates; the tax earnings would likely be definitively calculated only when it is necessary to do so. There is

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[140] *See* I.R.C. § 902. Pre-1987 earnings [Confirm vocabulary correct, i.e. that figure cited is after reduction for prior subpart F inclusions.]

[141] E.g. non-U.S. Section 338 election in connection with acquisition; taxable D reorg.

[142] Julie H. Collins, John R. M. Hand & Douglas A. Shackelford, *Valuing Deferral: The Effect of Permanently Reinvested Earnings on Stock Prices*, *in* International Taxation and Multinational Activity (James R. Hines Jr., ed) 143, 143-44 (2000) (citing APB no. 72 (1973) UPDATE). The PRE feature of the COET seeks to take advantage of firms' incentive to maximize their permanently reinvested earnings and thus minimize firms' incentive to plan to reduce the tax base. *See generally* Daniel Shaviro, *The Optimal Relationship Between Taxable and Financial Accounting Income: Analysis and a Proposal*, 97 GEO. L.J. 423, 484 (2009) (proposing "a 50% adjustment of taxable income towards financial accounting income for large, publicly traded companies").

[143] [*See, e.g.*, Linda Krull, *Permanently Reinvested Earnings, Taxes, and Earnings Management*, 79 Acct'g Rev. 745 (2004); Jennifer Blouin, Linda Krull & Leslie Robinson, *Where In the World are "Permanently Reinvested" Earnings* (unpublished manuscript, *available at* SSRN).]

[144] [*See* CREDIT SUISSE EQUITY RESEARCH, PARKING EARNINGS OVERSEAS (Apr. 26, 2011).]

no reason to calculate the earnings of lower-tier subsidiaries, for example, until those subsidiaries pay dividends upstream.

For purposes of the constitutional and tax treaty design constraints, the use of PRE provides the advantage of distancing the COET from the related corporate income tax. A one-time excise tax on the corporate asset of unrepatriated earnings as calculated for accounting purposes arguably raises even less serious constitutional issues than a tax on the tax-calculated figure of offshore unrepatriated earnings,[145] thus further reducing the chance of litigation. In addition, a one-time excise tax on a PRE base may reduce the chance of tax treaty-based objections, since such a tax might qualify as a covered income tax within the meaning of relevant treaties.[146]

A PRE base also minimizes a COET's exposure to tax avoidance and to related administrative and compliance costs. Tying the tax base to a financial accounting figure closely related to retained untaxed offshore earnings seeks to leverage firms' incentive to report accurate – not artificially low -- offshore earnings for financial accounting purposes. In contrast, firms might manipulate their non-U.S. earnings, as calculated for tax purposes, to minimize them. The incentive to do so exists in U.S.-parented multinational structures already, as firms are incented to "supercharge" foreign tax credits by reducing the ratio between the foreign income tax they pay and their non-U.S. income (as calculated under U.S. tax rules).[147] For this reason, the proposed COET tax base could be no less than PRE. One concern raised with respect to conforming financial and tax accounting, which is that the political process that sets tax law could infect the more expert-driven process of setting financial accounting rules, [148] poses a less significant problem where the tax base conformity in question relates to a one-time lump-sum excise tax.

There is also the question of when to measure PRE for this purpose. One concern is that firms might take steps between learning of the possibility of a COET and its effective date to minimize its effects. For example, a firm might sell or spin off non-U.S. subsidiaries holding high earnings and enter into contractual relationships with them instead, or keep open the possibility of buying them back after some decent interval of time. If the minimum tax base equals the PRE figure as of the date the tax is proposed, then the prospect that a sale of a non-U.S. subsidiary would reduce the COET due and payable would be significantly

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145 *Cf.* Flint v. Stone Tracy Co., 220 U.S. 107, 151-52 (1911) (holding a corporate income tax constitutional, i.e. not a direct tax subject to apportionment, because of its nature as an "excise" tax). The Court subsequently overruled Flint on a different point of law. *See* Garcia v. San Antonio Metropolitan Transit Authority, 469 U.S. 528, 542 (1985) (noting Court's later rejection of the idea that the "provision of municipal water supply" was not a government function).

146 *See, e.g.*, U.S. Model Treaty Article 2 (covering income and "substantially similar" taxes, but not property or excise taxes).

147 E.g. 338 election for foreign subs.

148 Shaviro in Georgetown.

reduced. Sales could still occur, but the COET would not incent their occurrence; the price of any sale instead would reflect the fact that the selling firm would retain the COET liability associated with the sold subsidiary's PRE, just as the sale price for a residence reflects the different parties' liability for related property taxes.

A disadvantage to using a PRE number based on the date the tax is proposed is that firms would have an incentive to realize revenue for tax and accounting purposes during the period between the date the COET was proposed and the effective date of the new steady-state system, whether worldwide or territorial. A solution to this problem is to make the new steady-state system's effective date contemporaneous with the PRE measurement date. Doubtless, tax accounting and financial accounting arbitrage opportunities would still exist, including timing arbitrage opportunities, but the lack of a gap between the PRE measurement date and the effective date of the new regime should minimize this.

On the other hand, the use of PRE as the base for a COET could increase the risk of giving corporate taxpayers incentives or messages with unfortunate results. Would corporations consider the use of PRE an unexpected blow from a Congress they had previously trusted to stick to more traditional tax base measures? Would this cause them to modify U.S.-parented structures at the first opportunity, even at the cost of a shareholder-level tax as in the Aon transaction? Evaluating this risk depends heavily on opinion and risk aversion. But some financial accounting elements are already present in U.S. tax law, such as tax-book comparisons now required to be attached to corporate tax returns. The idea of tax-book conformity is also present in academic discourse and in other nations' tax laws.[149] This suggests that the use of a financial accounting benchmark should neither come as a surprise nor represent a feature of U.S. law that significantly departs from the tax law of other countries.

C. *COET Rate*

The COET rates considered here include 0%, 5.25%, 15%, 25%, and 35%. The 0% rate, of course, would mean no COET. It represents the exemption of unrepatriated earnings from tax upon the adoption of a worldwide consolidation or territoriality reform.

The 5.25% rate equals the rate imposed on repatriated earnings during the tax holiday of 2004-05 and also equals the rate of transition tax that would be imposed on unrepatriated earnings under the Camp territoriality proposal floated in November 2011. Many firms did in fact bring back offshore retained earnings to the U.S. at the 5.25% rate in 2004, and some firms have since clamored for a repeat of the repatriation holiday. This provides some evidence that 5.25% is a good benchmark, at least from a political salience perspective, for an appropriate

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[149] See Wolfgang Schoen, *The Odd Couple: A Common Future for Financial and Tax Accounting?*,58 TAX L. REV. 111 (2005).

rate for a COET intended as a trade for the eventual repatriation tax. The 5.25% rate gives a back-of-the-envelope revenue result of about $68 billion assuming PRE of $1.3 trillion.

The 25% rate equals the assumed corporate tax rate that would generally imposed under the assumed accompanying worldwide consolidation reform. The 35% rate equals the historic maximum corporate income tax rate. The 15% rate is a stand-in for a rate that would represent the maximum rate with a rough-justice allowance for foreign tax credits.

One way to allow for foreign tax credits is to allow a corporation to credit all of its as-yet-uncredited foreign income taxes subject to applicable limitations, including the requirement to calculate foreign tax credit limitations separately for general basket and passive income.[150] This approach would comport with the treaty, but raise the problem of significant administrative and compliance costs. Another approach would take a rough justice view of the problem, and provide a reduced tax rate or a reduction in the amount of foreign income that would be taxed to acknowledge the general or average effect of foreign tax credits. For example, if a study of firms' accumulated foreign taxes and foreign earnings revealed that foreign tax credits would likely shelter between 50 and 60% of distributions from non-U.S. corporations if all unrepatriated earnings were distributed, then a rough justice COET tax rate figure assuming a starting tax rate of 35% would be 15%. The 15% rate in Table 2 below stands in for a rate that would take rough account of the reduction in tax liability (i.e. from 35% or 25%) resulting from the use of foreign tax credits.

[150] *See* I.R.C. § 904.

Table 2, below, summarizes advantages and disadvantages of the different rates according to the design constraints considered here. An explanation of each of the lines follows the table

TABLE 2: DESIGN CONSTRAINTS AND DIFFERENT COET RATES

	0%	5.25%	15%*	25%	35%
Revenue	$0	$68 billion	$195 billion	$325 billion	$455 billion
Constitution	OK	OK	OK	OK	Some exposure to litigation
Tax Treaties	No Exposure - Most Exposure				
Tax Avoidance	No Exposure - Most Exposure				
Risk of incentives or messages with unfortunate results	Possibly material; compare expectation of additional repatriation holiday.	Minimal unexpected results; comports with repatriation holiday rate request	Increasing risk of unfortunate result e.g. move toward expatriation as tax rate increases. Risk may not increase smoothly as a linear function of tax rate; may be lumpy. If accompanied by a worldwide consolidation reform, possibly offset by benefit of encouraging corporations to anticipate tax policy changes, e.g. with a COET rate of 25%.		

Revenue is calculated as the tax rate multiplied by $1.3 trillion, the estimate of total offshore PRE.

The claim with respect to the constitutional design constraint is that a substantive due process claim raises significant concerns only with an explicitly retroactive tax. The form of the COET as a one-time excise tax, rather than a tax requiring corporations to reopen each of their years, refile their returns, and pay interest, does not raise significant substantive due process issues. Perhaps the imposition of the current maximum statutory rate of 35%, however, would raise the possibility that the tax would at least be challenged on constitutional grounds.

Evaluating the tax treaty claim presents challenges because the tax treaty concern is one that does not directly follow from the rate of tax. The usual commitment to combat double taxation in tax treaties (though only with respect to income taxes, not with respect to excise taxes) is made on a taxpayer-by-taxpayer basis, and even at a 5.25% rate specific firms might make treaty-based objections that their particular circumstances would produce a lower amount of tax if they were permitted to calculate their foreign tax credits rather than relying on the proxy rate reduction.[151] The risk of tax treaty challenge nevertheless increases with the tax rate, as more firms would have reason to complain that their tax liability would be less if they were permitted to calculate their own tax credits. The tax treaty risk, unlike the risk of giving corporate taxpayers incentives or messages with unfortunate results, is discoverable; it can be researched through communications with tax treaty partners. Speculation on the outcome of such communications is beyond the scope of this Article.

As described above, the choice of tax base – unrepatriated U.S. earnings, but not less than permanently reinvested earnings recorded for financial accounting -- is intended to reduce firms' ability to tax plan to reduce the corporate tax base. Nevertheless, to the extent there is slippage – and there is sure to be some – the incentive to tax plan under a COET, as under other taxes, would increase with the tax rate. This presents a greater concern if the design of the tax leaves open more tax planning opportunities.

Finally, an unknowable constraint is the risk of giving corporate taxpayers incentives or messages with unfortunate results. This constraint also yields different predictions for different COET rates. In the game of chicken in which the U.S. government and corporate MNCs are engaged, the U.S. government faces the unenviable challenge of evaluating whether a tax change, like a COET or the adoption of worldwide consolidation, will indeed cause corporate taxpayers to take actions that hurt the U.S. economy, such as avoiding a U.S.-parented firm structure. The government must also consider the possibility that corporate taxpayers will interpret transition tax rates that are too low as an encouragement to engage in continued aggressive tax planning behavior. Part III below further considers this design constraint.

D. The Budget Window

[151] The nature of a COET as an excise tax supports the argument that no opt-out is required for such firms, since the tax arguably is not an income tax covered by the treaty. An opt-out would tend to consistently lose revenue for the government, as taxpayers would simply choose the least expensive alternative. In addition, an opt-out regime could increase the deadweight loss of tax planning as advisors perform the service of comparing the two options.

But if it were thought that compliance with treaty requirements for eliminating the double taxation of income required that taxpayers have some way of challenging the default option if it differs from their situation, the government might impose a surcharge on those who wanted to do so. For example, the government might establish an expensive private letter ruling-like process as a requirement to opt out of the default. The time and financial resources, and the tolerance of uncertainty that a firm would have to accept under such a process might well often drive them to choose the default, flat-rate option.

One political advantage of a COET is that it might raise enough revenue to permit a worldwide reform within the four corners of the U.S. corporate tax law that reduces the U.S. corporate rate to, for example, 25%. In the current political landscape legislators stand ready to block any increase to the personal income tax and any adoption of a value-added tax, and instead insist that corporate tax reform stand on its own. This leaves three possible revenue sources in the case of a worldwide consolidation reform: base-broadening, the repeal of deferral itself, and a COET. A COET could help bridge the gap to a successful corporate tax reform package.

One might object that the COET is a legislative accounting trick. It is designed only to pay for a lower corporate tax rate for the budget window period of ten years.[152] The COET plus worldwide consolidation or well-designed territoriality at 25% would over a longer period likely raise less revenue than worldwide consolidation or well-designed territoriality at 28%.[153] The COET does not make any revenue contribution outside the 10-year window of the legislative rule.

But this uncertainty about how revenue will be raised in ten years could be an advantage. The shape of U.S. corporate tax policy in ten years should depend in part on the response of U.S. trading partners to the 25% U.S. corporate tax reform plan. For example, if the U.S. adopts worldwide consolidation, and if trading partners embrace the U.S. approach by strengthening the enforcement of their own corporate income taxes, the U.S. should be able to keep or even strengthen its worldwide consolidation system. As another example, the tax policy plan in ten years may also depend, for example, on whether the U.S. political climate ten years hence is hospitable to a value-added tax, and on the extent to which technology can support a progressive consumption tax.

III. RATIONAL EXPECTATIONS AND THE RISK OF GIVING TAXPAYERS INCENTIVES OR MESSAGES WITH UNFORTUNATE RESULTS

A. The Circularity of Rational Expectations

As Michael Graetz[154] and Louis Kaplow[155] have argued, rational taxpayers should form rational expectations about transition taxes. Under this assumption, transition relief is not required, and retroactive taxation should be appropriate –

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[152] *Cf.* Sullivan testimony 11/11

[153] At least under a static analysis.

[154] Michael J. Graetz, *Legal Transitions: The Case of Retroactivity in Income Tax Revision*, 126 U. PA. L. REV. 78-79 (1977). (rejecting claim that fairness requires transition relief, in part because affected parties should predict the change with more and more confidence as it makes its way through the legislative process).

[155] Louis Kaplow, *An Economic Analysis of Legal Transitions*, 98 HARV. L. REV. 509 (1986).

after all, taxpayers should price in the likelihood of a change in policy when they buy assets or make other decisions, and there is no reason for the government to assume the risk of such a change in policy. At the same time, experience demonstrates that Congress generally follows what Dan Shaviro calls an "anti-nominal retroactivity norm," meaning that although it permits prospectively effective taxes to retroactively affect the value of assets, it does not nominally impose retroactive taxes that, for example, require the recalculation of income tax imposed with respect to an already-closed accounting period.[156] Taxpayers therefore might alter their expectations and forecasts with respect to retroactive taxation because of their understanding that Congress generally follows an anti-nominal retroactivity norm.

There is a circularity to rational expectations about what the government might do.[157] Perceived rules of thumb (e.g., an anti-nominal retroactivity norm) or mere talk about possible legislative options (e.g., the Camp proposal's inclusion of a 5.25 percent transition tax on unrepatriated offshore earnings) become inputs into the rational expectation calculus. If one assumes (heroically) that corporate tax directors read academic articles, any point on the transition tax debate continuum could be defended as a possibility that should have been duly considered and handicapped.

This Part III is more interested in how corporate tax decisionmakers would in fact respond to a COET than in how they should be expected to respond to a COET. One question is whether a COET would cause such decisionmakers to take actions with unfortunate results? The feared bugaboo is a trend of expatriation at any available opportunity. Particularly if the accompanying reform was a territorial reform, another possible unfortunate result would be the movement of U.S. firms' economic activity outside the U.S. Another question is whether corporate taxpayers would react positively to a COET, for example by interpreting the imposition of a COET as a regulatory move that signaled the importance of reducing aggressive tax planning.

The analysis of likely results upon the adoption of a COET can be organized in three parts. First, the likely contours of taxpayers' most prominent rational expectations influence what may surprise them and lead them to take unexpected actions. Second, if taxpayers do not develop rational expectations about tax

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[156] SHAVIRO, *supra* note 29, at 104-10 (describing "anti-nominal retroactivity" norm, acknowledging the "arbitrariness" of anti-nominal retroactivity and offering supporting arguments based on lower contracting costs, public choice limitation, and consistency with short-term budgetary windows) The relevant statutory construction principle holds that statutes have prospective effect absent a clear expression of retroactive legislative intent. *See, e.g.*, Landgraf v. USI Film Products, 511 U.S. 244, 270 (Blackmun, J.) ("Since the early days of this Court, we have declined to give retroactive effect to statutes burdening private rights unless Congress had made clear its intent.").

[157] [Cites to / treatment of transition literature incomplete. Need Logue; Doran; others.]

transition policy, for example because corporate tax decisionmakers are unable to process the nuances of various tax policy possibilities and likelihoods in numerous relevant jurisdictions, the substance of what taxpayers anchor on helps determine their reaction a COET. Third, a goal of modifying taxpayers' way of forming rational expectations, so that they begin to expect some nominally retroactive transition taxes, would also affect COET design.

B. Existing Rational Expectations

Taxpayers might develop different rational expectations for fundamental corporate income tax reform, including expectations about the transition treatment of unrepatriated earnings.[158] As the below possibilities indicate, the COET, as a tax designed to approximate an immediate tax on all existing unrepatriated offshore earnings, adjusted for foreign tax credits, raises a nominal retroactivity issue. A corporate tax decisionmaker might anticipate a COET with any of the rates, from zero to 35%, considered in this paper; or with more precise adjustments for foreign tax credits. Either a tax or financial accounting measure of untaxed offshore earnings might be anticipated. Finally, the different COET flavors might be anticipated in connection with either a worldwide consolidation reform or a territoriality reform.

I know of no empirical data on the question of what corporate tax directors, for example, actually expect from international corporate tax reform. However, various reports on the prospects for such reform mention this transition problem and explicitly consider the possibility of a transition tax on unrepatriated offshore earnings.[159] They generally appear to contemplate a "small" transition tax, apparently designed to offset the windfall of repeal of eventual tax on the repatriation of untaxed offshore earnings at the moment of enactment. The concept is cousin to the idea of imposing a tax to offset the windfall that would otherwise accrue to old equity upon the adoption of a dividends-paid deduction as

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[158] There is also the possibility of incremental international tax reform, like that proposed in Obama administration budgets

[159] *See, e.g.*, JOINT COMMITTEE ON TAXATION, BACKGROUND AND SELECTED ISSUES RELATED TO THE U.S. INTERNATIONAL TAX SYSTEM AND SYSTEMS THAT EXEMPT FOREIGN BUSINESS INCOME 13 (May 20, 2011) ("One issue is the treatment of earnings attributable to periods before the enactment of the territorial legislation. One approach is to have the exemption system apply only in respect of CFC earnings generated after the effective date."); DELOITTE, RESETTING THE CODE: ISSUES IN CORPORATE TAX REFORM 10 (2011) (describing 5.25% Camp transition tax); Testimony of Mr Stephen Edge Before the Committee on Ways and Means U.S. House of Representatives Hearing on How Other Countries Have Used Tax Reform To Help Their Companies Compete in the Global Market and Create Jobs 8 (May 24, 2011) (noting UK decision not to impose a transition tax on the adoption of territoriality, partly on the theory that "the idea that the government would collect tax on those unremitted amounts was "illusory"); Grubert & Altshuler, *supra* note 6, at 347 ("We ignore the pool of previously unrepatriated income that could be subjected to a small one-time tax under the reform option.").

a means of corporate integration.[160]

Honoring rational expectations – for example, by enacting no more than a 5.25% COET on the theory that taxpayers anticipate its possibility – is one way to react to such expectations. Failing to honor rational expectations could throw taxpayers into a disruptive tailspin as they tried to figure out whether other retroactive rules they previously would not have expected might also be enacted sometime in the future. The concern is that excessive investment in planning for possible future transition taxes, including perhaps by repatriating in greater numbers, might result.

Decisions about whether to expatriate, where to locate investments and so forth may not follow a linear relationship relative to the degree to which a COET deviates from a particular taxpayers' rational expectations. Consider the possibility that such decisions are mediated by a network of relationships among corporate tax directors and their advisors, and that network generates heuristics and norms and best practices about where to incorporate, how to structure and so forth. If this is so, then it is possible that the key question is when the transition tax deviates sufficiently from some average or modal expectation to prompt a change in the heuristic, or norm, or best practice, to a new equilibrium.[161]

C. In the Absence of Rational Expectations

It is also possible that taxpayers behave not based on rational expectations about future law in this case, but rather as if they do not expect the law to change. This underlying assumption thus presents a direct conflict with the underlying assumption of the two analyses just described, which rest on the assumptions that taxpayers do develop rational expectations about policy changes. What if corporate tax directors are unable to process the nuances of likelihood and the disorganized web of tax policy change possibilities, so that they anchor on existing law when planning? On one hand, corporate tax directors might predict future tax policy with some precision. Such individuals have access to high-quality information (for example, through lobbyists and industry groups) about what changes are likely, and it is their job to manage their firm's tax position. On the other hand, these questions are extremely complicated, involve numerous moving parts, and interact with the corporate income tax laws of every other country in which the firm does business, creating a vast array of possible combinations of

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[160] *See* Alan Auerbach, *Debt, Equity and the Taxation of Corporate Cash Flows*, *in* DEBT, TAXES, AND CORPORATE RESTRUCTURING 70, 94-97 (John B. Shoven & Joel Waldfogel eds. 1990) (describing ALI proposal to avoid windfall gains to old equity by tracing dividend payments to pre-enactment earnings and alternative of imposing a one-time tax on accumulated earnings at the time of enactment).

[161] *Cf.* Robert Cooter, *Do Good Laws Make Good Citizens? An Economic Analysis of Internalized Norms*, 86 VA. L. REV. 1577, 1587 (2000) (theorizing shifts between compliance equilibria).

rules, which must presumably be risk-ordered in order to make a prediction.

This might be a situation of systematic bias. In other words, the difficulty faced by corporate tax directors in evaluating new information (e.g. the introduction of a worldwide consolidation bill and a fairly detailed territoriality proposal made in Congress in the space of a single session) could be so extreme that corporate tax directors and other decisionmakers instead anchor on the status quo as the system they will assume will be the system in the future.[162] If so, it could make sense to design transition tax policy in a way that provides some "government insurance" against changes in existing law.[163]

This framework supports a low, for example a 5.25%, COET. This is because such a COET represents an effort to impose a detriment approximately equal to the repealed detriment of a tax on the eventual repatriation of offshore earnings. A low-rate COET, in other words, minimizes changes to existing law, consistent with the goal of providing "government insurance" against retroactive changes in law. This argument works equally well for a worldwide consolidation or a territorial reform, since it hinges on each reform's repeal of the existing tax on the eventual repatriation of offshore earnings.

D. A Case for Modifying Rational Expectations

But what if taxpayers *should* expect some retroactive transition taxes?[164] We might not want to accept the uncertainty that would result if nominally retroactive taxes of all shapes and sizes rained down on unsuspecting taxpayers (although we do accept the uncertainty that results from the retroactive effects of myriad nominally prospective taxes and judicial decisions). But what if we could logically describe the set of circumstances under which such taxes made sense, and persuade ourselves that Congress could develop a slightly different precommitment norm around a shifted logical framework relating to nominal statutory retroactivity?

If we accept this possibility, there is a theory that might support the enactment of a COET not only at the lower, windfall-offsetting tax rate of 5.25%; but also at a higher rate. This theory depends on consistency between the retroactive tax and the accompanying steady-state policy change. Because the higher COET rate would be consistent with worldwide consolidation, but not consistent with territoriality, this theory would only work if the accompanying reform were a

[162] *See* SHAVIRO, *supra* note 29, at 23 ("[T]he evidence for [anchoring] may suggest that, in more dynamic and ongoing settings, people continue using obsolete rules of thumb and struggle for a while to reconcile new information with them.").

[163] *See* SHAVIRO, *supra* note 29, at _____ (acknowledging government insurance argument in systematic bias situation).

[164] *Cf.* Ben Alarie, *Retroactivity and the General Anti-Avoidance Rule, in* Tax Avoidance in Canada 197, 215-17 (David G. Duff & Harry Erlichman eds., 2007) (noting rule-of-law as well as efficiency-based arguments against retroactivity and arguing that one could "reasonably expect" a retroactively applied GAAR to substantially reduce tax abuse).

worldwide consolidation reform.

Under this theory, "yes" answers to the following questions would indicate strong support for a higher-rate COET.[165] First, is the underlying policy – for purposes of this analysis assumed to be worldwide consolidation at a rate of 25% -- a desirable policy for past periods as well as future periods? Second, is a COET consistent with the underlying policy of worldwide consolidation? Third, is it reasonable to expect taxpayers to lay odds on the future course of tax policy? Fourth, is it possible to frame a COET within logical guidelines capable of supporting Congressional pre-commitment, predicting when similar retroactive transaction taxes might occur in the future, and avoiding unacceptable levels of taxpayer uncertainty about retroactive policy? The answer to each of these questions is "maybe," "yes," "maybe," and "maybe." The enactment of such a higher-rate COET, in other words, carries risks.

The first two questions deal with whether worldwide consolidation is a "good" policy and whether a COET is consistent with it. Strong arguments, outlined in Part I, support the conclusion that worldwide consolidation is the right policy, although counterarguments grounded in ownership neutrality theory are not without force. And the COET goal of taxing already-earned unrepatriated earnings is consistent with worldwide consolidation's policy choice to tax offshore earnings in the future. One might also argue that the 2004-05 repatriation holiday produced the wrong incentives for corporate taxpayer predictions, and that a higher-rate COET would have the salutary effect of discouraging corporations from expecting and predicting regular and generous tax holidays. The idea of a high-rate COET recalls the regulatory origins of the U.S. corporate income tax.[166]

The third question relates to taxpayers' ability to predict future tax policy. In other words, the application of this theory assumes that taxpayers do in fact develop rational expectations about future policy, subject to the possibility of systematic error.[167] As to the fourth question, the fact that a COET would take

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[165] This analysis applies because the adoption of a COET would be a policy-change retroactive tax – a tax intended to accomplish essentially the same purpose retroactively as the "steady-state new rule." *See* SHAVIRO, *supra* note 29, at 47-51; Kaplow (1986) (Shaviro cites 529, 598).

[166] Several scholars have told the story of the origins of the U.S. corporate income tax in 1909 as at least in part the "express[ion] of social antipathy towards monopoly power," Ajay K. Mehrohtra, *The Public Control of Corporate Power: Revisiting the 1909 U.S. Corporate Tax from a Comparative Perspective*, 11 THEOR. INQ. IN L. 491, 531 (2010). Compare Reuven S. Avi-Yonah, *Corporations, Society, and the State: A Defense of the Corporate Tax*, 90 VA. L. REV. 1193 (2004) *and* Marjorie E. Kornhauser, *Corporate Regulation and the Origins of the Corporate Income Tax*, 66 IND. L. J. 53 (1990) *with* Steven A. Bank, Entity Theory as Myth in the Origins of the Corporate Income Tax, 43 WM. & MARY L. REV. 173 (2001).

[167] *See* SHAVIRO, *supra* note 29, at 19-25 (listing heuristic sources of systematic bias including availability bias, endowment effect, optimism bias, and anchoring).

away a deferral benefit only, trading an eventual tax on earnings as repatriated for a simpler, immediate tax on existing accumulated offshore earnings, and the replacement of an implicit tax with an explicit tax could help cabin the circumstances under which similar retroactive transition taxes might be imposed in the future.

A COET that raised additional revenue to permit the imposition of a lower corporate tax rate under a worldwide consolidation regime could be described in part as trading an explicit tax for an implicit tax. In particular, the incremental reduction to the corporate tax rate would avoid an incremental decrease in the value of a U.S.-parented MNC's offshore assets. If, for example, a COET permitted a corporate tax rate of 25% instead of 28%, U.S.-parented MNCs' non-U.S. assets would lose incrementally less value. In lieu of that incremental decrease in the value of the U.S.-parented MNC's offshore assets, the firm would pay a COET.[168]

One problem with the theory of trading an implicit tax for an explicit tax is that an across-the-board reduction in U.S. corporate income tax rates benefits not only U.S.-parented MNCs, but also exclusively U.S.-based corporations. The described COET design makes no attempt to allocate the transition tax burden among corporate taxpayers according to how those taxpayers benefit from the lower rate paid for by the COET. For example, U.S. corporations with relatively little offshore activity "win" as a result of worldwide consolidation adoption[169] but need not pay a COET. In addition, COET burdens among those U.S.-parented MNCs with offshore activities need not correspond to the benefit of a smaller reduction in the value of offshore assets produced by a marginally lower tax rate. But although the offset is not perfect, a trade does exist.

Of course, the possible advantages of using a COET to modify corporate taxpayers' expectations about retroactive tax policy changes must be offset against the risk that a high-rate COET would cause unfortunate results like increased expatriation. And the magnitude of such a risk is more or less unknowable. Perhaps it can be estimated from the vociferousness of corporate taxpayers' objections to a high-rate COET proposal, but such objections may be shaped by lobbying strategy rather than by real forecasts. Just as the possibility of adopting worldwide consolidation may be stymied by the uncertain and volatile nature of the risk that corporations may simply leave the U.S., so too uncertainty aversion and risk aversion may dim the prospects for a high-rate COET.

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[168] This kind of corporate tax rate reduction/transition tax tradeoff has been proposed before.

[169] also does not address e.g. costs to TP existing from base-broadening measures, contrast Treasury II which is cited pre-1986 example from Shavior WRC p. 118

CONCLUSION

Poorly designed international tax rules have helped to produce a crisis for the U.S. corporate income tax. One solution is worldwide consolidation. Worldwide consolidation draws support from the redistributive advantages of the U.S. income tax system, the goal of minimizing wasteful tax planning, the thinness of fiscal sovereignty-based objections, and worldwide efficiency arguments based on the theory of capital export neutrality. Another solution is territoriality, which draws support from capital ownership neutrality theory and related concerns about U.S. firms' competitiveness in international markets when corporate tax rates imposed on U.S.-parented firms under worldwide consolidation exceed rates imposed on competing firms under territorial systems.

Either a worldwide consolidation reform or a territorial reform would include the repeal of the current rule that taxes earnings of non-U.S. subsidiaries upon repatriation to U.S. parent corporations. Either reform thus raises the question of whether and how to tax untaxed offshore earnings accumulated before the date of the reform's enactment. This Article considers the imposition of a corporate offshore excise tax, or COET, in connection with a worldwide consolidation or territorial reform.

This Article considers five COET design constraints: revenue, Constitutionality, tax treaty compliance, tax avoidance exposure, and the risk of giving corporate taxpayers incentives or messages with unfortunate results. It argues that these constraints support a COET base equal to U.S.-parented MNCs' permanently reinvested earnings as recorded for accounting purposes. It then considers rates ranging from 0% to 35%. Rates considered include a 5.25% rate, which would equal the effective rate imposed during the repatriation tax holiday of 2004-05, at a 15% rate, intended as a proxy for a 35% or 25% rate with a rough-justice adjustment to account for foreign tax credits. Design constraints offer opposing pros and cons for these rates, as the risk of tax treaty challenge and tax avoidance strategies, as well as the revenue opportunity, increase with the applicable rate.

The most challenging design constraint is the risk of giving corporate taxpayers incentives or messages with unfortunate results. This constraint includes the concern that an excessive COET, like a harsh worldwide consolidation policy, could have the results of encouraging businesses to avoid the U.S.-parented MNC form. The magnitude and uncertainty of this risk is very difficult, perhaps impossible, to quantify. In addition, it is possible that this risk does not follow a linear relationship relative to the tax rate, but rather that it is mediated by heuristics and norms that may move between equilibria in a more abrupt fashion.

Given the risk presented by this design constraint, one relatively safe option is to stay within the bounds of taxpayers' likely expectations about transition tax policy. Such taxpayers have reason to expect a modest transition tax, such as a

5.25% transition tax. Such a modest tax also comports with existing law, relevant in the event that corporate taxpayers have anchored on existing law instead of predicting future policy, because it represents a rough justice trade for the benefit of not taxing the current accumulation of untaxed offshore earnings at any point in the future.

A higher tax faces a higher risk of unfortunate results. Yet it could be defended under the theory that it would properly incent taxpayers to expect transition taxes. The objection that taxpayers would not have enough information to predict when transition taxes might be imposed is minimized by precise circumstances that support a transition tax in this case, including the repeal of deferral and the partial trade of an implicit tax for an explicit tax.

APPENDIX A: COMBINED NATIONAL AND SUBNATIONAL CORPORATE INCOME TAX RATES FOR OECD COUNTRIES, 2011[170]

Country	**Rate**
Japan	39.5%
United States	**39.2%**
France	34.4%
Belgium	34.0%
Germany	30.2%
Australia	30.0%
Mexico	30.0%
Spain	30.0%
New Zealand	28.0%
Norway	28.0%
Canada	27.6%
Italy	27.5%
Portugal	26.5%
Sweden	26.3%
Finland	26.0%
Average of all OECD countries	**25.0%**
United Kingdom	25.0%
Austria	25.0%
China	25.0%
Denmark	25.0%
Netherlands	25.0%
Switzerland	21.2%
Greece	20.0%
Poland	19.0%
Ireland	12.5%

170 *See* SULLIVAN, *supra* note 82, at 50.