NEW YORK UNIVERSITY SCHOOL OF LAW

COLLOQUIUM ON TAX POLICY
AND PUBLIC FINANCE
SPRING 2012

"Unpacking Territorial"

Stephen Shay
Harvard Law School

March 27, 2012 (Tuesday)
NYU School of Law
Vanderbilt Hall-208
Time: 4:00-5:50pm
Number 9

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. "Progress for the Poor, Chapters 6, 8 and 9."

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 – Alan Auerbach, Berkeley Economics Department and NYU. "The Mirrlees Review: A U.S. Perspective."

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

Draft of March 19, 2012
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Unpacking Territorial

Stephen E. Shay,* J. Clifton Fleming, Jr.** and Robert J. Peroni***

Abstract

[This paper evaluates the House Ways and Means Majority October 26, 2011 discussion draft proposal to shift the United States from its current system of deferring taxation of active foreign income to a territorial system that would exempt active foreign income from United States tax.]

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Contents

I. INTRODUCTION

House Ways and Means Committee Chairman Dave Camp has proposed to shift the United States from its current system of deferring U.S. taxation of active foreign income earned through a foreign corporation to exempting active foreign business income from United States tax (the "Ways and Means Majority proposal" or "Discussion Draft"). [1] [Senator Mike Enzi, a Republican Senate Finance Committee member representing Wyoming, also has released a territorial proposal in bill form (S. 2091).[2]] This paper evaluates the House Ways and Means Majority proposal [and discusses S. 2091 in contexts where its approach differs materially from the Ways and Means Majority proposal].

Irrespective of one's views regarding the proposed policy, publication of the Discussion Draft and request for public comment, and Senator Enzi's release of his bill, are welcome. Discussions of potential territorial reforms have tended to contrast the current law deferral system against a generic and generalized territorial system design that does not take account of historic U.S. political and policy contexts and current revenue constraints. The Discussion Draft proposal is intended to be revenue neutral and it revenue considerations apparently have affected a number of design decisions. [3] Comparison of a politically plausible territorial system against the base line of current law allows for a more relevant policy analysis.

The second part of the paper provides an overview of the relevant current law deferral rules and the Ways and Means majority proposal.

The third part of the paper evaluates shifting from current law to a territorial system as envisioned in the House Ways and Means Majority proposal from traditional tax policy perspectives. This part considers the expected effects of such a change to a territorial system on (i) U.S. multinational investment, (ii) repatriation of future foreign subsidiary earnings to a U.S. parent corporation, (iii) the administration and compliance burden of international tax rules, and (iv) Federal revenues. In selected instances, the paper contrasts the treatment of U.S. multinationals with treatment of U.S. individuals holding foreign direct investments directly, or more realistically through private equity funds, to highlight the advantageous taxation of foreign income available to U.S. resident individual investors in foreign direct investments that achieve low effective rates of foreign tax.

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[1] The Ways and Means Majority proposal and a technical explanation may be found at: http://waysandmeans.house.gov/taxreform/ (last visited Feb. 23, 2012).

[2] S. 2091, 112TH CONG., 2D SESS. (Feb. 9, 2012).

[3] House Ways and Means Committee One-Page Summary (Oct. 26, 2011) ("Includes a number of anti-abuse rules to prevent erosion of the U.S. tax base and help make the participation exemption system a revenue neutral component of tax reform") at http://waysandmeans.house.gov/UploadedFiles/Territorial_one_pager.pdf (last visited Feb. 27, 2012).

The fourth part of the paper evaluates the Ways and Means Majority proposal's approach to important structural issues that arise in design of a territorial system: (i) the scope of exemption for foreign income and its relation to measures to prevent avoidance of taxation in the domestic tax base; (ii) the treatment of foreign branches; (iii) the allowance of expenses incurred by domestic affiliates that relate to earning exempt foreign income of a foreign subsidiary, but under current international practice are not chargeable to the foreign subsidiary and are not deductible against source country taxes; (iv) the scope of foreign tax credits allowed against foreign income and source of income rules, and (v) the treatment of pre-effective date earnings.

The paper's principal observations follow:

- Evaluating the impact on investment of a change from current law deferral to a territorial system depends on the relationship of the effective rate of U.S. corporate tax to the effective rate of foreign tax on foreign income. In order to evaluate the net effects of a shift to a territorial system in the context of a corporate rate reduction, it is necessary to know the U.S. corporate tax base and rate and the relation of the effective rate of U.S. tax to the effective foreign tax rates achievable under reasonable planning, taking into account transfer pricing and multinational taxpayers' abilities to transform returns from real business operations into "stateless income." It also is necessary to know the individual business tax base and rate and the relation of the corporate tax to the shareholder tax of an individual. As a matter of process, reform of international taxation should not precede, but should follow (or at most parallel), resolution of the individual and business tax base and rate reforms.

- The shift to territorial will result in a material reduction in tax on foreign income, independent of a change in the corporate tax rate, by eliminating the U.S. residual tax on distributed foreign earnings. There is evidence that, absent any change in corporate base and rate, this will result in materially increased investment abroad by U.S. multinationals.

- If, as the Ways and Means Majority proposal assumes, the U.S. corporate tax rate is reduced to 25%, the effect of the rate reduction depends on how the rate reduction is paid for under a revenue neutrality constraint. If corporate tax expenditures are reduced and/or eliminated, this will increase tax burden almost exclusively on domestic corporate income, while foreign income will be advantaged by the shift to exemption. [4] This would be expected to increase the incentive for foreign investment by U.S. multinationals.

- Under standard assumptions of constant returns (domestically and abroad) and unchanged tax rates on repatriation, switching to a territorial system would not reduce the tax incentive to retain earnings offshore compared to current law deferral and is not itself a solution to a lockout of the foreign earnings of U.S.-controlled controlled foreign corporations. There is evidence that the prospect of future tax reductions on distributed earnings has materially

[4] With such a U.S. corporate rate reduction, the claimed detriments from restricting deferral would diminish and the relative advantages of broader rather than reduced taxation of foreign income should have greater policy relevance.

affected repatriation decisions and it is likely that the financial accounting treatment of deferral contributes to retaining abroad earnings that are subject to permanent reinvestment accounting treatment.

- Shifting to a territorial system will increase the incentive to engage in international tax planning and is unlikely to result in a material net reduction the level of resources devoted to planning, administration, and compliance. We suggest that the experiences of countries that have recently shifted to territorial systems be reviewed by independent researchers for empirical data on these issues.

- The Ways and Means Majority proposal would not be revenue neutral within the budget window if the cost of a permanent extension of the active financing exception to Subpart F were taken into account and it would lose revenue over the longer term when revenues from transitional taxation of pre-effective date earnings are no longer relevant. Shifting to a territorial system is not likely to have a long term impact on rates of foreign subsidiary earnings repatriation. Under the so-called "new view" of dividends, assuming unchanged tax rates and constant investment returns, the tax disincentive to make distributions from foreign earnings eligible for exemption from home country tax under a territorial system is the same as the disincentive to distribute untaxed earnings under the current system of deferral.

- It is an unproven empirical question whether a change to a territorial system would enhance economic efficiency, and, if it did, whether any such gains would offset the inefficiencies of higher taxes and cost burdens attributable to revenue loss and costs of future tax and transition planning and asset redeployments to maximize the benefits of exemption.

Turning to structural issues in designing a territorial system:

- The Ways and Means Majority proposal does not base exemption of foreign business income on avoidance of double taxation. Absent adoption of a broad anti-base erosion provision conditioned on a material foreign tax, exempting controlled foreign corporation stock gains from taxation may result in double non-taxation of international income. Moreover, such exemption would eliminate domestic corporate shareholder level tax on corporate income without there being any corporate level tax.

- A lower effective corporate tax on exempt foreign income under a territorial system invites increased tax avoidance by shifting domestic income through transfer pricing to be exempt foreign income. There is broad international consensus on the arm's length framework for transfer pricing, but there also is strong evidence that current transfer pricing rules allow substantial strategic tax avoidance. This advantages multinational businesses that earn income through controlled affiliates and can take advantage of transfer pricing to reduce global effective tax rates.

- The Ways and Means Majority proposal is not specific as to its proposed scope of exemption because it does not specify which anti-base erosion option it intends to use. Because the incentive for avoidance is not limited to income from intangibles, a broader anti-base erosion rule based on the effective tax rate on income combined with a geographic business nexus test (similar to Option 2 of the Discussion Draft) would be preferable to rules targeted at categories of income or activities such as intangibles income (though more than one base erosion provision could be adopted).

- It is desirable to treat branches and subsidiaries in the same manner to the extent possible. The Ways and Means Majority proposal's approach of deeming a branch to be a controlled foreign corporation is an improvement over the disparate treatment of a foreign subsidiary and a branch under current law. Exempting active business income of a foreign branch would eliminate the opportunity under current law to place loss generating activity in a branch (until it is sufficiently income generating) and income generating activity in a subsidiary.

- If an exempt branch is not treated as a controlled foreign corporation, it would be necessary to separately charge the branch for intangibles owned by the corporation that are used in the branch business, or risk substantial revenue loss from planning to earn exempt intangible income through bundling returns to intangibles into income from sales by the branch of the product using the intangible.

- The Ways and Means majority proposal's 95% exemption rate allows 5% of income to be taxed as a surrogate in lieu of disallowing expenses, such as interest, overhead expenses and research and development expenses, incurred in the home country but allocable to exempt foreign income and not chargeable to the source country under current international practice. This approach would be simpler than allocating expenses, however, it materially understates the amount of deductions allocable under current rules to foreign income. It advantages businesses with high allocable deductions and disadvantages businesses with low allocable deductions. Failing to disallow deductions for expenses allocable to exempt income would amount to a subsidy of foreign investment and increase the relative advantage of earning foreign rather than domestic income.

- The preceding analysis highlights the potential benefits from increased international alignment of tax rules beyond what is currently achieved through income tax treaties and consensus on principles of arm's length transfer pricing. It would be desirable for major trading partner countries to align anti-base erosion instruments and to agree on reciprocal recognition of expense allocations.

- The combination of (i) unrestricted scope for exemption and avoidable anti-base erosion proposals, and (ii) materially relaxed foreign tax credit limitation allowing unrestricted cross-crediting, (iii) restoration of foreign tax splitters allowing separation of foreign taxes from associated income, and (iii) unchanged interest, royalty and export source rules, opens the door for foreign tax credits to erode U.S. tax on income not taxed by any foreign country. This will result in material revenue loss and will encourage substantial tax-motivated restructuring of activity. The proposed changes to the foreign tax credit limitation rules should be eliminated and interest, royalty and export income should not be treated as foreign source income.

- The Ways and Means Majority proposal provides for mandatory inclusion of pre-effective date accumulated deferred foreign earnings of a controlled foreign corporation with an 85% deduction. The decision of how to tax pre-effective date earnings is fundamentally a revenue decision. The signaling of an intention to provide reduced tax rates on pre-effective date retained earnings increases the incentive of U.S. multinational taxpayers to retain earnings abroad. In the present revenue constrained environment, a date of enactment inclusion of old earnings would be superior to a windfall exemption of old earnings or continued deferral treatment of pre-effective date earnings.

II. WAYS AND MEANS MAJORITY TERRITORIAL PROPOSAL VERSUS CURRENT LAW DEFERRAL

A. Current Law Deferral System: The Benchmark

Under current U.S. deferral rules, a U.S. multinational is taxed on active foreign income earned through a controlled foreign corporation (including, generally, a greater than 50% foreign subsidiary) when the earnings are distributed as a dividend or are deemed included in income under certain anti-base erosion rules.[5] A residual U.S. tax is paid unless the credits for foreign income taxes paid with respect to the dividend, as well as excess foreign taxes paid in respect of other foreign income of the U.S. parent in the same foreign tax credit limitation category, are sufficient to offset the U.S. tax on the dividend.[6] The current highest corporate tax rate is 35% for net income over $10 million.[7]

A domestic corporation that owns 10% or more by voting power of the stock of a foreign corporation is allowed a credit for the foreign corporate level taxes imposed with respect to earnings received as a dividend from the foreign corporation.[8] Domestic corporations are not allowed a dividends-received deduction in respect of foreign corporate earnings that are not taxed by the United States; the indirect foreign tax credit in effect relieves double inter-corporate taxation (subject to the limitation on the credit).

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[5] I.R.C. §§61(a)(7), 951 - 964. Technically, a controlled foreign corporation is a foreign corporation that is more than 50% owned by vote or value, directly or indirectly by attribution, by United States shareholders, in turn defined for this purpose as a United States person that owns 10% or more by voting power, directly or indirectly by attribution.

[6] I.R.C. §§901, 902, 904.

[7] I.R.C. §11(b). The recapture of lower-bracket rates results in the corporate marginal rate to exceed 35% over limited income ranges that can be disregarded for purposes of analysis.

[8] I.R.C. §902. These credits are referred to as "indirect" or, alternatively, "deemed paid" foreign tax credits.

A U.S. resident individual is taxed on a foreign dividend and is allowed a credit for foreign withholding taxes imposed on the dividend. Consistent with the U.S. classical approach to corporate taxation, a resident individual is not allowed a credit for foreign corporate-level taxes. Since 2003, however, an U.S. individual taxpayer may treat dividends from a qualified foreign corporation as qualified dividend income ("QDI") eligible for a 15% tax rate (through [2012]), the same rate as on capital gains of a U.S. resident individual.[9] The conditions for QDI treatment do not include a minimum level of foreign corporate taxation of the earnings from which the dividend are paid or a subject to tax condition.[10]

Generally, as noted above, the United States allows a taxpayer to elect to credit foreign income taxes paid or deemed paid. The foreign tax credit is subject to a limitation that the credit may not exceed the pre-credit U.S. tax that otherwise would be paid by the taxpayer on foreign source net income in the same limitation category as that on which the foreign tax is paid. Today, there are only two foreign tax credit limitation categories, one for passive income and another "general" category that includes all non-passive income.[11] In determining foreign source net income from a limitation category, expenses of a U.S. taxpayer must be allocated between U.S. and foreign income.[12] In addition to following general principles of expense allocation that roughly parallel traditional cost accounting concepts, detailed rules apply to allocate interest, research and development and other expenses that relate to foreign income.[13] Expenses allocated to foreign income reduce the foreign tax credit limitation and, if a taxpayer has excess foreign tax credits, causes the credits to carry over to other years within the carryover period (of one preceding and ten succeeding years).

[9] I.R.C. §1(h)(11)(b)(i)(II). The conditions for QDI treatment are (1) the security on which the distribution is made is equity, rather than debt, under U.S. tax principles; (2) the distribution is a dividend for the corporation's taxable year in which it is paid; (3) either (a) the stock with respect to which the dividend is paid is readily tradable on an established securities market in the United States or (b) the foreign corporation is eligible for benefits of a comprehensive income tax treaty with the U.S. (for the taxable year in which the dividend is paid); and (4) the foreign corporation is not a passive foreign in- vestment company (PFIC) for the taxable year of the corporation in which the dividend is paid or in the preceding year.

[10] QDI classification is allowed to a dividend from a corporation organized in a zero-tax country if it is publicly traded on a U.S. exchange. In the case of a non-publicly traded foreign corporation, QDI classification is allowed if the foreign corporation is eligible for treaty relief with respect to its U.S. source income. In the experience of one of the authors, it is customary for cross-border private equity investments to be routed through a treaty country to preserve QDI treatment for a dividend, including a dividend resulting from a leveraged recapitalization of the portfolio company.

[11] I.R.C. §902. Because the U.S. tax on foreign income earned by a foreign corporation is deferred until the earnings are repatriated, rules are required to associate the foreign taxes to the earnings that are repatriated, either as an actual dividend or as income inclusions under subpart F. In addition, to permit the foreign tax credit limitation to operate effectively, the limitation categories are applied on a look-through basis to income of a controlled foreign corporation and a non-controlled section 902 corporation.

[12] I.R.C. §§861(b), 862(b).

[13] See I.R.C. §§ 864(e), (f) and (g). For a description and critique of these rules, see American Bar Association Tax Section Task Force on International Tax Reform, *Report of the Task Force on International Tax Reform*, 59 TAX LAW. 649, 765-770 (2006) [hereinafter "ABA Task Force Report"].

U.S. multinational taxpayers that earn high-tax foreign income may use excess foreign tax credits against other low-taxed foreign income. For example, excess foreign tax credits can be used to offset U.S. tax on royalty income and income from export sales that is treated as foreign-source income for U.S. tax purposes (though this income generally would not be taxed by the source country).[14]

The United States corporate tax base suffers from erosion through interest expense that is allowed as a deduction even though the taxpayer earns deferred or exempt income. U.S. rules governing allowance of interest deductions associated with exempt income are easily avoidable and more robust rules to disallow excess interest paid to related tax exempt persons do not apply to earning income exempt by reason of expensing of investment or substantially exempt through extended deferral of low-taxed foreign earnings from U.S. tax.[15]

Under Subpart F of the Code, a United States shareholder in a controlled foreign corporation is subject to current taxation on passive income, including interest, dividends, rents, royalties and capital gains not earned in an active business.[16] In addition to limiting deferral for passive income, otherwise active business income earned through use of "base companies" that is subject to an effective rate of foreign tax that is lower than 90% of the U.S. corporate tax rate.[17] The two principal categories of active income that are subject to the anti-deferral rules are foreign base company sales income and foreign base company services income.[18] The theory behind these provisions was that use of a base company in a low-tax jurisdiction is an indicator of tax avoidance that should preclude the benefit of deferral. These provisions do not apply, however, to income earned in the country of organization of the corporation or to income from sales of property manufactured by the corporation. With the advent of U.S. "check-the-box" entity classification rules and the acceptance of contract manufacturing by a separate party as manufacturing for purposes of the exception from current taxation, it is easy to avoid the reach of the Subpart F current taxation rules for most active income for intercompany passive income.

The level of concern regarding a residual home country tax on dividends is related to the strength of rules that restrict an offshore subsidiary from making its offshore earnings available to the U.S. group other than through a taxable dividend distribution. U.S. tax rules treat a controlled foreign corporation's offshore earnings that are invested in a broad range of U.S. investments,

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[14] *See generally* J. Clifton Fleming, Robert J. Peroni & Stephen E. Shay, *Reform and Simplification of the U.S. Foreign Tax Credit Rules*, 101 TAX NOTES 103 (2003), 31 TAX NOTES INT'L 1145 (2003).
[15] *See, e.g.*, I.R.C. §§163(j), 265.
[16] Subpart F is in Subchapter N of Chapter 1 of the Code. A controlled foreign corporation is a foreign corporation that is more than 50% owned, by vote or value, directly or indirectly under constructive ownership rules, by United States shareholders. I.R.C. § 957(b). A United States shareholder is a U.S. person that owns ten percent or more by vote, directly or indirect under constructive ownership rules, of the foreign corporation. I.R.C. § 951(b). Passive income defined as "foreign personal holding income" defined in Code section 954(c) is taxed currently.
[17] I.R.C. §§ 954(d) and 954(b)(4).
[18] I.R.C. §§ 954(d) and (e).

including a loan to its U.S. affiliates, as though the earnings were distributed to a U.S. affiliate.[19] The "investment in U.S. property" rules, adopted in 1962, also prevent a controlled foreign corporation from acting as a pledgor or guarantor of any loan to its U.S. affiliates. The rules were further strengthened after a U.S. shipping magnate circumvented this restriction by using his controlled foreign corporation shares as collateral for a loan.[20] In response, regulations were amended with addition of a rule known to all U.S. multinational financing lawyers (and auditors) – a pledge of stock will be deemed to be an indirect pledge of the assets of the controlled foreign corporation if "at least 66 2/3rds percent of the total combined voting power of all classes of stock entitled to vote is pledged and if the pledge is accompanied by one or more negative covenants or similar restrictions on the shareholder effectively limiting the corporation's discretion with respect to the disposition of assets or the incurrence of liabilities other than in the ordinary course of business."[21]

The investment in U.S. property rules further include significant exceptions that are designed to allow investment of offshore earnings in U.S. portfolio securities.[22] Accordingly, it is commonplace for a controlled foreign corporation to hold U.S. dollar bank deposits, U.S. government and corporate debt securities of unrelated issuers, and U.S. equity securities of unrelated issuers. So the consequence of the residual U.S. tax is the timing of a tax cost for using offshore in the U.S. group's business, repayment of U.S. group debt, or distributions to U.S. group shareholders, and not whether these offshore earnings are held as savings in the U.S. banking and capital markets. The investment in U.S. property rules, in other words, defends the residual U.S. tax on distributions but do not block holdings of U.S. portfolio investments.[23]

Stepping back from the details, the larger picture is that, based on the most recent publicly reported tax return data, approximately 80% of controlled foreign corporation earnings are retained and deferred from U.S. taxation, roughly 8% are distributed as dividends and 12% are currently taxed under Subpart F.[24] The average effective rate of foreign tax on foreign earnings of controlled foreign corporations with positive foreign earnings was approximately 16.4%.[25]

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[19] I.R.C. § 956.
[20] Ludwig v. Comm'r, 68 T.C. 979 (1977), *nonacq.*, 1978-2 C.B. 1.
[21] Treas. Reg. §1.956-2(c)(2) (T.D. 7712, 1980). See Gustafson, Peroni & Pugh, TAXATION OF INTERNATIONAL TRANSACTIONS [¶6200- 6220] (4th Ed. 2011)
[22] I.R.C. §956(c).
[23] A recent survey by the U.S. Senate Permanent Investigations Subcommittee majority staff estimates that of $538 billion of undistributed accumulated foreign earnings (of 27 surveyed multinationals as of the end of FY 2010) approximately 46% was invested in U.S. bank accounts and securities. U.S. Senate Permanent Investigations Subcommittee Majority Staff, Report Addendum to *Repatriating Offshore Funds: 2004 Tax Windfall for Select Multinationals* (Dec. 14, 2011).
[24] 2006 IRS Statistic of Income (SOI) data show that 12.2% of foreign earnings and profits of controlled foreign corporations (with positive current year earnings) were taxed currently under Subpart F. Statistics of Income, Table 3. U.S. Corporations and Their Controlled Foreign Corporations: Number, Assets, Receipts, Earnings, Taxes, Distributions, and Subpart F Income, by Selected Country of Incorporation and Industrial Sector of Controlled Foreign Corporation, Tax Year 2006, at http://www.irs.gov/taxstats/bustaxstats/article/0,,id=96282,00.html (accessed July 10, 2011). An additional 7.9% of foreign earnings were distributed in a taxable distribution. Lee

According to OECD data, the total Federal, state and local corporate tax burden on domestic corporate earnings is on average 39.2%. State taxes often do not apply to (or put differently are easily avoided with respect to) a U.S. multinational's foreign dividends. Assuming a 15% effective foreign corporate-level tax, for a U.S. multinational there is approximately a 20% difference in effective tax on a controlled foreign corporation's retained and distributed foreign earnings. If we turn to the level of a U.S. individual shareholder in the U.S. multinational and take account of the 15% tax on dividends, the difference increases to approximately 30%.

For a U.S. resident individual holding directly an investment in a controlled foreign corporation, dividends from which qualify for QDI treatment, there is approximately a 13% difference in tax on the controlled foreign corporation's retained and distributed foreign earnings.[26] The total foreign and Federal tax on such a shareholder is approximately 28%.

B. Ways and Means Majority Proposal

The centerpiece of the House Ways and Means Majority proposal is a 95 percent dividends received deduction for dividends received by a domestic C corporation that that is a 10 percent shareholder in a controlled foreign corporation or a foreign corporation that elects to be treated as a controlled foreign corporation.[27] After satisfaction of a one-year holding period, the foreign source portion of any dividend from a controlled foreign corporation is 95 percent exempt. The dividends received deduction would not apply to earnings attributable to U.S. source effectively connected income or U.S. dividends. There is no requirement that exempted income bear or be subject to a foreign corporate tax.

Exemption is mandatorily extended to foreign branches of a domestic corporation. The mechanism employed is to deem each foreign branch to be a controlled foreign corporation (which is for all purposes of the title) and apply the dividend received deduction to distributions

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Mahony and Randy Miller, *Controlled Foreign Corporations, 2006*, STATISTICS OF INCOME BULLETIN 197, 202 Figure C (Winter 2011) (taxable payout ratio of 9.7% in relation to positive current year earnings and profits net of Subpart F income) see http://www.irs.gov/pub/irs-soi/11coforeign06winbull.pdf (accessed July 10, 2011). When the 9.7% is measured in relation to positive current year earnings it is 7.2% (9.7% multiplied times the ratio of positive current year earnings and profits net of Subpart F income/positive current year earnings and profits (400,854,698/491,235,961) = 7.9%).

[25] Statistics of Income, Table 3. U.S. Corporations and Their Controlled Foreign Corporations: Number, Assets, Receipts, Earnings, Taxes, Distributions, and Subpart F Income, by Selected Country of Incorporation and Industrial Sector of Controlled Foreign Corporation, Tax Year 2006, at http://www.irs.gov/taxstats/bustaxstats/article/0,,id=96282,00.html (accessed July 10, 2011) and authors' calculations. The average effective rate disguises far lower effective rates for certain industries and companies, such as Google and other high tech companies as well as pharmaceutical companies. Companies in the resource industries often pay much higher levels of foreign tax.

[26] Assuming a 15% foreign tax on $100 of pre-foreign tax earnings and qualification of the distribution for QDI treatment, the U.S. tax on a distribution would be $12.75 ($85 * 15% = $12.75). If there were a 15% foreign withholding tax, the result would be the same, except that the foreign country would collect the $12.75 and the U.S. tax would be zero after crediting the foreign withholding tax.

[27] Discussion Draft, §301(a). Virtually all of the rates in the Discussion Draft are bracketed, including the exemption rate. This paper does not retain the brackets in its discussion in order to avoid distracting the reader.

from the branch. In addition, a domestic corporate shareholder in a foreign corporation that is more than 10 percent owned by a domestic corporation but is not a controlled foreign corporation (a "noncontrolled 10/50 corporation") may elect to treat a noncontrolled 10/50 corporation in which it owns shares as a controlled foreign corporation and, if it would be a United States shareholder by reason of owning 10 percent of the voting power, thereby be eligible for the dividends received deduction. As noted below, the indirect credit for foreign corporate level taxes, previously allowed to a 10 percent corporate shareholder in a noncontrolled 10/50 corporation would be repealed, so it is likely that this election would be made by most corporate shareholders.

Gain of a domestic corporate United States shareholder on the sale of stock in a "qualified foreign corporation" also would be eligible for a 95 percent deduction. A "qualified foreign corporation" is a controlled foreign corporation stock in which is eligible for the dividend received deduction if, in addition, 70 percent of its assets were active assets under a three-year look back test. No loss will be allowed on a sale of the stock.[28]

A foreign tax credit is not allowed with respect to any dividend for which the deduction is allowed. The Ways and Means Majority proposal provides for a top corporate tax rate of 25 percent (once income exceeds $50,000).[29] Accordingly, the effective rate of U.S. tax on foreign earnings eligible for the deduction would be 1.25 percent.[30]

The Ways and Means Majority proposal make a series of foreign tax credit changes apparently intended as simplifications in light of the proposed territorial exemption. The Discussion Draft's proposed changes include repeal of the indirect foreign tax credit (of Section 902) while retaining the indirect credit (of Section 960) in respect of current year Subpart F inclusions.[31] The Discussion Draft also would limit the allocation of deductions for purposes of the foreign tax credit limitation to direct expenses[32] and eliminate the separate foreign tax credit limitation category of passive income so the foreign tax credit is applied only to one category of income.[33] The Discussion Draft would repeal the recently enacted Code section 909 rule suspending credits for foreign taxes until the related foreign income is taken into account for U.S. tax purposes.[34]

The Ways and Means Majority proposal sets out three alternative anti-base erosion options for consideration without indicating which one or combination of the three would be preferred. The

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[28] Discussion Draft §302(a), adding new Code §1247.
[29] Discussion Draft §201(a), amending Code §11(b).
[30] 5% * 25% = 1.25%
[31] Discussion Draft §311(a) - (b).
[32] Discussion Draft §312.
[33] Discussion Draft §313.
[34] Discussion Draft §314.

first is based on a proposal in the Obama Administration budgets and proposals to the Joint Select Committee on Deficit Reduction.[35] Under the provision, if a U.S. person transfers intangible property from the United States to a related controlled foreign corporation, certain excess income from transactions benefiting from or connected with the transferred intangible property (outside the country of organization of the controlled foreign corporation) is currently includible in income as a new category of subpart F income. For this purpose, excess income would be income attributable to use or exploitation of intangibles that has not been subject to a minimum 10% effective rate of foreign income tax (or included pro rata as the rate scales from 10% to 15%) to the extent that such income exceeds 150 percent of costs attributable to such income.[36] The second Ways and Means Majority proposal option would require current inclusion in a United States shareholder's income low-taxed cross-border income earned by a controlled foreign corporation that is not derived from the conduct of an active trade or business in the home country of the controlled foreign corporation and is not subject to a 10% effective rate of foreign tax.[37] The third alternative would tax currently income of a controlled foreign corporation from intangibles, but would allow to a domestic corporation a deduction equal to 40 percent of foreign intangible income and currently included income controlled foreign corporation income from intangibles.[38] This would provide an effective 15% rate for foreign source royalty income earned by a domestic corporation directly and the same lower effective rate on foreign royalty income earned through a controlled foreign corporation.

The Ways and Means proposal addresses concerns regarding use of debt to earn exempt income with a limitation on interest deductions. The proposal would suspend the deductibility of net interest expense of a domestic corporation that is a United States shareholder with respect to any controlled foreign corporation in the same worldwide affiliated group to the extent of the lesser of (i) the excess domestic indebtedness ratio determined by the amount by which U.S. group members' debt gives rise to a domestic debt to equity ratio in excess of the worldwide group's debt to equity ratio over the worldwide group's debt, and (ii) an unspecified percentage of the domestic corporation's adjusted taxable income (EBITDA under rules of Code section 163(j)(6)(A)).[39] Disallowed interest may be carried forward to subsequent taxable years.

The Ways and Means Majority proposal provides that immediately prior to the effective date of the exemption regime, accumulated deferred foreign earnings of a controlled foreign corporation will be included in the income of a United States shareholder. A corporate United States shareholder will be entitled to an 85% deduction and the taxable portion may be reduced by foreign tax credits. The tax on the increased Subpart F income may be paid in 2 or more and up to 8 installments.

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[35] Office of Management and Budget, "Living Within Our Means and Investing in the Future: The President's Plan for Economic Growth and Deficit Reduction," p. 269 (September 2011).
[36] Discussion Draft §331A.
[37] Discussion Draft §331B.
[38] Discussion Draft §331C.
[39] Discussion Draft §332.

C. Senator Enzi's Proposal – S. 2091.

III. WAYS AND MEANS MAJORITY TERRITORIAL PROPOSAL: EFFECTS ON INVESTMENT, EARNINGS REPATRIATION, ADMINISTRATIVE BURDEN AND REVENUE IN RELATION TO CURRENT LAW DEFERRAL

A. Evaluating the Ways and Means Majority Territorial Proposal In Relation to Current Law

The objective of tax policy evaluation is to weigh alternative approaches to raising the same amount of revenue according to competing policy demands. The traditional tax policy criteria for evaluating alternative taxation rules in relation to a budget constraint are fairness, efficiency and administrability. In evaluating the Ways and Means Majority proposal, we apply these standards in relation to possible alternative policies that are relevant in the sense that they can be implemented by taxpayers and tax administrations and it is plausible that they can be adopted.

We have previously written at length regarding the role of fairness in international taxation and concluded that fairness considerations favor current taxation of worldwide income.[40] Deferral and territorial systems each are second best in relation to current taxation of foreign income when considered from a fairness perspective. On this ground, we would favor ending or curtailing deferral, which at a lower corporate tax rate is a plausible alternative.[41] We will not reprise our earlier discussion, but focus our comments here on efficiency, administrability and revenue aspects of the Ways and Means Majority proposal in relation to the current law deferral system.

We also do not here revisit the debates regarding which of the "alphabet soup" of neutralities should guide policy regarding taxation of cross-border capital to maximize welfare of U.S. citizens and residents.[42] In 2008, Rosanne Altshuler and Harry Grubert expressed the view that the scope of current knowledge is insufficient to develop economic models and estimate behavioral elasticities required to definitively judge an international tax system.[43] Subsequent

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[40] See J. Clifton Fleming, Jr., Robert J. Peroni and Stephen E. Shay, *Fairness in International Taxation: The Ability-To-Pay Case for Taxing Worldwide Income*, 5 FLA. TAX REV. 299 (2001) [hereinafter Fleming, Peroni and Shay, *Fairness in International Taxation*]; *see also*, Stephen E. Shay, *Commentary on Ownership Neutrality and Practical Complications*, 62 TAX LAW REV. 317, 330-331 (2009).

[41] See, e.g., §204(c), S. 727, 112th Cong. 1st Sess. (April 5, 2011) (Wyden-Coats Bipartisan Tax Fairness and Simplification Act of 2011, requiring current taxation of income of controlled foreign corporations).

[42] [Cites to extensive literature.]

[43] They go on to observe the various neutrality principles of capital export neutrality (CEN), capital import neutrality (CIN), national neutrality (NN) and capital ownership neutrality (CON) are based on very simple models that do not reflect adequately the complexities of actual economic activity and cannot serve as a reliable guide for policy.

discussion of these theories has not altered our view of their policy relevance. We will evaluate the principal elements of the Ways and Means Majority proposal in relation to the behavioral margins that they affect, including the allocation of U.S. multinational investment between domestic and foreign activity and the decision repatriate earnings.[44]

B. Effect on Investment.

We examine separately two effects of deferral and territorial systems. The first is the effect of the wedge or difference between the tax on income from a domestic investment and the same investment qualifying for deferral or exemption under a territorial system on a U.S. multinational's investment location decision. The second effect, which is distinct from the first, is the distortion of the timing of a controlled foreign corporation's foreign distributions to United States corporate shareholders.[45] Before considering how investment location and repatriation decisions would be affected by a shift to territorial, the next section compares the effects of present law deferral and the proposed territorial regime.

1. Effect of Present Law Deferral (with a Credit for Foreign Taxes) and Exemption under a Territorial Regime

As we previously have demonstrated, if it is assumed that (i) earnings are ultimately repatriated, (ii) deferred earnings are reinvested at a constant pre-tax rate (that does not differ if the earnings are held in the controlled foreign corporation or in the U.S. parent corporation), and (iii) the tax rates on repatriated and reinvested earnings remain constant, the tax benefit from deferral is for the period of deferral the difference between the U.S. and the foreign tax rate times an amount equal to the return on the earnings reduced by the U.S. tax rate.[46] (Generally, there is no tax benefit from deferring repatriation of foreign earnings that are taxed at a foreign effective rate in

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Rosanne Altshuler and Harry Grubert, *Corporate Taxes in the World Economy: Reforming the Taxation of Cross-Border Income*, in FUNDAMENTAL TAX REFORM: ISSUES, CHOICES, AND IMPLICATIONS 319, 320 (MIT 2008) [hereinafter "Altshuler and Grubert, *Reforming the Taxation of Cross-Border Income*"]. From a somewhat different perspective, in 2006 the American Bar Association Tax Section Task Force on International Tax Reform also observed that there was a lack of consensus on what form of neutrality was in the overall U.S. interest and essentially treated that debate as not having policy relevance. ABA Task Force Report, *supra* note 13, at 661.

[44] Altshuler and Grubert, *Reforming the Taxation of Cross-Border Income*, *supra* note 43, at 321; *see also*, Harry Grubert, *Tax Credits, Source Rules, Trade, and Electronic Commerce: Behavioral Margins and the Design of International Tax Systems*, 58 TAX LAW REV. 149, 149-155 (2005).

[45] This effect is often referred to as lock-in and is equally applicable in circumstances where the domestic corporate rate is reduced below the rate that would apply to income earned directly by a shareholder. Unless, the personal tax rate is reduced, this likely would result from a reduction in the corporate tax to 25%. For a discussion of issues raised, see Halperin, *Mitigating the Potential Inequity of Reducing Corporate Rates*, 126 TAX NOTES 641 (2010) [hereinafter "Halperin, Reducing Corporate Rates"].

[46] J. Clifton Fleming, Jr., Robert J. Peroni and Stephen E. Shay, *Worse than Exemption*, 59 Emory LAW J. 79, 96-104 (2009) [hereinafter Fleming, Peroni and Shay, *Worse Than Exemption*].

excess of the domestic effective rate that would apply to repatriated earnings.[47]) Why is the benefit limited to the reinvested after-U.S. tax amount? Because, the deferred U.S. tax itself will be reinvested at the assumed rate of return and therefore the tax on earnings when ultimately repatriated will be, on a present value basis, the same as though the tax were imposed in the year earned.[48] An example is set out at Appendix A illustrating a comparison of full current U.S. taxation, worldwide with deferral and territorial exemption.

If it is assumed that the same rate of return is available on reinvested earnings held abroad or distributed to the United States and constant tax rates, then the benefit of deferral is a function of how long the earnings are reinvested overseas and the differential in tax rate that applies to the reinvested earnings.[49] If, based on the most recent Statistics of Income tax data, it is assumed that the effective foreign corporate rate is approximately 15%, there is no foreign withholding tax, that there are no state taxes on a foreign dividend and that the domestic corporation's marginal Federal corporate tax rate is 35%, then the rate saved on holding reinvested earnings offshore is 20%. Under the Ways and Means Majority proposal, however, we assume that the domestic corporation's marginal effective tax rate would be 25% and, applying the same assumptions, the rate difference on reinvested versus repatriated earnings would be approximately 1.25%.[50] However, if the corporate rate is reduced to 25% and the same assumptions apply, the rate difference on reinvested versus repatriated earnings would shrink to 10% under the current law deferral system. The difference of 9% is modest (and decreases if there is a foreign withholding tax that cannot be avoided). The distinct effect of the rate reduction highlights the importance of analyzing separately the effects of different structural elements of the proposal.

2. Investment Location

[47] However, the excess foreign tax credit from high foreign-taxed earnings may under the current law deferral system offset U.S. tax on other foreign income in the same limitation category (cross-crediting). Postponing repatriation defers the start of a limitation on the use of excess foreign tax credits as carryovers. *See* I.R.C. §904(c).

[48] The understanding that under assumptions of a constant tax rate and a constant return the timing of a corporate distribution should be unaffected by a shareholder tax derives from analysis of classical corporate tax systems that impose a separate shareholder tax. The application of this New View of dividends to the timing of foreign subsidiary distribution was first discussed in David Hartman, *Tax Policy and Foreign Direct Investment*, J. Pub. Econ. 107, 115-16 (1984). For a discussion of this analysis, *see* Fleming, Peroni and Shay, *Fairness in International Taxation*, supra note 40, at 304 n. 10; James R. Repetti, *Will U.S. Investment Go Abroad in a Territorial Tax: A Critique of the President's Advisory Panel on Tax Reform*, 8 FLA. TAX REV. 303, 307 (2007); *see also* Daniel Halperin, *Reducing Corporate Rates*, *supra* note 45, at 646-648; [Alvin Warren, *The Relation and Integration of Individual and Corporate Income Taxes*, 94 HARV. L. REV. 717 (1981)].

[49] In theory capital would be allocated according to after tax returns and therefore jurisdictions with lower effective tax rates should attract investment such that pre-tax rates of return are lower than where there would be higher effective tax rates. Because of the non-transparency of and variances in after-tax rates of return, we disregard this potential effect in our analysis.

[50] In the experience of one of the authors, in many contexts the foreign withholding tax may be avoided (e.g., through Dutch or Luxembourg structures), however, the 5% treaty direct dividend rate is considered a reasonable intermediate assumption.

The principal efficiency issue posed by the Ways and Means Majority proposal is the effect on investment of shifting to a territorial system. Under an exemption system, the taxpayer earns an after-tax return based on the foreign tax rate alone, so the advantage over a domestic investment is an after-tax return of 85% of pre-tax earnings (assuming a 15% foreign tax rate) versus an after tax return of 65% of pre-tax earnings (assuming a 35% U.S. tax rate). In other words, the residual U.S. tax on after-foreign tax profits is eliminated altogether. Based on the aggregate data, shifting to a territorial system would result in a substantial tax reduction on foreign income, assuming ultimate distribution of earnings. Accordingly, as a first order result, a shift to a territorial system would result in increased foreign investment and reduced domestic investment by U.S. multinationals.

While there has been limited empirical work addressing directly the question of the effect of a change from deferral to a territorial system, a recent study suggests that there would be a material effect. A recent study by Michael Smart examined Canada's experience when, under Canadian tax rules, investment in a non-Canadian country shifts to eligibility for exemption of "exempt surplus" (generally, income from active business in that country) as a result of the country's entry into a treaty with Canada. Smart's analysis indicates that investment in a newly exempt country increases by an average of 79% on average for a sample of tax treaties implemented in the last 35 years.[51]

While there is no direct advantage from exemption if income does not bear a lower effective rate of tax than in the United States, Professor Kleinbard has highlighted that international tax planning techniques used by U.S. multinationals permit earnings in high foreign tax countries to be shifted outside the country where the income is earned in a manner that results in material a reduction of the effective foreign tax rate on the income.[52] Accordingly, the effect on investment location decisions of shifting to a territorial regime is not limited to investments in nominally lower tax rate jurisdictions.

It is an empirical question whether and the extent to the reduced U.S. investment would be replaced by domestic investment by foreign investors or otherwise as suggested by Professor Hines and, if so, whether this would enhance or decrease U.S. welfare. We have questioned key bases for his arguments, as have others, but to this point the Professor Hines' theory has not been developed to the point that it has been modeled. A recent review of the broader debate over

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[51] Michael Smart, *Repatriation taxes and foreign direct investment: Evidence from tax treaties* (Working Paper Feb. 2011) at http://accounting.uwaterloo.ca/oxfordv2.pdf.

[52] Edward D. Kleinbard, *Stateless Income's Challenge to Tax Policy,* 132 Tax Notes 1021, 1033 (Sep. 5, 2011) ("Even if a multinational enterprise's income is sourced in the first instance by every country according to some economically rational set of agreed principles, stateless income tax planning simply extracts the income from the source country (for example, through deductible interest, royalty, or fee payments) and deposits it in a more tax-friendly locale."), Edward D. Kleinbard, *Lessons of Stateless Income*, ___ TAX L. REV. ___, Part VI.B (201[2]). One of the authors has direct practice experience executing planning of the nature described in Professor Kleinbard's Stateless Income articles.

international tax rules does not find theory conclusive as to the effect of foreign investment on national welfare and summarizes the empirical studies as finding that foreign investment does not affect domestic investment of the same firm, but does find that in the aggregate foreign investment crowds out domestic investment "dollar for dollar".[53] Becker and Fuest observe "Given the state of the debate, the question arises why there is such a strong movement toward exemption."[54] The answer to the question may lie in the realm of political economy, including the influence of multinational lobbying and campaign contributions, more than policy.[55] In any event, we do not find that this literature provides a clear theoretical or empirical basis for policy prescription.[56]

So far, we have not discussed the separate effect of lowering the U.S. statutory tax rate. Taken alone, a lower statutory corporate tax rate will mitigate the effect on investment location of shifting to a territorial system. The lower the U.S. corporate rate, the less the differential will be between the U.S. and foreign rate and the immediate tax impact of a shift to a territorial system. If, however, the base broadening changes adopted to raise revenues to pay for the reduced corporate tax rate increase the effective rate on domestic investment, this would offset the mitigating effect of lower corporate tax rate on the location of affected investments.[57] The effect of the change on investment behavior would rest on whether the U.S. effective U.S. corporate rate on the same investment remains the same or is decreased and, if decreased, by how much. It is not possible to know how this factor affects particular categories of investment

[53] Johannes Becker and Clemens Fuest, *The Taxation of Foreign Profits – The Old View, the New View and a Pragmatic View*, 46 INTERECONOMICS 92, 95-96 (2011) [hereafter "Becker and Fuest, Taxation of Foreign Profits"].
[54] *Id*. at 96.
[55] Recent work by political science and governance scholars has highlighted the success of special interests in achieving policy objectives through legislation that advance their self-interest. *See, e.g.*, Jacob S. Hacker and Paul Pierson, WINNER-TAKE-ALL-POLITICS HOW WASHINGTON MADE THE RICH RICHER- AND TURNED ITS BACK ON THE MIDDLE CLASS (2010); Lawrence Lessig, *Republic, Lost* (Twelve 2011). The taxation of foreign income of U.S. multinationals is a paradigm of an issue in which a special interest, the U.S. multinational business community, has a substantial stake, the issue is technical and there are no countervailing organized political constituencies capable of scrutinizing their claims and, where unfounded, offsetting their lobbying for unjustified proposals. As discussed below, the repatriation holiday is closely linked with the House Ways and Means Majority' s territorial proposal. *See* note __, *infra*. Bloomberg News reports that over 160 lobbyists are registered to lobby the repatriation holiday issue for the WinAmerica Campaign and its member companies and associations and 60 of those lobbyists are former staff members for sitting members of Congress. Richard Rubin and Jesse Drucker, Google Joins Apple in Push for Tax Holiday, Bloomberg News Sep. 29, 2011, at http://www.bloomberg.com/news/2011-09-29/google-joins-apple-mobilizing-lobbyists-to-push-for-tax-holiday-on-profits.html. Regarding lobbying on tax issues by large corporations generally *see*, David Cay Johnston, The Corporations That Occupy Congress, Reuters Dec. 20, 2011, at http://blogs.reuters.com/david-cay-johnston/2011/12/20/the-corporations-that-occupy-congress/ ; Public Campaign, *For Hire: Lobbyists or the 99%?* (Dec. 2011) (reporting that 30 companies paid more to lobby Congress and federal agencies in 2008-2010 than they paid in federal income taxes on aggregate book profits of $164 billion).
[56] See references at note 43.
[57] See, Stephen E. Shay, *Daunting Fiscal and Political Challenges for US International Tax Reform*, (forthcoming) 66 Bull. Intl. Taxn. 4/5 (2012).

until the rest of the corporate tax reform is specified and the actual corporate tax rate change is finally determined.[58]

The effect of differences in effective tax rates on investment is related to the use of transfer pricing to increase the amounts of income shifted to lower effective rate environments. In 2010, the Treasury described increased tax-induced shifting of U.S. corporate income offshore documented in studies.[59] The impact on investment of shifting to a territorial system depends in part on any corporate rate reduction and how it is paid for, as just discussed, and in part on the scope of anti-base erosion provision intended to constrain increased tax-induced shifting of U.S. corporate income offshore.

We discuss the three anti-base erosion alternatives in the Discussion Draft, below, however, like a corporate rate reduction, they each could be adopted under current law as well as under a territorial system and arguably should be analyzed separately. Depending on the approach taken, however, at least some income would be subject to current full U.S. taxation (with an indirect credit under section 960). For the affected income, such current U.S. residual taxation would eliminate a tax incentive to earn income offshore.

3. Timing of Repatriation - Relative Tax Disincentive to Repatriate Earnings Is The Same Under Territorial As Under Deferral.

Under a territorial system there is a tax benefit from retaining earnings abroad if when reinvested the return on the reinvestment would be subject to a lower tax rate than in the United States. If earnings are repatriated to the parent and held in the parent, the receipt of the earnings will not be taxed, but the U.S. tax will apply to the return from reinvesting the earnings in the U.S. parent (instead of the lower foreign tax that would apply to a foreign subsidiary's reinvestment of the earnings abroad). As discussed above, so long as the U.S. tax on repatriation is unchanged (assuming a constant tax rate and reinvestment at a constant rate of return), the tax advantage of not repatriating earnings is formally the same under a territorial system as under a deferral regime.

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[58] The reduction in corporate tax rate likely will be tied to the revenue gains from base broadening on corporate and pass-through business income.

[59] Treasury's testimony reviewed a range of studies that indicate substantial income shifting to lower tax countries, including evidence from company tax data of margin increases correlated inversely with effective tax rates. Testimony of Stephen E. Shay, Deputy Assistant Secretary International Tax Affairs, U.S. Department of Treasury, House Ways and Means Committee, Hearing on Transfer Pricing Issues (July 22, 2010), http://democrats.waysandmeans.house.gov/media/pdf/111/2010Jul22_Shay_Testimony.pdf. Martin Sullivan has examined financial statement data to evidence profit shifting to low tax jurisdictions that is disproportionate to asset and payroll factors. *See e.g.*, Martin A. Sullivan, *Obama Launches International Reform: The Battle Begins,* 123 TAX NOTEs 646, 648-49 (2009) (presenting a study showing that for 2006, five low-tax countries were the source of 23.1% of all U.S. multinationals' foreign profits-even though those five countries accounted for only 3.1% of the worldwide employment of U.S. multinationals, only 6% of their tangible property, and only 15.7% of their worldwide sales).

Under the analysis (and assumptions) described above, the marginal additional U.S. tax from repatriating offshore earnings does not on a present value basis result from the home country tax on repatriation, but from foregoing the ability to reinvest earnings offshore at a lower foreign tax rate. Under that analysis, the incentive to hold earnings offshore actually is the same under an exemption system as under a deferral system – except that in a territorial exemption system the advantage of the lower rate on reinvested earnings will benefit the whole amount of reinvested earnings unreduced by a future tax on repatriation. Under this analysis, and if tax were the only consideration, one would expect that, after a transition period, the amount of earnings that are not repatriated under a territorial system would in equilibrium settle at the same or greater rate of reinvestment as under a deferral system. [60]

It has been suggested that in the U.S. context the tax on repatriation is not invariant and therefore it does distort the repatriation decision.[61] Thus, for example, it may be possible to avoid tax on repatriation. Several repatriation avoidance strategies have been foreclosed in recent years through case law challenges,[62] regulation changes[63] or legislation. [64] If enforcement efforts are successful, the repatriation tax would be expected to be become more robust.

Altshuler and Grubert review a number of strategies that might postpone repatriation, such as (i) investing active earnings in passive assets, (ii) making equity investments in high-tax affiliates (which seems fairly rare in practice), and (iii) holding low-taxed affiliates under high-taxed affiliates (also not customary in practice).[65] If active earnings eligible for deferral are invested in passive assets, the returns on those investments generally would be subject to current U.S. taxation under the Code Subpart F anti-deferral rules, which would effectively eliminate the advantage of reinvestment of earnings at the foreign tax rate. Strategies that blend foreign taxes with low-taxed earnings may be thought of as changing the character of the earnings in question from low-taxed to higher-taxed, but the preceding analysis applies nonetheless to the extent earnings are low-taxed in relation to the taxpayer's U.S. effective rate. (It is common for multinationals to develop high- and low-taxed pools of earnings and to manage distributions to maximize use of foreign tax credits.) While these strategies would not be the same under a territorial regime, there nonetheless would be the same or greater incentive to reinvest earnings in lower tax arrangements offshore. These strategies would not appear to be a basis for concluding that the timing of repatriation would change materially for tax reasons under a territorial system.

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[60] [We propose for future research the relative accumulations of companies operating in deferral and territorial systems.] [Has this been done?]

[61] Yin, *Reforming the Taxation of Foreign Direct Investment*, *infra* note 111, at 512 note 5.

[62] See, e.g., *Schering-Plough Corp. v. United States*, 651 F. Supp.2d 219 (D.N.J. 2009), aff'd sub nom., *Merck & Co. Inc. v. United States*, _ F.3d _ (2011).

[63] See, e.g., Treas. Reg. §1.367(b)-10 adopted in T.D. 9626 (May 19, 2011)

[64] See, e.g., I.R.C. §960(c), added by P.L. 111-226, §214(a).

[65] Altshuler and Grubert, *Repatriation taxes, repatriation strategies and multinational financial policy*, 87 J. PUB. ECONOMICS 73 (2002).

It also is possible, however, that the tax rate on repatriation may change or be expected to change and this could have an impact on behavior. If the tax on repatriation is expected to increase, it would accelerate repatriations and if it is expected to decrease it would increase retentions. Until the 2004 repatriation holiday, a U.S. multinational had little reason to expect that the U.S. tax on repatriation would vary from the normal corporate tax on foreign income.

Once a lower effective rate was potentially available, the potential advantage of earning low-taxed offshore income increased. It has been well documented that post-2004 the amount of un-repatriated earnings for which a permanent reinvestment accounting treatment applies has increased materially for companies that made distributions under the 2004 repatriation holiday.[66] Prospects of a future holiday, and now, the prospect of a future exemption system without full taxation of previously-deferred earnings, likely will increase the holding of profits offshore. Under the preceding analysis, assuming that tax is the only consideration and that avoidance of tax on repatriation is limited, the recent build-up of offshore earnings may be viewed as in part a self-inflicted wound tied to prospects of legislative amnesties.

One question that arises is why the pressure for repatriation holidays did not arise until the 21st century when the deferral system had been in place since 1962. The tax on repatriated earnings was not identified as a material issue for U.S. multinationals until quite recently. Increased attention to the U.S. residual tax has paralleled reductions in foreign corporate tax rates in relation to the U.S. tax rate and resulting reductions in excess foreign tax credits. In the 1990s, discussion of the pressures of deferral abated after the repeal of the earnings invested in excess passive asset rules and adoption of the so-called PFIC overlap rule that excluded a United States shareholder in a controlled foreign corporation from the reach of the PFIC rules. Notwithstanding reductions in foreign tax rates and excess foreign tax credits, however, relatively small amounts of earnings are distributed as taxable dividends (estimated to be less than 10% of earnings).[67] In other words, whatever pressure has been building, it has not resulted in material distributions. If the tax rules support a fairly invariant repatriation tax, is there another explanation for low levels of dividend distributions?

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[66] *See* Brennan, *What Happens After a Holiday?, supra* note 107, at 15-17 (For sampled companies, permanently reinvested foreign earnings increased after 2004 holiday both absolutely and in relation to pre-tax foreign earnings. Pre-tax foreign earnings also increased relatively to domestic earnings for six of eight industry groups in the sample.)

[67] 2006 IRS Statistic of Income (SOI) data show that 12.2% of foreign earnings and profits of controlled foreign corporations (with positive current year earnings) were taxed currently under Subpart F. Statistics of Income, Table 3. U.S. Corporations and Their Controlled Foreign Corporations: Number, Assets, Receipts, Earnings, Taxes, Distributions, and Subpart F Income, by Selected Country of Incorporation and Industrial Sector of Controlled Foreign Corporation, Tax Year 2006, at http://www.irs.gov/taxstats/bustaxstats/article/0,,id=96282,00.html (accessed July 10, 2011). An additional 7.9% of foreign earnings were distributed in a taxable distribution. Lee Mahony and Randy Miller, *Controlled Foreign Corporations, 2006*, STATISTICS OF INCOME BULLETIN 197, 202 Figure C (Winter 2011) (taxable payout ratio of 9.7% in relation to positive current year earnings and profits net of Subpart F income) see http://www.irs.gov/pub/irs-soi/11coforeign06winbull.pdf (accessed July 10, 2011). When the 9.7% is measured in relation to positive current year earnings it is 7.2% (9.7% multiplied times the ratio of positive current year earnings and profits net of Subpart F income/positive current year earnings and profits (400,854,698/491,235,961) = 7.9%).

A non-tax explanation for the disincentive to repatriate offshore earnings may be the effect of an exception to the normal accounting rule of recognition of tax expense for actual or expected tax expense when earnings are generated in a foreign affiliate. The accounting rule exception allows the reporting company to not record the withholding tax, if any, and residual U.S. tax on un-repatriated foreign subsidiary earnings if the reporting company represents to auditors that the earnings will be invested abroad indefinitely and evidences specific plans for reinvestment of the undistributed earnings demonstrating that remittance will be postponed indefinitely.[68] The exception to recognition of the future U.S. tax liability, sometimes referred to as the indefinite reversal exception, allows a reporting entity to postpone recognition of a liability for home country tax on earnings that are "permanently reinvested" overseas thereby increasing reported earnings for the period the offshore earnings are earned or, if the exception is asserted in a later year for earnings of a prior year, in the later year. If the earnings are subsequently distributed as a dividend, the financial statement "benefit" is reversed. The dividend of earnings is eliminated as an intercompany transaction (recall that the earnings underlying the dividend were included in consolidated financial statement earnings in the year first earned), but any residual U.S. tax on the earnings is taken into account in the year of the dividend reducing consolidated earnings for the year (and inflating the "book" tax rate). Moreover, financial accounting does not "discount" the tax to take account of the fact that it is paid long after the earnings were taken into account. The undiscounted hit to earnings is perceived as problematic since it also can have an effect on stock price. If a stock tends to be priced in relation to earnings, say at a price to earnings ratio of 10 to 1, the potential stock price effect of the earnings reduction can be 10 times the earnings hit.

Recent work into the intersection of taxation and accounting treatment in economic analysis of corporate behavior examines whether investment decisions are enhanced because they provide managers with discretion over the timing of book income (or taxable income).[69] Shackelford, Slemrod and Sollee point to the discretion offered by the APB 23 accounting treatment and the fact that a company may conclude that profits whose tax has already been booked will not be repatriated after all, which has the effect of increasing book earnings in the year the accounting treatment is changed.[70] They state that "this discretion in financial reporting provided by foreign operations provides firms with an (additional) incentive to locate in low-tax countries, e.g., tax havens." Blouin and Robinson report findings that the reporting incentive to defer repatriation has a consistent and significant effect on repatriation decisions of public companies and is

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[68] *See* Barry Jay Epstein and Lawrence G. May, *The Differential Influence of U.S. GAAP and IFRS on Corporations' Decisions to Repatriate Earning s of Foreign Subsidiaries*, 37 INT'L TAX J. 25, 31-33 (Mar. – Apr. 2011) ("To summarize the foregoing, under U.S. GAAP, strictly interpreted, there should be a relatively high hurdle for the nonrecognition of the tax effects of the earnings of foreign subsidiaries of domestic corporations, … .") at http://ifrsaccountant.com/media/pdfs/foreign-earnings-repatriation-accounting-gaap-ifrs.pdf. .

[69] *See*, Douglas A. Shackelford, Joel Slemrod and James N. Sallee, *Financial Reporting, Tax and Real Decisions: Toward a Unifying Framework*, 18 INT'L TAX AND PUBLIC FINANCE 461 (2011) [hereafter "Shackelford, Slemrod and Sallee, Financial Reporting Tax and Real Decisions"].

[70] [As a real example of this flexibility, in 2008 and 2009 General Electric reversed prior charges for taxation on $2 billion and $1 billion of earnings respectively and increased after-tax book earnings by $700 million and $350 million respectively for those years. Cite GE 10-K MDAA and tax footnotes for 2008 and 2009.]

stronger for companies that rely on the indefinite reversal exception.[71] Indeed, for public companies that face strong accounting incentives to defer reporting tax expense, Blouin, Krull and Robinson find repatriations reduced by about 17% to 21% annually.

The principal proponents of a so-called repatriation holiday are companies that have substantial "permanently reinvested" earnings on their books.[72] Companies in this group for which 2010 data breaking down onshore and offshore holdings of cash was publicly available also reported very high levels of cash held in their domestic affiliates.[73] This suggests that an important part of the political pressure on repatriation is the desire of these multinationals for financial flexibility to access foreign retained earnings with a reduced tax cost (and a lower reduction in book earnings).[74]

The preceding discussion raises an empirical question with obviously significant public policy ramifications: whether the financial accounting incentives dominate the tax incentives to hold funds offshore. Whether or not this is the case, the apparent significance of the indefinite reversal exception as an incentive for suboptimal behavior, and the evidence that the level of discretion in applying the indefinite reversal exception may counteract the financial reporting

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[71] Jennifer L. Blouin, Linda K. Krull and Leslie A. Robinson, *Is U.S. Multinational Dividend Repatriation Policy Influenced by Reporting Incentives?* (Tuck School of Business Working Paper 2009-68, Sept. 2011) at http://papers.ssrn.com/sol3/papers.cfm?abstract_id=1468135 [hereafter "Blouin, Krull and Robinson, *Multinational Dividend Repatriation Policy*"]. These findings are consistent with surveys of tax managers regarding the high value placed on the financial reporting flexibility under a deferral system.

[72] Ten of the original members of the Win America Coalition seeking a tax holiday to repatriate their foreign earnings alone had over $150 billion of "permanently reinvested" foreign earnings for their fiscal 2010 years. (This number is aggregated from the companies' FY 2010 Form 10-K reports to the Securities and Exchange Commission.) These U.S. multinationals appear to pay very low effective book rates of foreign tax. The ratio of foreign "book" taxes to foreign "book" earnings before tax (EBT) as disclosed in FY 2010 financial statements of eleven of the original members of the Win America Coalition range average 10% (weighted by foreign EBT) and include Cisco's 4.8%, Google's 3.4%, and Apple's 1.5% foreign book tax rates. (Author's calculations based on information from financial statement tax and geographic segment footnotes in FY 2010 10-Ks.) Most companies determine geographic segment reporting based on the location of the customer so this geographic division does not correspond with source rules for tax purposes. Moreover, there is no purpose other than disclosure to identify foreign versus domestic income, so this calculation is at best a broad approximation of these companies' effective tax rates on foreign income under U.S. tax principles.

[73] Four of the Win America coalition companies who publicly disclosed the geographic location of cash at their fiscal 2010 year-end, Apple, Cisco, EMC and Google, had a combined total of $50 *billion* of *U.S.* cash and cash equivalents available for investment in the United States.

[74] Consistent with the view that the repatriation holiday reflects balance sheet flexibility than investment concerns, independent third party market analysts have been skeptical that a repatriation holiday would have a meaningful economic effect. In July, 2011, Moody's analyzed U.S. multinationals' offshore cash holdings and did not expect offshore cash to come back to the US because a large portion of their growth will come from international markets and they have access to credit markets for U.S. needs. Moody's Investors Service, *Special Comment: US Corporate Cash Pile Rises to $1.2 Trillion; Nearly Half of the Money Sits Overseas*, 4 (July 26, 2011). In July, 2011, Merrill Lynch economists similarly concluded that a repatriation holiday would not have a material economic impact: "Today, businesses are investing slowly not because their tax burden is high but because demand for goods and services is soft." Bank of America Merrill Lynch Economic Commentary, *Repatriation Games* (July 7, 2011). J.D. Foster, Norman B. Ture Senior Fellow in the Economics of Fiscal Policy at the Heritage Foundation, reached the same conclusion in testimony before the Senate Budget Committee. *See* Statement of J.D. Foster, Hearing on Promoting Job Creation in the U.S., Committee on the Budget, United States Senate (Sept. 20, 2011).

objectives of the rule, strongly suggest that one potential policy response should be to reconsider the indefinite reversal exception or to constrain its use.

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4. *Other claims for shifting to a territorial system.*

Other arguments made against the current deferral system are based on the assertion that a higher U.S. tax on foreign investments is capitalized into the stock price of the U.S. multinational and thereby increases its cost of capital. If the Ways and Means Majority proposal is indeed revenue neutral in relation to foreign income, then one would expect that the cost of capital should be unaffected across U.S. multinationals in the aggregate, unless one expects the marketplace to miss perceive the offsetting revenue increases on foreign income. Even though revenue neutral, the proposal will create winners and losers, but if the revenue estimate is broadly correct, one would expect the advantages to the winners to be offset by the detriments to the losers. Accordingly, it is difficult to rationalize a shift to territorial on the grounds it would reduce the cost of capital to U.S. companies.[75]

Similarly, claims are made that the current rules disadvantage ownership of foreign assets through U.S. companies and stimulate foreign takeovers of U.S. companies and initial formation of businesses as foreign companies. Presumably, this consideration also would be unaffected across U.S. multinationals in the aggregate, and the benefits to the "winners" would equal the adverse effects for the "losers." The existing evidence suggests that these effects are weak under current law and that there would be little reason to expect that to change.[76]

C. *Administrative Burden of the Proposed Territorial System in Relation to Current Law*

The Ways and Means Majority proposal would not achieve simplification gains such that there would be a meaningful reduction in compliance burden. The principal simplification of the proposal, after transition, is to reduce the extent to which it is necessary to track historic pools of earnings and associated foreign taxes for U.S. foreign tax credit purposes. In addition, the allocation of deductions to foreign income would be required only for purposes of determining allowable foreign tax credits in relation to currently taxed foreign income.

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[75] It might be possible that the winners, companies that operate in low-tax countries or that maximize stateless income, are more efficient than the losers, companies that pay higher levels of foreign tax such as natural resource sompanies, so there would be an overall welfare benefit. This does not seem likely to be correct.

[76] *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.).

The most significant functions requiring U.S. tax accounting resources would be unaffected. Thus, it would be necessary to determine foreign subsidiary's U.S. earnings and profits and maintain records of accumulated profits in order to determine whether a distribution is a dividend or return of capital. Allocations of deductions would be required at the level of the controlled foreign corporation and a United States corporation with a foreign branch between exempt and non-exempt (currently taxed) income. The proposed changes likely would increase the resources devoted to maximizing the use of foreign taxes as credits given the unlimited scope for cross-crediting against U.S. tax on non-exempt income. There would be an even higher premium on saving foreign taxes that would be imposed on exempt income, since they could not be used as credits. Additional resource costs could offset the savings, if any, from reduced planning in relation to U.S. taxes. It is likely that the net administrative burden reduction, if any, would have an immaterial effect on cost.

It would be interesting to examine the experience of U.K. and Japanese multinationals and determine whether they have reduced headcount and effected savings directly related to the changes in those countries from credit to territorial tax systems. We are not aware of empirical evidence that administration and compliance costs have decreased as a result of the change to territorial systems in the United Kingdom and Japan. This would seem to be a worthwhile area for work by objective researchers.

D. Federal Revenues and Revenue Constraints

1. Why Isolate The Territoriality Debate from Business Tax Reform? – The Relevance of Tax Expenditure Analysis

Any set of tax rules operates under a budget constraint requiring that an amount of revenue be raised. In the present fiscal environment of structural deficits, the revenue constraint is especially important. In light of the practical fact that an alternative revenue instrument is unlikely to be adopted in the near- to medium term, tax reform needs to be devoted to building an income tax base that affords the United States flexibility to increase revenues. An important minimum role for international tax rules is to prevent erosion of the domestic tax base. Whether or not to further privilege or to increase revenue from foreign income is a distinct question, but it is properly the subject of traditional tax expenditure analysis.

In prior work,[77] two of us have explained that deferral is a tax expenditure because it intentionally carves foreign-source income out of the business tax base and gives it a much lower effective tax rate[78] (often a zero U.S. tax rate when cross-crediting is utilized[79]) than the usual

[77] *See* J. Clifton Fleming, Jr. & Robert J. Peroni, "Can Tax Expenditure Analysis Be Divorced from a Normative Tax Base?: A Critique of the "New Paradigm" and Its Denouement," 30 *Va. Tax Rev.* 135, 170-71 (2010); J. Clifton Fleming, Jr. & Robert J. Peroni, "Reinvigorating Tax Expenditure Analysis and Its International Dimension," 27 *Va. Tax Rev.* 437, 528-41 (2008) (hereinafter Fleming & Peroni, "Reinvigorating").

[78] *See* Fleming, Peroni and Shay, *Worse Than Exemption*, *supra* note 46, at 96-104.

rate for business income. This conclusion applies equally to a territorial system which isolates business income from the worldwide tax base[80] and confers a zero residence country tax rate on the isolated income even though a zero rate is typically more generous than what is required to eliminate double taxation[81] and even though the ability-to-pay principle requires the inclusion of foreign-source-income in the tax base.[82] Indeed, the usual plea for enacting a U.S. territorial system – that it would make U.S. multinational corporations more competitive in low-tax foreign countries[83] – is an admission that a territorial system is a device for delivering financial aid in support of an industrial policy of supporting hoped for "national champions."

Because a territorial system is a tax expenditure, it should receive the cost/benefit scrutiny that typically applies to all direct expenditure programs of the U.S. government and that should apply to all tax expenditure programs,[84] particularly in light of the U.S. budget deficit position.[85] This point is crucially salient with regard to the Camp proposal, which seems to call for isolating the question of adoption of a territorial system from a consideration of overall business tax reform. That would clearly be the wrong approach. Proponents of a U.S. territorial system should be required to explain why the economic inefficiency[86] and normative inequity[87] of such a system

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[79] *See* Fleming, Peroni and Shay, *Worse Than Exemption*, *supra* note 46, at 132-37.

[80] Worldwide taxation without deferral and with a foreign tax credit is the appropriate baseline for an income tax for both equity and efficiency reasons. *See* Reinvigorating p. 532-41; Fleming, Peroni, & Shay, *Fairness in International Taxation: The Ability-to-Pay Case for Taxing Worldwide Income*, *supra* note 40.

[81] The traditional justification for a territorial system is that it relieves international double taxation by ensuring that foreign-source income is taxed only by the source country. Elimination of international double taxation does not, however, require a zero U.S. tax rate unless the foreign tax rate on the foreign-source income of a U.S. resident is equal to or greater than the U.S. tax rate on that income. If the foreign tax rate is lower than the U.S. tax rate, double taxation is eliminated by the United States crediting the lower foreign tax against the U.S. tax and collecting a U.S. residual tax equal to the difference between the two taxes. If the United States gives up the residual tax, as required under a territorial system, the United States would effectively make a revenue transfer to earners of foreign income.

[82] *See* Fleming, Peroni, & Shay, *Fairness in International Taxation: The Ability-to-Pay Case for Taxing Worldwide Income*, *supra* note 40, at 311-14.

[83] *See e.g.* Staff of Joint Comm. on Tax'n, Present Law Issues in U.S. Taxation of Cross-Border Income 87 (JCX-42-11 Sept. 6, 2011) (hereinafter Joint Comm. on Tax'n, "Present Law"); Michael Beller, "Portman Plans Bill to Shift U.S. to Territorial System," 133 *Tax Notes* 1199 (2011); Michael S. Knoll, "The Corporate Income Tax and the Competitiveness of U.S. Industries," 63 *Tax L. Review* 781-83 (2010).

[84] *See* Fleming & Peroni, "Reinvigorating," *supra* note 77, at 487-89, 525-28.

[85] *See e.g.* Office of Management & Budget, Fiscal Year 2013 Budget of the United States Government 205 (2012) (projecting cumulative federal deficits of $6.684 trillion for the 2013-2022 period).

[86] *See* J. Clifton Fleming, Jr., Robert J. Peroni, & Stephen E. Shay, "Perspectives on the Worldwide vs. Territorial Taxation Debate," 125 *Tax Notes* 1079, 1083-85 (2009) (hereinafter Fleming, Peroni & Shay, "Worldwide vs. Territorial"). The Staff of the Joint Committee on Taxation recently stated that "further analysis is needed to assess whether efficiency would be improved with regard to investment location decisions" if the United States adopted a territorial system. Joint Comm. on Tax'n, "Present Law," *supra* note 83, at 87. However, this statement was made with respect to the possibility of replacing the current U.S. international income tax system with a territorial regime. The current U.S. system is so flawed by tax expenditures and aberrations that it is even more distortive than a well-designed territorial system. Thus, replacing the existing U.S. international income taxation system with a territorial regime would probably not increase systemic inefficiencies. *See generally* Fleming, Peroni and Shay, *Worse Than Exemption*, *supra* note 46. However, the correct analytical approach is to compare a territorial system against a well designed worldwide system (i.e. without deferral and cross-crediting). From that standpoint, it is clear that a territorial regime is inefficiently distortive. *See* Fleming, Peroni & Shay, "Worldwide vs. Territorial," *supra* at 1081-86.

should be tolerated and why scarce revenue should be diverted to increase the after-tax profitability of a discrete set of business activities (business carried on by U.S. multinationals in low-tax foreign countries) in lieu of a generally applicable rate reduction and/or additional funding for homeland security, border control, education, healthcare, Social Security and Medicare solvency, etc.[88] If adoption of a U.S. territorial system is considered in isolation, there is serious danger that these critical items will be minimized or overlooked in a blizzard of competitiveness rhetoric. This is much less likely to happen if the territoriality question is taken up as part of a comprehensive review of the U.S. business income tax system in which territoriality is required to compete against other business tax expenditures for scarce revenue.

Even if the territoriality question is taken separately, there is little empirical evidence supporting U.S. multinationals' claim for additional relief for their foreign income. Indeed, the evidence is to the contrary. Tax data show that U.S. multinationals pay low effective rates of tax on their foreign income and financial statement data evidence that their worldwide effective tax rates are not higher than their foreign competitors. The most recent IRS statistics of income data (for 2006) for the 7,500 largest U.S. controlled foreign corporations show that 80% of controlled foreign corporations' foreign earnings were not repatriated to the United States[89] and that the average effective rate of foreign tax on foreign earnings of controlled foreign corporations with positive foreign earnings was approximately 16.4%.[90] The average effective foreign tax rates on controlled foreign corporations declined from 33.98% in 1986 to 19.24% in 2002.[91] Recent analyses of newly available financial statement data for foreign companies indicates that financial statement effective tax rates for U.S. multinationals are lower not higher than for reasonably comparable foreign multinationals. The average effective tax rates for the period

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[87] *See* Fleming, Peroni, & Shay, "Worldwide vs. Territorial," *supra* note 86, at 1091-1104.

[88] President Bush's Advisory Panel on Federal Tax Reform articulated a standard for evaluating proposals that favor one activity over another and should be applied to evaluate the territorial proposal:

> Tax provisions favoring one activity over another or providing targeted tax benefits to a limited number of taxpayers create complexity and instability, impose large compliance costs, and can lead to an inefficient use of resources. A rational system would favor a broad tax base, providing special tax treatment only where it can be persuasively demonstrated that the effect of a deduction, exclusion, or credit justifies higher taxes paid by all taxpayers.

PRESIDENT'S ADVISORY PANEL ON FEDERAL TAX REFORM, FINAL REPORT xiii (Nov. 1, 2005), *available at* http://www.taxreformpanel.gov/final-report/ [hereinafter PRESIDENT BUSH'S ADVISORY PANEL REPORT].

[89] Internal Revenue Service, STATISTICS OF INCOME, Table 3. U.S. Corporations and Their Controlled Foreign Corporations: Number, Assets, Receipts, Earnings, Taxes, Distributions, and Subpart F Income, by Selected Country of Incorporation and Industrial Sector of Controlled Foreign Corporation, Tax Year 2006, *supra* note 67; Lee Mahony and Randy Miller, *Controlled Foreign Corporations, 2006*, *supra* note 67.

[90] The average effective rate disguises far lower effective rates for certain industries and companies, such as Google and other high tech companies as well as pharmaceutical companies. Companies in the resource industries often pay much higher levels of foreign tax.

[91] *See* Yin, *Reforming Taxation*, *supra* note 61, at 174 tbl. 1 (presenting average foreign income tax rates over time of 7,500 largest controlled foreign corporations of U.S. parent corporations).

2001-2010 for the 100 largest U.S. multinationals is less than the rates for the 100 largest EU multinationals.[92]

The term "competitiveness" is thrown about, generally with little definition, in support of territoriality. We have previously expressed our view that the relevant measure of competiveness for U.S. Federal tax purposes is whether the standard of living of Americans is improved.[93] We contrast this with U.S. multinational competitiveness, which essentially is an industrial policy to favor "national champions."[94] Further reductions in taxation of foreign income of U.S. multinationals only is a coherent policy if multinationals create a positive benefit for the United States that is related to reduced taxation of foreign income.

In an intriguing analysis, Creal, Robinson, Rogers and Zechman examine the sources of premium attributable to U.S. multinationals with foreign operations. They find the ability to exploit international differences in tax codes to be the one of the explanatory factors, in addition to access to favorable factor prices and lower profit volatility.[95] The "tax arbitrage" factor finding is consistent with and supports Professor Kleinbard's analysis regarding the ability of U.S. multinationals to reap "tax rents" from cross-border tax planning.[96] The advantages of multinational organization attributable to tax advantaged transfer pricing undermine justification for tax subsidies that benefit foreign income. The shifting of profits from the United States using transfer pricing that is found in the most recent data does not advance the welfare of the United States. To the extent that a territorial system would exacerbate incentives to use transfer pricing shift income, this factor argues against such a change.

2. Revenue Games

In the fiscal environment anticipated for the next decade, budgetary gamesmanship will be unhelpful as a matter of policy as it may exacerbate existing fiscal imbalances.[97] The Joint

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[92] See Reuven S. Avi-Yonah and Yaron Lahav, *The Effective Tax Rate of the Largest US and EU Multinationals (*October 25, 2011). Available at SSRN: http://ssrn.com.ezp-prod1.hul.harvard.edu/abstract=1949226. Avi-Yonah and Lahav criticize the comparative effective rate study performed by PricewaterhouseCoopers for among other items covering 2000 companies from 58 countries that include companies that are not serious competitors to U.S. multinationals. See http://businessroundtable.org/uploads/studies-reports/downloads/Effective_Tax_Rate_Study.pdf. OECD data cited by the Business Roundtable on its website is nominal tax rates, not what companies actually pay. See http://businessroundtable.org/news-center/corporate-tax-reform-u.s.-job-creation/.

[93] Fleming, Peroni and Shay, *Worse Than Exemption*, *supra* note 46, at 109-110. We also have questioned how the deferral privilege related to a meaningful definition of competiveness. *Id*. at 106-109.

[94] Cite Canadian report.

[95] Drew D. Creal, Leslie A. Robinson, Jonathan L. Rogers and Sarah L. C. Zechman, *The Multinational Advantage* (Working Paper Sept. 2011) at http://www.uic.edu/cba/accounting/Documents/Rogers-paper-Fa11.pdf.

[96] Kleinbard, *Stateless Income's Challenge to Tax Policy*, supra n. __, at 1034 ("Stateless income tax planning offers multinational firms, but not wholly domestic ones, the opportunity to convert high-tax source country pretax marginal returns into low-tax country inframarginal (supranormal) returns, by redirecting pretax income from the high-tax country to the low-tax country. Multinational firms can thus be said to capture 'tax rents.'").

[97] Following enactment in August, 2011 of the debt ceiling agreement in the Budget Control Act of 2011 (Pub. L. No. 112-25), the Congressional Budget Office (CBO) estimate of the 10-year cumulative Federal deficit through

Committee on Taxation is the arbiter of the revenue gains and losses from tax legislation and works under budget conventions to evaluate revenue costs of proposals. These conventions include use of a 10-year budget period and expression of revenue costs in nominal dollars (i.e., they are not discounted for time value of money).[98] Within these conventions, it is possible to manipulate the perception of the cost of a proposal. The Ways and Means Majority proposal is intended, we understand, to be revenue neutral within the international provisions alone,[99] however, the proposal reflects practice of the arcane art of budget revenue sleight of hand.

While there is no revenue estimate for the Ways and Means proposal, at either an assumed 25% corporate tax rate or at the current law 35% corporate rate, a shift to territorial taxation instead of deferral, holding other changes constant, loses revenue.[100] The revenue losing territorial aspect of the Ways and Means Majority proposal should be evaluated separately from revenue offsetting provisions. The revenue increasing changes, including the thin capitalization proposal and the anti-base erosion rules could be made in relation to current law without a shift to a territorial system.[101]

In addition, a one-time tax is imposed on accumulated untaxed earnings, payable over as long as 8 years. While the decision to tax all undistributed earnings is a reasonable choice from among several plausible resolutions of a transition problem (though we believe a higher rate is appropriate), the resulting revenue from a one-time transition provision should not be taken into account in determining whether the territorial system is revenue neutral. The Ways and Means Majority proposal also does not propose changes to the Subpart F rules, so the cost of exempting active financing income is not added to the proposal. The related revenue increasing offsets

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2021 assuming an extended policy baseline (instead of current law with its assumed expiration of Bush tax cuts and certain other adjustments) is $8.5 trillion, taking into account $2.1 trillion of reductions under the deficit agreement. Congressional Budget Office, The Budget and Economic Outlook: An Update, x, 25 – 28 (August 2011) at http://www.cbo.gov/ftpdocs/123xx/doc12316/08-24-BudgetEconUpdate.pdf. The budgetary legerdemain underlying the 2001 and 2003 Bush tax cuts is a significant contributor to the country's current structural deficit. *See*, Hacker and Pierson, WINNER-TAKE-ALL-POLITICS , supra note 55, at 215 – 218 (describing "tricks of the tax cut trade" used in 2001 and 2003 to make tax cuts look smaller by phase-ins and sunsets and failing to adjust the alternative minimum tax).

[98] *See* Staff of the Joint Committee on Taxation, *Overview of Revenue Estimating Procedures and Methodologies Used by the Staff of the Joint Committee on Taxation*, 9-10, 12 (JCX-1-05 2005), at http://www.jct.gov/publications.html?func=startdown&id=1181.

[99] House Ways and Means Committee One-Page Summary, *supra*, note 3.

[100] The most recent public estimate of a territorial system of which we are aware is a statement in The President's Economic Recovery Advisory Board, The Report on Tax Reform Options 90 (Aug. 2010) [hereafter "PERAB Tax Reform Options"] ("According to rough estimates from the Treasury, a simplified territorial system without full expense allocation rules would lose $130 billion over the 10-year budget window.") This estimate presumably was at a 35% rate and was not of the Ways and Means Proposal.

[101] Evaluation of and work to refine these collateral revenue increasing changes potentially is useful whether or not the decision is made to shift to a territorial system. As we will discuss below, the relaxation of the foreign tax credit limitation through eliminating separate limitation categories and reducing the allocation of deductions to foreign income, unless amended, also will lose revenue. We believe that these efforts to simplify the foreign tax credit were collateral to the shift to a territorial system and not conceptualized as a structural. Nonetheless, as discussed below, these provisions should be modified to address their potential for abuse.

would have to be increased to address the broader scope of the exemption. To the extent that the international revenue neutrality is achieved (i) without taking into account the revenue loss from extending the active finance exception and thereby exempting active finance income, and (ii) using the one-time revenue pick up from taxing pre-effective date accumulated earnings, the proposal will lose revenue over the longer term and actually worsen the structural long-term U.S. budget deficit.

Under revenue estimating conventions, the revenue loss attributable to shifting to a territorial system may be reduced if the corporate rate is 25% instead of 35%. If the rate reduction is stacked first, then the revenue cost of exempting foreign income and of behavioral changes to earn more exempt income is reduced from what it would be under current law. Accordingly, the Committee's assumed corporate tax rate of 25% makes it appear that the cost of shifting to territorial is smaller than it will be in fact if the corporate rate cannot be reduced to that low a rate.[102]

Moreover, if the international rules are revenue neutral for foreign income *after* taking account of the rate reduction, and corporate tax reform as a whole is revenue neutral, then the effective rate must increase on domestic business activity and decline on foreign business income. The available base broadening proposals for reducing the corporate rate overwhelmingly benefit domestic income.[103] In addition to the fact that foreign income is more advantaged in relation to domestic income under exemption than deferral if everything is held equal, a revenue neutral shift to a lower corporate rate exacerbates this differential.

The most interesting "revenue game" is being played out against the backdrop of the House Ways and Means territorial proposal. A subset of major multinationals does not want to wait for tax reform to obtain a tax break on repatriating their overseas earnings.[104] They have pushed for the introduction of legislation that would establish another "repatriation holiday" similar to that in 2004.[105] In March, 2011, Representative Lloyd Doggett of Texas, an opponent of repatriation, requested a revenue estimate from the Joint Committee on Taxation of the cost of

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[102] It is unlikely that business tax changes are available that could to achieve a 25% corporate tax rate without increasing taxes on individuals or resorting to timing or budget window gimmicks. *See*, Memorandum from Thomas Barthold, Chief of Staff, Joint Committee on Taxation, to [Unnamed Recipients], Revenue Estimates (Oct. 27, 2011) at http://democrats.waysandmeans.house.gov/media/pdf/112/JCTRevenueestimatesFinal.pdf.

[103] The most significant provisions by revenue include accelerated depreciation (which applies predominantly to domestic use assets), the domestic production deduction and the research and development deduction and credit.

[104] Letter from 15 Win America Campaign CEOs to President Obama and Congressional Leaders (Nov. 15, 2011), at http://www.winamericacampaign.org/wp-content/uploads/2011/11/WIN-Letter-from-CEOs.pdf (CEOs who signed the letter were Steve Ballmer (Microsoft), Carl Bass (Autodesk), David Bell (Intersil), Safra Catz (Oracle), John Chambers (Cisco Systems), Timothy Guertin (Varian Medical systems), Paul Jacobs (Qualcomm), Michael Klayko (Brocade Communications), William McCracken (CA Technologies), Shantanu Narayen (Adobe Systems), Ian Read (Pfizer), Jim Rogers (Duke Energy), Kevin Sharer (Amgen), Kevin Surace (Serious Energy) and Thomas Werner (SunPower Corporation)).

[105] *See*, *e.g.*, S. 1671 Foreign Earnings Reinvestment Act, introduced ___; H.R. 1834 Freedom to Reinvest Act of 2011, introduced ___.

another 2004-type repatriation provision. The Joint Committee estimate of the 10-year revenue cost of an 85% dividends received deduction was $78.7 billion.[106]

The reason the a temporary repatriation holiday loses revenue when measured against the base line of current law is in part because future taxable repatriations will decrease and the revenue loss (at tax rates assumed under revenue estimating conventions to be current law rates) exceeds the revenue gain from the reduced tax on the increased amounts repatriated during the holiday. Professor Thomas Brennan's analysis of the effect of the 2004 repatriation holiday provides strong empirical support for this behavioral response to the 2004 holiday.[107]

The one-time reduced tax on prior earnings in the Ways and Means Majority proposal, which is essentially the same proposal as estimated by the Staff of the Joint Committee on Taxation except that it would be mandatory and therefore apply to all earnings, raises revenue because reduced future repatriations generally would be exempt from U.S. tax under the territorial regime in the Ways and Means Majority proposal. Packaged as part of the Ways and Means Committee proposal, the revenue that would be lost from the lower tax on prior earnings is disguised as a revenue gain.[108] Moreover, as discussed below, this one-time gain is used as a "pay-for" for a corporate tax reduction on foreign income.

E. Summary

The shift to territorial will result in a material reduction in tax on foreign income, independent of a change in the corporate tax rate, by eliminating the U.S. residual tax on distributed foreign earnings. There is no prima facie reason to believe that reducing the tax on foreign income earned by U.S. multinationals in low-tax foreign countries will enhance overall economic efficiency or that any such gains would offset the inefficiencies of higher taxes and cost burdens attributable to revenue loss and costs of future tax and transition planning and asset redeployments to maximize the benefits of exemption.

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[106] Letter from Thomas Barthold to Representative Lloyd Doggett, 2 (April 15, 2011), letter is posted at http://www.ctj.org/pdf/jct_repatriationholiday.pdf.

[107] *See* Thomas J. Brennan, *What Happens After a Holiday?: Long-Term Effects of Repatriation After the AJCA*, 5 NW. J. LAW AND SOC. POL. 1 (2010) [hereafter "Brennan, What Happens After a Holiday?"].

[108] This is a classic example of revenue gamesmanship. House Ways and Means Committee Chairman Camp and Treasury Secretary Geithner each have said they oppose a repatriation holiday that is not a part of broader tax reform. [Cite to press reports.] Whether or not intended, in the context of a territorial proposal this has the effect of turning the $79 million revenue loss into a (smaller) revenue gain that can be used to pay for other revenue losing items. Moreover, some multinationals that otherwise might oppose a territorial proposal might support it if it is the only way to obtain tax relief for accumulated earnings.

Under standard assumptions of constant returns (domestically and abroad) and tax on repatriation, switching to a territorial system would not reduce the tax incentive to retain earnings offshore compared to current law deferral and is not itself a solution to a lockout of the foreign earnings of U.S.-controlled controlled foreign corporations. There is evidence that the prospect of future tax reductions on distributed earnings has materially affected repatriation decisions and it is likely that the financial accounting treatment of deferral contributes to retaining abroad earnings that are subject to permanent reinvestment accounting treatment. Put simply, the shift to territoriality is not justified as a means to mitigating a lock out effect but should be analyzed as a measure to increase a tax preference for foreign-source income.

Shifting to a territorial system will increase the incentive to engage in international tax planning and is unlikely to result in a material net reduction the level of resources devoted to planning, administration, and compliance. We suggest that the experiences of countries that have recently shifted to territorial systems be reviewed by independent researchers for empirical data on these issues.

The Ways and Means Majority proposal would not be revenue neutral within the budget window if the cost of a permanent extension of the active financing exception to Subpart F were taken into account and it would lose revenue over the longer term when revenues from transitional taxation of pre-effective date earnings are no longer relevant.

IV. STRUCTURAL ELEMENTS OF THE WAYS AND MEANS MAJORITY TERRITORIAL PROPOSAL[109]

A. *Scope of Exemption*

1. *Introduction*

After a one-year holding period is satisfied, the foreign source portion of any dividend from a controlled foreign corporation will be subject to a 95% deduction and therefore bear an effective 1.25% U.S. C corporation tax (after bearing a deduction for foreign taxes), unless it is attributable to U.S. source effectively connected income or U.S. dividends.[110] Under the Discussion Draft, there is no requirement that exempted income bear or be subject to a foreign corporate tax. It would be advisable at a minimum to add a subject to tax requirement.[111]

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[109] This paper does not address treaty [other] issues raised by the Discussion Draft.

[110] (5% * 25% = 1.25%) Under the proposal, the previously taxed income rules are repealed. If currently taxed earnings are not immediately distributed, they will be taxed again when distributed subject to the 95% dividends received deduction. It is not clear why this second tax is necessary; why not just treat distributed previously taxed earnings as 100% exempt rather than tax them a second time?

[111] Professor Yin has made a similar comment in relation to President Bush's Advisory Panel's recommendation of a form of exemption system as part of its overall corporate tax revision proposal. George K. Yin, *Reforming the Taxation of Foreign Direct Investment by U.S. Taxpayers*, 118 TAX NOTES 173 (Jan. 7, 2008).

The Discussion Draft's proposed territorial regime creates three tax systems for foreign income: one allows a C corporation shareholder in a controlled foreign corporation a 95% exemption for foreign subsidiary and branch income within its scope. The second system imposes current taxation with a foreign tax credit on the controlled foreign corporation's income (including income of a branch treated as a controlled foreign corporation) that is taxed currently under Subpart F and unlimited cross-crediting of excess credits against U.S. tax on all non-exempt foreign income, including Subpart F income and foreign source interest, royalty and export sales income. A third system is retained for taxing foreign income earned through a controlled foreign corporation by U.S. individuals and other non-C corporation taxpayers, including as holders through private equity and hedge fund partnerships. This system allows deferral of current taxation and a direct (but not indirect) foreign tax credit with unlimited cross-crediting foreign tax credits against all foreign income.

With respect to the first two systems, as applicable to U.S. multinationals, there will be substantial individual company winners and losers. Broadly, and depending on the scope of the anti-base erosion rules, U.S. multinationals whose controlled foreign corporation subsidiaries have low- to mid-level foreign effective tax rates would be winners. U.S. multinationals owning highly foreign-taxed controlled foreign corporations will be losers, unless they are able to cross-credit foreign taxes in a way that would offset this detriment. Even with modifications to limit abusive cross-crediting, these two tax systems create two silos. One will have full taxation with cross-crediting and the other will have 95% exemption. These silos will encourage planning and possibly substantial asset restructuring to maximize after-tax income under the two regimes.

Contrasting the first and third systems, there is a potentially substantial disparity between taxation of earnings of a controlled foreign corporation to domestic individual shareholders that own controlled foreign corporation shares directly, on the one hand, or through a C corporation on the other, if distributed earnings are not eligible for qualified dividend treatment. If an U.S. individual holds shares in a controlled foreign corporation directly (or through a partnership), a dividend that is not eligible for treatment as a qualified dividend income would be fully taxed at graduated rates applicable to ordinary income (after bearing foreign taxes as a deduction). If instead, the foreign corporate shares are held through a domestic corporation, a dividend from the controlled foreign corporation would be taxed at an effective 1.25% rate to the domestic corporation and when distributed would be taxed at a 15% rate in the hands of the individual U.S. shareholder for an effective rate of 16% (after bearing foreign taxes as a deduction).

Table _

	Individual Owning CFC Directly - Not QDI Eligible	Individual Owning CFC Thru C Corp	Individual Owning CFC Directly - QDI Eligible
CFC after-foreign tax earnings	$100.00	$100.00	$100.00
C corporation tax	$0.00	-$1.25	$0.00
C corporation E&P	$100.00	$98.75	$100.00
Tax on qualified dividend income	-$35.00	-$14.81	-$15.00
After-tax cash	$65.00	$83.94	$85.00
Total US taxes	$35.00	$16.06	$15.00
Effective tax rate	35.00%	16.06%	15.00%

This disparity likely would induce U.S. individuals and non-C corporations to hold controlled foreign corporations through a domestic corporation, unless the shareholder uses self-help and inserts as a holding company a controlled foreign corporation that would distribute qualified dividend income.[112]

While this analysis might lead to a view that qualified dividend treatment should be extended to all controlled foreign corporation dividends, such a change would expose the domestic individual tax base to erosion to a far greater degree than previously. We would recommend going in the opposite direction and denying qualified dividend treatment (i) to a dividend from a controlled foreign corporation (irrespective of where organized), and (ii) to a dividend from a domestic corporation to the extent attributable to earnings that are subject to the proposed Section 245A dividends received deduction.[113]

This issue highlights the importance of knowing not only the corporate tax base and rate in connection with designing international tax rules, but also the shareholder tax rate on dividends from a domestic C corporation. We consider individual shareholder taxation as an important element of business tax reform, because it is central to consideration of important design issues such as entity classification and treatment of foreign income.

2. Anti-Base Erosion Measures

It may be inferred from the failure to include a subject to tax test, that the House Ways and Means Majority territorial proposal is not based on the traditional rationale for an exemption system that it is an alternative method to avoid double taxation.[114] At first blush, it would appear

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[112] Private equity funds structure holdings of foreign portfolio companies through a top-tier foreign corporation a dividend from which would be eligible for qualified dividend treatment in the event that there is a leveraged recapitalization of the portfolio company before exit that would be taxable as a dividend under U.S. tax principles.
[113] The Obama Administration proposal to tax all dividends at an ordinary income rate would achieve the same effect as this proposal. [Cite.]
[114] *See* HUGH J. AULT & BRIAN J. ARNOLD, COMPARATIVE INCOME TAXATION [492-] (3d ed. 2010).

to be an unprincipled entrant in the "race to the bottom" competition among developed countries to champion multinational companies with local parent companies. Option 2 of the Discussion Draft's anti-base erosion alternatives, however, would treat as Subpart F income a controlled foreign corporation's income taxed at an effect rate of less than [15%] if it is earned outside the country in which the controlled foreign corporation is organized or the branch that earns the income is located. While this appears to indirectly impose a subject to tax test, it does not. Moreover, it is avoidable using planning structures that were standard two decades ago. As constructed, it this anti-abuse rule would restore structures using of separate locally organized corporations for any business operation that is subject a sufficiently low tax rate. In many cases, this will involve filing a check the box election to treat an existing disregarded foreign business entity as a corporation.[115]

There are many kinds of income that can be earned through the conduct of activity that is labeled active business activity, including activities of financial institutions and intellectual property management. The Discussion Draft would come into effect after the active financing and active insurance company exceptions from Subpart F expired (at the end of 2011) and those categories of income would no longer be exempted from U.S. tax under Subpart F. This was the state of the law for a decade after the 1986 Tax Reform Act, however, it seems clear that the Ways and Means Majority's intent is to extend the finance and insurance exceptions currently in Sections 954(h) and (i). This would be a good example of activity that may be and is conducted in low tax jurisdictions that would be eligible for the exemption (unless currently taxed under an anti-base erosion rule).

In addition, the fact that the earnings have been stripped into a zero tax haven without tax will be irrelevant under the rules for exemption if subpart F (as enhanced by anti-base erosion rules) has been avoided. If a foreign country, such Ireland, permits income to be allocated to another country (such as Bermuda) and the activities in the other country do not rise to the level of a trade or business under U.S. concepts, the income could be exempt under the Discussion Draft whether or not a tax is imposed by the other country.[116]

Non-U.S. shareholders of domestic corporations will remain subject to withholding tax on dividends from the domestic corporation, however, a number of U.S. treaties provide for a zero rate of withholding for 80% or greater corporate shareholders resident in the treaty partner country and satisfying certain conditions.[117] Accordingly, the Ways and Means Territorial proposal will in a range of cases make holding foreign subsidiaries through U.S. domestic corporations substantially more tax efficient for multinational companies resident in treaty

[115] If an initial election to treat the entity as disregarded was made on the date of formation of the entity, or has been in effect for 60 months, there is no restriction on making such an election. Treas. Reg. §301.7701-3(c).

[116] *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*.

[117] Treaties with the following countries have such a provision: Australia, Belgium, Denmark, Finland, Germany, France, Mexico, New Zealand, Sweden and the United Kingdom.

partner countries. As under current law there is no U.S. tax on gains from the sale of shares in a domestic corporation that is not a U.S. real property holding company and non-dividend redemptions are not subject to withholding tax. Accordingly, it should be possible to dispose of or distribute foreign subsidiaries and foreign branch assets without U.S. tax. It would be expected that there would be possibly material post-enactment re-shuffling of non-U.S. assets among U.S. and non-U.S. groups. Assets with built-in losses presumably would be sold in pre-enactment transactions.

Arguments have been made that the disadvantages in relation to owning non-U.S. assets under the current deferral system increases the likelihood that U.S. companies will be acquired by foreign parent groups who can make more tax-efficient use of the non-U.S. assets.[118] To the extent that these asserted detriments would be mitigated by the dividends received deduction for foreign earnings, and taking account of the exemption permitted for gains on the sale of controlled foreign corporations, one would expect that U.S. companies that hold foreign operations will be *more* attractive as acquisition targets under the Ways and Means Majority proposal than under deferral because of the reduced U.S. tax costs of holding or transferring the foreign assets. As with any corporate tax reduction of this kind, shareholders of "winners" under the shift will be windfall beneficiaries of the change so the issue is whether the efficiencies resulting from the change are justified by its costs.[119]

In light of the fact that the Ways and Means Majority proposal is revenue neutral in relation to foreign income as a whole, it is likely that in many or most cases foreign acquiring companies would want to transfer controlled foreign corporations outside of a U.S. group, particularly if the anti-base erosion rules of the foreign parent country are more favorable. The exemption for gains on sale of controlled foreign corporation stock will make this easier.

The first anti-base erosion alternative, which would tax currently excess earnings attributable to intangibles transferred from the United States, would serve as a limited scope back stop to current transfer pricing rules. It is a modest and less efficient alternative than a broader rule that limits exemption to instances where income has borne a modest foreign tax of at least 10%. The third anti-base erosion alternative, which would reduce U.S. tax on foreign intangible income, would be extremely difficult to administer, would add yet another unfocused and inefficient incentive that applies to successful research and development and therefore is biased toward larger taxpayers, and would induce substantial tax planning to recast income as royalties (much as occurs today in relation to capital gains). There is no objective data supporting the need and efficacy of this incentive, yet it would result in material revenue loss. Of the anti- base erosion

[118] [Cites.] Most formulations of these arguments do not address the U.S. corporate tax that would be imposed on transfers of the foreign assets out of U.S. corporate tax solution.

[119] Susan Morse points out that a tax on pre-effective date profits may be viewed as an offset to the windfall that would otherwise benefit pre-effective date shareholders. Susan C. Morse, *International Tax Reform and a Corporate Offshore Excise Tax* 40-41 (working draft dated 3/8/12) at http://www.law.nyu.edu/ecm_dlv4/groups/public/@nyu_law_website__academics__colloquia__tax_policy/documents/documents/ecm_pro_071878.pdf.

alternatives proposed, an across the board restriction of the dividends received deduction to income that has borne a minimum rate of foreign tax, regardless of where earned, would be superior to any of the alternatives proposed in the Discussion Draft.

3. *Gain and Loss on Sale of CFC Stock by a Domestic Corporation United States Shareholder*

The Discussion Draft proposal would provide a 95% exclusion of gain on the sale by a domestic corporation United States shareholder in a "qualified foreign corporation," which is a controlled foreign corporation for purposes of 245A, if 70 percent of its assets were active assets under a three-year look back test.[120] The theory for exempting gain on the sale of stock in an exemption system, which not every country with a territorial system does, is that the gain is an alternative mechanism to recognize value that is equivalent to a sale of assets and distribution. If the distribution as a dividend of gain from the sale of assets would be exempt, the argument is so should the gain on a stock sale. This theory was originally applied in a context where there was or could be a corporate-level tax on earnings so there would be at least one level of tax. The shift to exemption without an underlying avoidance of double taxation principle means that income can (and will) go completely untaxed.

Under the U.S. classical system of corporate taxation, a domestic C corporation's gain on the sale of stock of a domestic subsidiary is subject to a corporate tax. Although there is a mechanism to treat the sale of 80% or greater stock interests as a sale of assets under section 338(h)(10), it only is practical in limited circumstances. In general, a taxable stock sale results in lower present value tax than an asset sale because the tax cost of the asset step-up only is offset over time by the tax benefit from the step-up.[121]

In the international context, the traditional division of income is that the residence country imposes tax at the shareholder level and the source country taxes at the level of the local corporation. The source country generally does not tax stock sale gains. Accordingly, in the international context, exempting stock gains often means that no tax applies on the disposition of the entire enterprise. In light of the U.S. classical system of corporate taxation, it is unclear why the United States should concede its residence tax jurisdiction in this case if it does not do it domestically and in doing so increases the likelihood of double non-taxation.[122]

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[120] Technically, this could include a branch deemed to be a controlled foreign corporation (for all purposes of the title), however, such a controlled foreign corporation does not issue actual stock. The technical explanation, while not addressing the issue directly, suggests this is not intended. This could be clearer, however, the more important point is that gain or loss on the sale of a branch trade or business that does not benefit from the 70% threshold presumably would be analyzed on an asset-by-asset basis.

[121] See generally, Myron S. Scholes, Mark A. Wolfson, Merle Erickson, Edward Maydew, Terry Shevlin, TAXES AND BUSINESS STRATEGY: A PLANNING APPROACH, ch. 14 (4th Ed. 2009).

[122] This is an instance where knowing the rest of the domestic corporate tax reform might be useful, e.g., if there is going to be substantially increased relief from corporate level taxation on corporate disposition of stock interests.

4. *Noncontrolled 10/50 Corporations*

A 10-percent domestic corporate shareholder in a noncontrolled 10/50 corporation (e.g., a foreign corporate joint venture) may elect to treat its stock as in a controlled foreign corporation and claim the 95% exemption (deduction) for dividends from this corporation. The indirect credit under section 902 that otherwise would apply to relieve double taxation is repealed whether or not the election is made. Moreover, pre-effective date accumulated deferred foreign income of a noncontrolled 10/50 corporation must be included in the 10-percent domestic corporate shareholder's income whether or not an election is made.

The only reason not to elect treatment of the interest as stock in a controlled foreign corporation is to avoid current Subpart F inclusions that would result from electing controlled foreign corporation status. While the election approach presumably reflects a concern that a 10% shareholder may not be able to obtain the information required to apply Subpart F, this is not correct in many if not most cases where the issue is known in advance (because access to information can be negotiated at the time of purchase) and is less likely to be true as ownership increases, say to 20% or 25%. Moreover, allowing this election at the level of 50% is inviting problems.[123] Treatment of the noncontrolled 10/50 corporation as a controlled foreign corporation should be mandatory, leaving some scope for transition and for the Secretary to provide for reference to financial statement information in the relatively rare cases where more specific information is unavailable. At a minimum, such treatment should be mandatory for 25% or greater ownership interests.

B. *Foreign branches*

The mandatory treatment of a foreign branch of a domestic corporation as a controlled foreign corporation if it carries on a trade or business is an important and sound design decision. Conformity of treatment of a foreign branch and a foreign subsidiary appropriately reduces the disparity in taxation of a branch and a subsidiary and tax planning to locate foreign loss operations in a branch to offset U.S. taxable income while placing profitable operations in a subsidiary eligible for the exemption. Moreover, deeming the branch to be a controlled foreign corporation "for purposes of this title" addresses a series of important domestic tax base protection issues in a way that is more manageable than alternative approaches (such as deeming royalties from a branch). It also has practical and transition implications that deserve discussion.

The principal issue that the deemed controlled foreign corporation approach addresses is the difficult problem of use by or the transfer to a foreign branch of U.S. intangible or other income-ripe assets, without a royalty or appropriate charge, to subsequently earn exempt income and thereby deprive the United States of its appropriate share of the income. Deeming the branch to be a controlled foreign corporation brings Section 367 into play and in theory makes it easier to

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[123] As a matter of tax system design, elections always operate against the fisc and should be limited to the fewest cases possible.

apply Section 482 to assure that the U.S. receives its fair share of income. It implies, however, that on the effective date, Section 367(d) will apply (as it should) to establish a deemed royalty for any Section 367(d) intangibles treated as assets of the branch and, under section 482, that a royalty would be established for any intangibles owned by the domestic corporation used by the branch. The deemed incorporation also triggers recapture of prior branch losses under Section 904(f)(3) and 367(a)(3)(C).

In addition to being appropriate if exemption is pursued as a policy, we assume that the revenue from treating foreign branches as exempt and the collateral aspects of the deemed incorporation of foreign branches is part of what keeps the proposal revenue neutral. It highlights, however, the transition planning that will be required by affected multinational businesses in order to make the change to a hybrid territorial system.

C. Allocation of Expenses

The 5 percent haircut on the exemption is intended to serve as a proxy for the disallowance of deductions of the U.S. group that are related in an economic sense (but indirect in a tracing sense) to the generation of exempt foreign income. As a threshold matter, the 5 percent disallowance understates the U.S. expenses that properly would be allocable to foreign income under existing allocation rules, which themselves are overly favorable in allowing deductions against domestic income.[124] Second, the haircut approach is necessarily aimed on the low side as a political matter because as an arbitrary test it hurts taxpayers with fewer allocable expenses and is a windfall for taxpayers with higher allocable expenses. In order to hurt as few as possible and help as many as possible, the haircut is set at an artificially low percentage. In other words, this approach both gets to the "wrong" answer in individual cases and loses revenue.

Allowing a deduction to earn exempt income creates a negative tax on (i.e., subsidizes) the exempt foreign income.[125] Allowing a deduction for interest without allocation of interest expense to foreign income cannot be justified on any neutrality ground.[126] Moreover, to the

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[124] For discussion of expense allocation rules, see ABA Task Force Report, *supra* note 43, 765 – 771.

[125] Michael J. Graetz, A Multilateral Solution for the Income Tax Treatment of Interest Expense 62 Bull. Int'l Tax'n 486, 491 ("[A]llowing a deduction in a higher-tax country for borrowing to invest in a lower-tax country can produce after-tax returns greater than the investment's pre-tax returns. This means that investments that would not be undertaken by anyone in a world without any corporate income taxes may become attractive in a world with varying tax rates and no interest allocation. Such investments clearly will decrease worldwide welfare and will, almost certainly, decrease welfare in the countries where the interest deductions are allowed.")

[126] Graetz, *supra* note 125, at 491 ("Empirical evidence about the benefits that might justify such a policy does not exist, nor does it seem likely that any evidence will be forthcoming that would justify such negative taxes as standard policy. A far better policy, ..., would be for all countries to allow interest deductions on borrowing in proportion to the assets in that country regardless of where the borrowing takes place.") Professor Hines has made formal argument for the optimality of home country allowance of deductions, but commentators have reached the opposite conclusion that restrictions on deductibility of costs related to income generated abroad are justified using a standard welfare function based on maximizing national income. See James R. Hines, Jr., Foreign Income and Domestic Deductions, 61 Nat. Tax J. 461 (2008) and Johannes Becker and Clemens Fuest, Foreign Income and Domestic Deductions – A Comment, 63 Nat. Tax J. 269 (2010).

extent that territorial exemption is not justified on welfare grounds, miss-allocation of deductions exacerbates the welfare loss.

The argument is made, however, that if a deduction for interest, stewardship or other indirect expense is not allowed as a deduction by the country of residence of the investor, and the source country does not allow the deduction, the resulting double taxation will penalize foreign investment. If the source country does not accept that an amount of interest or stewardship expense should be deducted as a cost of earning source country income, and double taxation results, under what principle should the residence country be required to alleviate the double taxation by allowing the deduction? As Professor Graetz has observed in relation to interest, this would go beyond avoiding double taxation as a rationale for exemption of foreign income, it would subsidize earning foreign income. The argument for allocating all expenses against domestic income amounts to a plea for subsidy for foreign income.

Professor Graetz recommends seeking a multilateral solution to the allocation of expenses.[127] We agree that it would be valuable to coordinate expense allocation among major trading partner countries. We also would support coordination to align anti-base erosion regimes. Indeed, in light of the budgetary pressures facing most of the developed world, in additional to international coordination of financial institution regulation, it would seem equally or more important to align measures that would more effectively protect national tax bases.

The proposal would suspend the deductibility of net interest expense of a domestic corporation that is a United States shareholder with respect to any controlled foreign corporation in the same worldwide affiliated group based on whether the U.S. group has excess domestic indebtedness in relation to the worldwide group or the domestic corporation's interest to adjusted taxable income exceeds a certain ratio. With the repeal of the investment in U.S. property rules, a controlled foreign corporation is unrestricted in making loans to the U.S. group and in guaranteeing U.S. group debt. The obvious planning incentive is to maximize interest deductions in the higher tax country and recognize interest income in a lower tax country. This rule is a significant structural component of the system and, with Subpart F rules, should limit gross abuses of the structure. [More to discuss.]

D. Foreign tax credit modifications

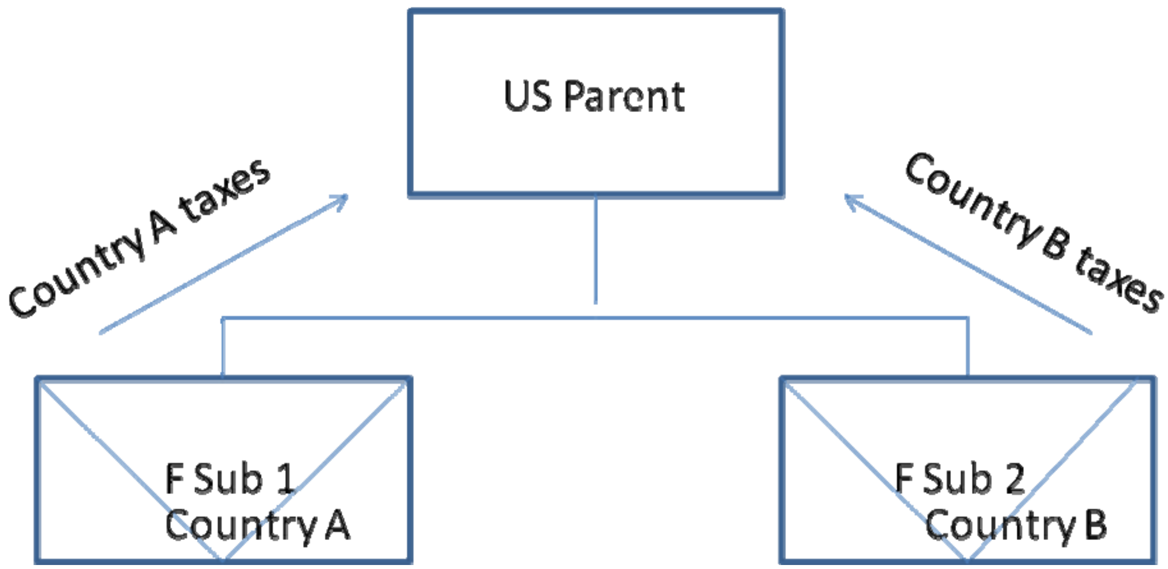
The Discussion Draft's foreign tax credit changes include repeal of the indirect foreign tax credit except in respect of current year Subpart F inclusions, limiting allocation of deductions for purposes of the foreign tax credit limitation to direct expenses, eliminating multiple foreign tax credit limitations and repealing the new section 909 rule suspending credits until income is taken into account. These changes are intended as simplifications but they disguise larger issues. As

[127] Graetz, *supra* note 125, at 492 – 93.

noted above, the discussion draft proposal creates (at least) two systems, one 95% exemption the other current taxation with unlimited cross-crediting. Taxpayers will maximize both, including cross-crediting.

There is no current rule other than Section 909 that is effective to prevent use of a reverse hybrid partnership structure (a foreign partnership treated as a corporation for U.S. tax purposes) to cause foreign taxes to be direct section 901 foreign tax credits. Moreover, by repealing the separate limitation for passive income, the discussion draft opens the whole panoply of financial instruments to achieve similar results. Under the Discussion Draft, once section 901 credits are on a U.S. tax return, they can be used against any foreign source income, including royalties, foreign source interest, sales that pass title outside the United States, any form of foreign source income. (The proposal makes no changes to the source rules, which it must if it is not going to lose substantial U.S. tax.) Moreover, the foreign source income that may be offset by any 901 credits that are generated will not be reduced by anything but direct deductions.

One example of potential planning under the Discussion Draft, which is a further refinement of the method for avoiding the Option 2 anti-base erosion rule, would be to establish reverse hybrid partnerships in each country of operation so that the base erosion rules are not tripped.



The taxes would be Section 901 credits, available for cross-crediting against active or passive foreign income. The income earned by the reverse hybrid local law partnership/U.S. tax law C corporation from a business in the country of organization would be exempt. To cut off this planning, we recommend against modifying the foreign tax credit limitations and most particularly section 909.

The proposal does not follow customary practice in other countries and cause interest and royalties earned by a U.S. persons to be taxable (i.e., by not allowing foreign taxes that are not imposed on the interest or royalty to be cross-credited against the US tax on interest). This will result in windfall benefits for financial institutions and technology companies both with respect to carryovers of foreign tax credits and future foreign taxes. Similarly, income from sales made from within the home country typically is taxable irrespective of whether or not the sale is an export sale. The revenue costs of not making these changes will be substantial.

The larger point is that by creating parallel systems of 95% exemption and full taxation with unlimited cross-crediting under Subpart F, potential savings are even richer than under current law as a target for tax planning. The Discussion Draft has upped the ante in a game the Government already is losing before this proposal. No doubt, a lower corporate tax rate will mitigate some incentive for tax planning, but if it is achieved with revenue increasing changes to the domestic corporate tax base, there will be great pressure to maintain low book tax rates with planning on the international side. That pressure will manifest itself as much or more at the boundaries of Subpart F as in the foreign tax credit rules.

E. *Inclusion of Pre-Effective Date Deferred Foreign Income Subject to 85% Deduction and Foreign Tax Credits*

The draft proposal provides that immediately prior to the effective date of the exemption regime, Subpart F income of a specified 10-percent owned foreign corporation will be increased by the accumulated deferred foreign income (undistributed earnings for all years not attributable to effectively connected income (ECI) and previously taxed earnings) and included in the income of a United States shareholder. While the earnings taken into account are not limited to the period of ownership by the United States shareholder, it will be entitled to a deduction equal to 85% of the increased Subpart F income. Moreover, the taxable portion may be reduced by foreign tax credits. The tax on the increased Subpart F income may be paid in 2 or more and up to 8 installments.

We expect that 8 installments was chosen as the maximum that could be allowed without a risk of some of the revenue falling outside the budget window once taxable years are taken into account. Interest is payable under section 6601. Generally, the section 6621 underpayment rate is the Federal short-term rate plus 3 percentage points (5% in the case of a large corporate underpayment). The short-term rate is inappropriate if the deferral is extended beyond a year. Moreover, the financing is favorable by definition as taxpayers who can obtain lower costs of financing without adverse effects would do so.

The current inclusion and 85% deduction also applies to non-corporate United States shareholders or at least application of the revised 965 is not limited to domestic corporations. We assume that the earnings inclusion will result in a basis step up for the shares of stock under Section 961. Depending on the facts, this can be detrimental or quite beneficial. If a taxpayer, such as a private equity fund, is going to sell a 10-percent interest in a foreign corporation at a substantial gain, coming within the rule allows the taxpayer to obtain a basis step-up at a maximum cost of 5.25% of the inclusion, instead of the 15% or 35% rate that might otherwise apply. There are no rules that restrict jumping into or out of United States shareholder or controlled foreign corporation status (such as the 5-year look back rule for controlled foreign corporation status under Section 1248).

The effect of the transition rule for pre-effective date earnings is to force a deemed repatriation of deferred earnings, but at a substantially reduced effective tax rate. While the acceleration is inconsistent with prior law deferral, and will be viewed by some as a change in government commitment (in contrast to the elective lower rate repatriation holiday adopted in 2004), the lower rate and extended time to pay mitigate the force of this objection. Others will claim that taxing old earnings is the most favored way to raise revenue because it will have the least distortive effect on future behavior under a territorial system.[128]

As noted above, to the extent that the a tax on pre-effective date earnings exceeds the tax that otherwise would be paid, which is in open question, it could be considered to offset windfall gains to prior equity owners.[129] In the present case, however, the tax is a favorable rate. Moreover, if the reform is revenue neutral, then in the aggregate there should be no windfall to old equity. While there will be winners and losers, it seems unlikely that the tax aligns so as to only tax the "winners" under a reform.

The decision of how to tax pre-effective date earnings is fundamentally a revenue decision. While it is inappropriate to take account of revenue from taxation of pre-effective date earnings in evaluating whether a territorial system is truly revenue neutral, as opposed to within a limited budget period, pre-effective date earnings are appropriately a potential source of revenue (for deficit reduction or otherwise). It should be acknowledged, however, that the choice to tax such earnings, and pre-announcement of the intended policy, will trigger pre-enactment and post-enactment behavioral responses that may not be captured fully under current revenue estimating methodology.

V. CONCLUSION

[To come.]

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[128] This is similar to the claim made by proponents of a consumption tax that the taxation of consumption from pre-effective date wealth rather than future capital income because the tax is lump-sum and will not distort future savings-consumption choices. Diamond and Saez observe that such a policy "strains the relevance of the assumption that the government is committed to a policy that this taxation of wealth will not be repeated" and suggest that such a policy could affect future savings decisions have efficiency effects. Peter Diamond and Emmanuel Saez, The Case for a Progressive Tax: From Basic Research to Policy Recommendations, 25 J. Econ. Perspectives 165, 179 (2011).

[129] See Morse, *International Tax Reform and a Corporate Offshore Excise Tax*, *supra* note 119.

Appendix A

Assume that a U.S. multinational (USCo) is choosing among a domestic active business investment that will yield $100 before tax and an equal investment in a 100% owned subsidiary, CFC-A, located in Country A, that will also earn $100 before tax. The plan is for the $100 to be reinvested in the active business during Year 2 and to be extracted at the end of that year. USCo's U.S. tax rate is 35%, CFC-A's Country A tax rate is 15% and the before-tax rate of return on investments in both the United States and Country A is 5%. Country A has no dividend withholding tax. The following table compares the results if USCo chooses the United States option with the outcome if USCo makes the investment in Country A and the United States has, in the alternative, a system of worldwide taxation with deferral or a territorial system.

Table 1

Country A Profits Tax	15.00%	15.00%	15.00%
U.S. Profits Tax	35.00%	35.00%	35.00%
Rate of return	5.00%	5.00%	5.00%
	Domestic Investment	Worldwide with Deferral	Territoriality
Year 1 Net Profit	$100.00	$100.00	$100.00
Year 1 Country A Profits Tax @ .15	NA	($15.00)	($15.00)
Year 1 U.S. Profits Tax @ .35	($35.00)	$0.00	$0.00
Invested in Year 2 @ .05	$65.00	$85.00	$85.00
Year 2 Return @ .05	$3.25	$4.25	$4.25
Year 2 Country A Profits Tax @ .15	NA	($0.64)	($0.64)
Dividend to USCo	NA	$88.61	$88.61
Year 2 U.S. Profits Tax @ .35	($1.14)	NA	NA
Year 2 U.S Dividend Tax @ .35 on $104.50 grossed-up amount and net of FTC	NA	($20.85)	$0.00
After-Tax	$67.11	$67.76	$88.61

This table yields several important observations.

If repatriation had occurred at the end of Year 1 in the worldwide scenario, the U.S. dividend tax would have been a tentative tax of $35, reduced by a $15 foreign tax credit, for a final tax of $20. When this amount is grown forward at the 4.25% after-tax rate of return (5% return minus 15% rate Country A tax), it becomes $20.85. This amount equals the Year 2 U.S. tax in the worldwide column. In other words, time value of money analysis makes it clear that the current U.S. tax when repatriation occurs at the end of Year 1 is equivalent to the U.S. dividend tax when repatriation is deferred until year 2. Thus the U.S. tax on repatriation of dividends is a neutral factor in USCo's decision to repatriate at the end of Year 1 or defer. This demonstrates that in the worldwide scenario, the repatriation tax should be irrelevant to USCo's choice between either mimicking the domestic scenario result by repatriating earnings at the end of Year 1 or delaying repatriation until the end of Year 2. Stated differently, concern over whether USCo was "locked into" delaying repatriation in the worldwide scenario by the "repatriation tax" on the dividend from CFC-A is not based an analysis of the effect of taxes on repatriation.

Instead, the principal tax consideration for USCo is the opportunity to earn a return on reinvested CFC-A profits, free of U.S. tax, by delaying repatriation and reinvesting during Year 2. USCo's after-tax result in the worldwide scenario is $67.76, which is just $0.65 larger than the after-tax result in the domestic scenario. This difference equals the difference between the foreign and U.S. tax rates (35% - 15% = 20%) times the investment return less the U.S. tax rate (5% * (1-35%) = 3.25% * 20% = 0.65%). By delaying repatriation, USCo avoids 57% ($0.65/$1.14) of the U.S. tax on the return to reinvestment if repatriation had occurred at the end of Year 1.

The difference between the bottom line results in the worldwide and territoriality columns is $20.85 ($88.61-$67.76). This amount equals the U.S. residual tax on the repatriation dividend in the worldwide column, which time value of money analysis has shown to be equivalent to the $20 undeferred Year 1 U.S. residual tax. Stated differently, the effect of U.S. adoption of a territorial system would be for the U.S. to give up its full residual tax of the difference in tax rate times the foreign earnings after foreign tax.

From the analysis above, it is clear that switching to a territorial system cannot be justified as a solution to a lockout of the foreign earnings of U.S.-controlled CFCs. Territoriality is not about mitigating a lock out effect. It is about increasing a tax preference for foreign-source income.