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INTERNATIONAL TAX REFORM BY MEANS OF CORPORATE INTEGRATION

by

Bret Wells[*]

Abstract

This Article focuses on a single organizing question, namely: how should a dividend paid deduction regime be designed so that it achieves acceptable international tax outcomes? By focusing on the international tax implications attendant with a dividend paid deduction regime, the author is not attempting to minimize the broader benefits of achieving shareholder-corporate integration, but in today's era, the overwhelming tax policy problem that must be solved rests on finding a solution to the systemic international tax challenges that face the country. The article sets forth three major systemic international tax policy challenges that plague the extant U.S. international tax regime and then provides analysis for how a properly designed dividend paid deduction regime can solve each of the international tax challenges. But, even though a properly designed dividend paid deduction regime provides a means to address systemic international tax challenges, such a regime still must address the inbound Homeless Income problem. Furthermore, the methodology for calculating the foreign tax credit limitation will need to be adjusted under a dividend paid deduction regime so that foreign earnings that are distributed as a dividend are not able to create a double tax benefit. And, Congress must be concerned with inappropriate shareholder efforts to cross-credit the shareholder withholding tax against the shareholders residual U.S. tax liability on other non-dividend income. Thus, significant design issues must be addressed in order for a dividend paid deduction regime to appropriately handle the systemic international tax problems that plague the United States.

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* Bret Wells is an Associate Professor of Law at the University of Houston Law Center. The author wishes to thank James D. Reardon, the participants of the Texas Tax Faculty Workshop, the members of the Houston Wednesday Tax Forum, and the Tax Section of the Houston Bar Association for their helpful comments to an earlier draft of this paper. The views expressed in this paper are solely the views of the author.

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I. INTERNATIONAL TAX CHALLENGES

Fundamental tax reform, at the moment, is the topic du jour. The Obama Administration issued a blueprint on fundamental business tax reform.[1] In 2014, Representative Dave Camp, who was at the time the chairman of the House Ways and Means Committee, released a

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1. *See* PRESIDENT'S FRAMEWORK FOR BUSINESS TAX REFORM: AN UPDATE—A JOINT REPORT BY THE WHITE HOUSE AND THE DEPARTMENT OF TREASURY 24 (Apr. 2016) (updating prior framework and more prominently focusing on a 19% minimum tax for extraterritorial income); PRESIDENT'S FRAMEWORK FOR BUSINESS TAX REFORM: A JOINT REPORT BY THE WHITE HOUSE AND THE DEPARTMENT OF TREASURY 11 (Feb. 2012) (argues for a 28% top corporate tax rate). After this article was far along in the publication process, the Presidential election and greater attention has been placed on an alternative reform proposal advocated by the House Ways and Means Committee. *See* HOUSE WAYS & MEANS COMM., 114TH CONG., A BETTER WAY: OUR VISION FOR A CONFIDENT AMERICA (June24, 2016), http://abetterway.speaker.gov/_assets/pdf/ABetterWay-Tax-PolicyPaper.pdf. The implications of that alternative reform proposal are beyond the scope of this article.

comprehensive tax reform plan that elicited considerable scholarly reaction.[2] Later in that same year, the Republican staff of the Senate Finance Committee provided their own report on how fundamental business tax reform should progress.[3] The Senate Staff Report indicates that Congress may seriously consider legislation that would allow C corporations to deduct the dividends paid to their shareholders and would subject those dividend distributions to a mandatory shareholder withholding tax.[4] For taxpayers subject to net basis taxation in the United States, this dividend withholding tax presumably would be creditable against the shareholder's final tax liability. For shareholders who are not subject to further taxation in the United States, the withholding tax presumably would be a final tax.

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2. Tax Reform Act of 2014, H.R. 1, 113th Cong. §§ 3001–3140 (2014) (proposing a top corporate tax rate of 25% and widely seen as the genesis, or at least benchmark, for ongoing Republican business-related reform discussions). The tax reform plan proposed by Chairman Camp was scored as revenue neutral by the Joint Committee on Taxation under its traditional revenue forecasting methods, as a significant revenue raiser under an alternative dynamic scoring methodology, and as having no significant detrimental distributional impact on lower-income taxpayers. STAFF OF THE JOINT COMM. ON TAX'N, 113TH CONG., JCS-1-14, TECHNICAL EXPLANATION, ESTIMATED REVENUE EFFECTS, DISTRIBUTIONAL ANALYSIS, AND MACROECONOMIC ANALYSIS OF THE TAX REFORM ACT OF 2014, A DISCUSSION DRAFT OF THE CHAIRMAN OF THE HOUSE COMMITTEE ON WAYS AND MEANS TO REFORM THE INTERNAL REVENUE CODE 640–82 (Joint Comm. Print 2014); *see also id.* at 493–534 (section discussing "Participation Exemption System for the Taxation of Foreign Income"). The author's views on the international tax implications of the Camp Proposal are set forth in a prior article and are not separately repeated here. Bret Wells, *Territorial Tax Reform: Homeless Income Is the Achilles Heel,* 12 HOUS. BUS. & TAX L.J. 1 (2012) [hereinafter Wells, *Territorial Tax Reform*]; *see also* Clifton J. Fleming, Jr., Robert J. Peroni & Stephen E. Shay, *Designing a U.S. Exemption System for Foreign Income When the Treasury Is Empty*, 13 FLA. TAX REV. 397 (2012).

3. *See* REPUBLICAN STAFF OF THE S. FIN. COMM., 113TH CONG., COMPREHENSIVE TAX REFORM FOR 2015 AND BEYOND (Comm. Print 2014) [hereinafter S. STAFF REP.]. Senator Hatch issued an accompanying press release where he stated that the Senate Staff Report represented an open invitation for all parties to work on these critical issues. *See* Press Release, Senate Fin. Comm., Continuing the Conversation on Corporate Tax Reform (Dec. 11, 2014), 2014 TAX NOTES TODAY 239-26 [hereinafter Hatch Press Release].

4. *See* S. STAFF REP., *supra* note 3, at 201–09. Earlier iterations of this idea were considered in prior eras but did not gain traction. *See, e.g.*, AM. LAW INST., FEDERAL INCOME TAX PROJECT: INTEGRATION OF THE INDIVIDUAL AND CORPORATE INCOME TAXES: REPORTER'S STUDY OF CORPORATE TAX INTEGRATION ¶ 2.4, Proposal 1 (1993), *reprinted in* INTEGRATION OF THE U.S. CORPORATE AND INDIVIDUAL INCOME TAXES: THE TREASURY DEPARTMENT AND AMERICAN LAW INSTITUTE REPORTS 672–73 (Michael J. Graetz & Alvin C. Warren eds., 1998).

Ironically, the need for international tax reform may now represent the catalyst for finally adopting a shareholder-corporate integration regime. In this regard, a growing number of respected tax policy thinkers are making the case that a dividend paid deduction regime is the pathway for solving several of the nation's systemic international tax problems.[5] This argument is being made at a time when near universal agreement exists that the current U.S. international tax regime is deeply flawed[6] and at a time when no consensus has been forged behind a specific reform proposal. In this regard,

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5. *See* Kaustuv Basu, *Hatch Says Corporate Integration Draft May Be Delayed Until May*, 150 TAX NOTES 1088 (Mar. 7, 2016); Aaron E. Lorenzo, *Hatch Sees Slower Timeline for Corporate-Integration Proposal*, DAILY TAX REP. (BNA), Mar. 2, 2016, at G-3 (quoting Senator Hatch as stating that the integration proposal might not be ready before May); Aaron E. Lorenzo, *Corporate Integration Plan Could Come in March, Hatch Says*, DAILY TAX REP. (BNA), Jan. 28, 2016, at G-6 (quoting Senator Hatch as stating that "[t]here's a lot of interest in [a corporate integration proposal] because it may be the only bipartisan possibility for getting inversions under control . . . ."); Dylan F. Moroses & Paul C. Barton, *Corporate Integration Can Complement Other Reforms, Hatch Says*, 2016 TAX NOTES TODAY 37-2 (Feb. 25, 2016) (Senator Hatch quoted as saying that "his corporate integration plan and the House Ways and Means Committee's efforts on international tax reform could complement each other"); Alex M. Parker, *Senate Finance Advisor: Integration Could Solve Inversions*, DAILY TAX REP. (BNA), Feb. 12, 2016, at G-6 (quoting Chris Hanna as stating that "[i]ntegrating the U.S. corporate tax code so there is no longer taxation of both the corporation and the shareholders could not only discourage inversions but also bring deferred income home and help lower the effective U.S. corporate tax rate.").

For a vigorous assertion of this linkage, see John D. McDonald, A Taxing History: Why Corporate Tax Policy Needs to Come Full Circle and Once Again Reflect the Reality of the Individual as Taxpayer 3–4 (2015) (unpublished manuscript) (on file with author) ("the goal of any integration approach should . . . focus . . . on using integration as a way to extricate the U.S. from the current system of tax competition that prevails amongst countries. Stated differently, integration approaches should not be judged by reference to how closely they eliminate the distinction between partnership and corporate taxation. The emphasis should be on how the approach minimizes tax competition."), available at http://www.law.uchicago.edu/files/file/integration_draft_commentary_paper.pdf. This observation has also been made in terms of advocating corporate integration via a shareholder imputation credit regime. *See* Michael J. Graetz & Alvin C. Warren, Jr., *Unlocking Business Tax Reform*, 145 TAX NOTES 707 (Nov. 10, 2014). For the assertion that a dividend paid deduction regime is superior to that of a shareholder imputation regime, see Dana Trier, *Corporate Integration in a World of Tax Competition,* 93 TAXES 195 (CCH), Feb. 2, 2016.

6. *Compare* Clifton Fleming, Jr., Robert J. Peroni & Stephen E. Shay, *Worse Than Exemption*, 59 EMORY L. J. 79 (2009–2010), *with* Tax Executive Institute, *TEI Guideposts for Tax Reform,* 61 TAX EXECUTIVE 460 (2009) (arguing that the subpart F regime is outmoded and anti-competitive).

although a territorial tax regime has been discussed for several years[7] and although many of the major U.S. trading partners have adopted their own form of a territorial tax regime,[8] no discernible progress has been made in the United States towards such a regime. Thus, the growing discussion in favor of a dividend paid deduction regime is occurring at a time when other competing reform proposals have languished and at a time when all sides of the political spectrum agree that fundamental international tax reform is needed.[9] Moreover, the tax community remains optimistic that a political

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7. For a discussion of the complexity in designing an appropriately designed territorial tax regime, see, e.g., Fleming, Peroni & Shay, *Designing a U.S. Exemption System, supra* note 2; *see also* JANE G. GRAVELLE, CONG. RESEARCH SERV., R42624, MOVING TO A TERRITORIAL INCOME TAX: OPTIONS AND CHALLENGES (2012); Wells, *Territorial Tax Reform*, *supra* note 2.

8. *See* STAFF OF THE JOINT COMM. ON TAX'N, 113TH CONG., JCX-33-11, BACKGROUND AND SELECTED ISSUES RELATED TO THE U.S. INTERNATIONAL TAX SYSTEM AND SYSTEMS THAT EXEMPT FOREIGN BUSINESS INCOME (2011) (analyzing territorial tax regimes in Australia, Canada, France, Germany, Japan, Netherlands, Spain, Switzerland, and the United Kingdom).

9. *See President Obama's Budget Proposals for Fiscal Year 2017: Hearing Before the H. Ways & Means Comm.*, 114th Cong. (Feb. 11, 2016), (prepared statement of Jacob L. Lew, Secretary, Dept. of the Treas. (http://congressional.proquest.com:80/congressional/docview/t39.d40.02115703.d45 ?accountid=10920)) ("[T]he only real solution is for Congress to enact business tax reform that addresses the root inefficiencies that cause these problems and specifically closes the inversion loophole. The growing bipartisan consensus in Washington on how to achieve business tax reform creates the opportunity to take this key step sooner rather than later. In the meantime, Congress should act this year to change our tax laws to stop corporate inversions."); *id.* (opening statement of Rep. Sander M. Levin (http://congressional.proquest.com:80/congressional/docview/t65.d 40.02110003.z62?accountid=10920)) ("[What's been happening here while the Republican majority has been essentially asleep in terms of action on tax reform is that more and more companies are moving overseas (inaudible) in order to avoid paying taxation—taxes."); Kaustuv Basu, *Ways and Means Moving Immediately on International Tax Reform,* 2016 TAX NOTES TODAY 30-4 (Feb. 22, 2016) (quoting Chairman Kevin Brady as stating that his committee will move immediately to draft international tax reform legislation); Kaustuv Basuv, *"Brady Seeks International Tax Reform in Difficult Environment,"* 2016 TAX NOTES TODAY 29-2 (Feb. 12, 2016) (quoting Speaker Paul Ryan as stating that "international tax reform might have to proceed without repatriated corporate earnings being used to pay for infrastructure . . . I would like to think people would want to fix these international tax law problems for the sake of fixing these international tax law problems."); Kaustuv Basuv & David Van Denberg, *Senate Finance Fails to Reach Consensus on Tackling Inversions,* 2016 TAX NOTES TODAY 28-2 (Feb. 11, 2016) (quoting Charles E. Schumer, ranking democratic member of the Senate Finance Committee as stating that "[w]e are trying to bridge over . . . divides in existing proposals"); Stephen K. Cooper & Kat Lucero, *Ways and Means to Address Inversions, Repatriation, Brady*

compromise will be found.[10] Thus, given the overarching need to reform the nation's international tax regime, this is an important moment to seriously consider whether a dividend paid deduction regime provides a path for achieving meaningful international tax reform.

This Article focuses on a single organizing question, namely: how should a dividend paid deduction regime be designed so that it achieves acceptable international tax outcomes? By focusing on the international tax implications attendant with a dividend paid deduction regime, the author is not attempting to minimize the broader benefits of achieving shareholder-corporate integration. The dividend paid deduction proposal, as to distributed earnings, would equate the tax treatment of debt and equity, and in so doing it would reduce distortions that current law creates with respect to debt and equity in the corporate context.[11] Furthermore, recent economic works suggest that the incidence of the corporate income tax burden is partially shifted to labor and away from shareholders[12] whereas a properly designed

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Says, 2016 TAX NOTES TODAY 10-1 (Jan. 15, 2016) (statement by Chairman Brady indicating that international tax reform is needed to address the inversion problem and lock-out effect); Amy S. Elliott, *March Deadline Set for U.S. International Tax Draft as Urgency Mounts,* 2016 WORLDWIDE TAX DAILY 37-1 (Feb. 25, 2016) (quoting Rep. Boustany as stating that he hopes to have a bill by March and then quoting Rep. Brady as stating that it is time to act immediately on international tax reform); Press Release, S. Fin. Comm. Ranking Member Ron Wyden Statement on Pfizer-Allergan Merger (Nov. 23, 2015), http://www.finance.senate.gov/ranking-members-news/wyden-statement-on-pfizer-allergan-merger ("Bipartisan, comprehensive tax reform will require serious political will and independence from members of Congress, but this inversion crisis shows that it needs to happen soon.").

10. *See* THE TAX COUNCIL & ERNST & YOUNG, LLP, TTC/EY TAX REFORM BUSINESS BAROMETER: VIEWS ON THE PROSPECTS FOR, AND KEY ASPECTS OF, FEDERAL TAX REFORM (Sept. 2015), http://www.thetaxcouncil.org/wp-content/files/2013/07/TTC-EY-tax-reform-business-barometer-september-2015.pdf. For an even more optimistic assessment, see Alexander Lewis, *International Tax Reform Could Advance in 2016, Advisors Say,* 2016 WORLDWIDE TAX DAILY 29-7 (Feb. 12, 2016).

11. *See* S. STAFF REP., *supra* note 3, at 149–57, 201, n.578. For recent testimony by a leading tax academic on the debt versus equity distortions and the need to seriously consider corporate integration proposals, see *Tax Reform: Examining the Taxation of Business Entities: Hearing Before the S. Comm. on Fin.,* 112th Cong. (Aug. 1, 2012) (statement of Alvin C. Warren).

12. For an excellent summary of the existing economic analysis of the distributional impact of the corporate income tax, see S. STAFF REP., *supra* note 3, at 163–71 ("Conclusion: It appears that 50 years after Harberger's groundbreaking article, it is still not clear from the economics literature precisely who bears the incidence of the corporate tax. However, it is clear that labor bears a significant fraction of the burden."). For recent testimony by leading tax academics that this literature should cause policy-makers to rethink the classic double taxation of

integration proposal puts the incidence of business taxation squarely on shareholders.[13] Furthermore, shareholder-corporate integration for C corporations harmonizes the divergent tax treatment that currently exists between C corporations and pass-through entities.[14] Thus, a corporate integration proposal provides a broad spectrum of potential benefits, and so not surprisingly significant scholarship has been dedicated towards how to best achieve shareholder-corporate integration.[15] But, in today's era, the

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corporate earnings, see *President's 2012 Trade Agenda: Hearing Before the S. Comm. on Fin.,* 112th Cong. (Mar. 8, 2011) (statement of Michael J. Graetz).

13. *See* S. STAFF REP., *supra* note 3, at 125–234; *see also* McDonald, *supra* note 5, at 2 ("The thesis of this paper is that Congress should shift the burden of corporate tax to certain shareholders of those corporations. This is because Shareholder taxation is the logical end point of globalization and increasing international tax competition.").

14. *See* S. STAFF REP., *supra* note 3, at 122 ("Eliminating the two-tier tax system would reduce or eliminate . . . the incentive to invest in non-corporate businesses rather than corporate businesses"); *see also* McDonald, *supra* note 5, at 2 ("The point of integration was to try and reduce the incentives for investing capital in pass-through entities . . . .").

15. *See* S. STAFF REP., *supra* note 3, at 125–234. This effort to achieve shareholder-corporate integration has been a longstanding area of scholarly and legislative attention for decades. *See* CONG. BUDGET OFFICE, REVISING THE CORPORATE INCOME TAX (1985), https://www.cbo.gov/sites/default/files/99th-congress-1985-1986/reports/85-cbo-009.pdf; OFFICE OF THE PRESIDENT OF THE U.S., THE PRESIDENT'S TAX PROPOSAL TO THE CONGRESS FOR FAIRNESS, GROWTH, AND SIMPLICITY (1985), https://www.treasury.gov/resource-center/tax-policy/Documents/Report-Reform-Proposal-1985.pdf [hereinafter U.S. PRES., TAX PROPOSAL FOR FAIRNESS]; THE PRESIDENT'S ECONOMIC RECOVERY ADVISORY BD., THE REPORT ON TAX REFORM OPTIONS: SIMPLIFICATION, COMPLIANCE, AND CORPORATE TAXATION 74-77 (2010), https://www.whitehouse.gov/sites/default/files /microsites/PERAB_Tax_Reform_Report.pdf; THE PRESIDENT'S ADVISORY PANEL ON TAX REFORM, SIMPLE, FAIR, AND PRO-GROWTH: PROPOSALS TO FIX AMERICA'S TAX SYSTEM 129 (2005), http://govinfo.library.unt.edu/taxreformpanel; DEP'T OF THE TREASURY, INTEGRATION OF THE INDIVIDUAL AND CORPORATE TAX SYSTEMS: TAXING BUSINESS INCOME ONCE 39–40 (1992), https://www.treasury.gov/resource-center/tax-policy/Documents/Report-Integration-1992.pdf [hereinafter TREAS., INTEGRATION]; 2 OFFICE OF THE SEC'Y OF THE TREASURY, TAX REFORM FOR FAIRNESS, SIMPLICITY, AND ECONOMIC GROWTH 133-50 (1984), https://www.treasury.gov/resource-center/tax-policy/Documents/Report-Tax-Reform-v2-1984.pdf [hereinafter TREAS., TAX REFORM FOR FAIRNESS]; AM. LAW INST., *supra* note 4, at 595; AM. LAW INST., FEDERAL INCOME TAX PROJECT, SUBCHAPTER C, PROPOSALS OF THE AMERICAN LAW INSTITUTE ON CORPORATE ACQUISITIONS AND DISPOSITIONS AND REPORTER'S STUDY ON CORPORATE DISTRIBUTIONS 346–47 (1982) [hereinafter AM. LAW INST., SUB. C]; Michael Graetz & Alvin Warren, *Unlocking Business Tax Reform*, 145 TAX NOTES 707 (Nov. 10, 2014); Daniel Halperin, *Corporate Rate Reduction and Fairness to Pass Through*

overwhelming tax policy problem that must be solved rests on finding a solution to the systemic international tax challenges that face the country, and so that is where this Article will focus.

In the remainder of this Part I, this Article sets forth three major systemic international tax policy challenges that plague the extant U.S. international tax regime. In Part II, this Article evaluates the dividend paid deduction proposal in light of these systemic policy challenges and then provides analysis for how a properly designed dividend paid deduction regime can solve each of the international tax challenges set forth in Part I. Finally, in Part III, this paper draws tentative conclusions about the way forward.

A. *Base Erosion and the Homeless Income Mistake*

A critical failure of the current U.S. international tax regime is its inability to prevent the "Homeless Income" mistake.[16] Homeless Income refers to profits that are removed from the host country where the economic activity occurs and are diverted to a low-tax jurisdiction. The income is "homeless" in the sense that it does not have a tax home[17] either in the host

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Entities, 147 TAX NOTES 1299 (June 15, 2015); Jeffrey L. Kwall, *The Uncertain Case Against the Double Taxation of Corporate Income*, 68 N.C. L. REV. 613, 644–45 (1990); Rebecca S. Rudnick, *Corporate Tax Integration: Liquidity of Investment*, 42 TAX NOTES 1107 (Feb. 27, 1989); Alvin Warren, *The Relation and Integration of Individual and Corporate Income Taxes*, 94 HARV. L. REV. 719, 736–37 (1981); Daniel Halperin, *Mitigating the Potential Inequity of Reducing Corporate Tax Rates* 5 (Tax Policy Ctr. Working Paper, 2009), http://www.taxpolicycenter.org/publications/mitigating-potential-inequity-reducing-corporate-rates ("Integrating the corporate and individual taxes is a more direct way of equating the treatment of pass-through entities with taxation of corporate income."). For an analysis of efforts for shareholder-corporate integration in the post-World War II era, see Steven A. Bank, *The Rise and Fall of Post-World War II Corporate Tax Reform*, 73 LAW & CONTEMP. PROBS. 207 (2010).

16. In other writings, the author and Cym Lowell have argued that the base erosion of source countries was a purposeful goal that became the foundational premise of the post-World War I international tax policy objective. The Homeless Income mistake was a natural consequence of these purposeful formative policy goals and has created substantial mischief. For a thorough discussion of the genesis of these foundational premises to modern international tax law along with the substantial mischief that the adherence to these principles creates, see Bret Wells & Cym Lowell, *Tax Base Erosion and Homeless Income: Collection at Source Is the Linchpin*, 65 TAX L. REV. 535 (2012) [hereinafter Wells & Lowell, *Homeless Income*].

17. What was envisioned as an allocation of taxing rights in favor of the resident home country has resulted in the creation of "homeless income" (income that is not effectively taxed in either the source country or the ultimate resident home

country or in the home country of the ultimate parent corporation. Homeless Income is created when a low-tax subsidiary is allowed to engage in related-party transactions with high-tax affiliates such that profits and profit-making opportunities are contractually shifted to the low-tax subsidiary. The tax minimization strategies that unlock Homeless Income can be further categorized along the following lines:

> *1. Interest Stripping Transactions.* The low-tax affiliate makes related-party loans to fund the capital needs of high-tax affiliates and charges interest on the related-party debt (Interest Stripping Transactions).[18] Under these Interest Stripping Transactions, the

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of the parent company). Source countries seek to retain taxing jurisdiction over routine profits through treaties and transfer pricing methods and cede taxing jurisdiction over residual profits to the taxpayer's country of residence. However, many countries have decided not to tax their resident corporations on extraterritorial income. For a detailed analysis of the causes of homeless income and the systemic policy challenges that it creates, see Wells & Lowell, *Homeless Income, supra* note 16, at 537–38. *See also* Edward Kleinbard, *Stateless Income's Challenge to Tax Policy*, 132 TAX NOTES 1021 (Sep. 5, 2011).

18. Inversion debt infused into the U.S. affiliate as part of the inversion is widely seen as a key financial incentive that motivates corporate inversions. *See* DONALD J. MARPLES & JANE G. GRAVELLE, CONG. RESEARCH SERV., R43568, CORPORATE EXPATRIATION, INVERSIONS, AND MERGERS: TAX ISSUES 4 (2015) (noting that the inverted company "can engage in 'earnings stripping': reducing income in the U.S. firm by borrowing from the U.S. company and increasing interest deductions. For example, a foreign parent may lend to its U.S. subsidiary. This intercompany debt does not alter the overall company's debt, but does result in an interest expense in the United States (which reduces U.S. taxes paid) and an increased portion of company income being 'booked' outside the United States."); OFFICE OF TAX POLICY OF THE DEP'T OF TREASURY, CORPORATE INVERSION TRANSACTIONS: TAX POLICY IMPLICATIONS 22 (May 2002) [hereinafter TAX POLICY OFFICE, INVERSIONS] (A feature common to many inversions is the presence of substantial indebtedness from the former group to the new foreign parent or one of its foreign subsidiaries. . . . While the steps through which debt is put in place vary, the result can be interest payments that effectively strip income out of the U.S. taxing jurisdiction."); Bret Wells, *Corporate Inversions and Whack-a-Mole Tax Policy* 143 TAX NOTES 1429 (June 23, 2014) [hereinafter Wells, *Whack-a-Mole Tax Policy*]; Bret Wells, *Cant and the Inconvenient Truth About Corporate Inversions,* 136 TAX NOTES 429 (July 23, 2012) [hereinafter Wells, *Inconvenient Truth*]; Bret Wells, *What Corporate Inversions Teach Us About International Tax Reform,* 127 TAX NOTES 1345 (June 21, 2010) [hereinafter Wells, *What Corporate Inversions Teach*].

This same technique has been recognized as a common earning stripping technique in both the inbound context and the foreign-to-foreign base erosion context. *See* STAFF OF THE JOINT COMM. ON TAX'N, 111TH CONG., JCX-33-11,

high-tax affiliate is entitled to claim a tax deduction on its interest payments that are made to the low-tax affiliate while the low-tax affiliate is entitled to claim a concessionary withholding rate[19] on its interest income and incurs only a minimal income tax cost on its interest income in its country of incorporation.

2. Royalty Stripping Transactions. The low-tax affiliate acquires the intellectual property, know-how, and other intangibles through intangible migration strategies. After ownership of the intangibles are migrated to the low-tax affiliate, the low-tax affiliate assumes the role of "IP owner" and "internal risk taker" with respect to the intangible returns of the multinational enterprise. The low-tax affiliate then licenses the valuable intangibles to high-tax affiliates and charges those affiliates a royalty under related-party licensing agreements (Royalty Stripping Transactions).[20] Through these

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PRESENT LAW AND BACKGROUND RELATED TO POSSIBLE INCOME SHIFTING AND TRANSFER PRICING 109 (2010) [hereinafter JCT, INCOME SHIFTING] ("[L]everage is also used to shift income from high-tax to low-tax jurisdictions. For example, it is common for foreign parent companies to leverage their U.S. operations, resulting in interest deductions at the higher U.S. tax rate and interest income in lower-tax jurisdictions. Taxpayers strategically use low-tax jurisdictions as the lenders in these transactions. Access to a robust treaty network is often a key consideration to limit or avoid withholding tax on interest payments. Additionally, U.S.-based multinationals structure debt in a manner that avoids subpart F income (for example, through the use of check- the-box entities.)").

19. Tax treaties regularly provide a concessionary tax rate on interest income. For models that afford such a reduced rate, see U.S. Model Income Tax Convention, art. 11 (Nov. 15, 2006); OECD Model Convention with Respect to Taxes on Income and on Capital, art. 11 (2014).

20. *See, e.g.*, MARPLES & GRAVELLE, *supra* note 18, at 4 ("Royalty payments, management fees, and transfer pricing arrangements are other avenues for earnings stripping,"); JCT, INCOME SHIFTING, *supra* note 18, at 103–04 (although diversity of techniques exist, the case studies of Charlie and Echo demonstrate IP migration with unidentified intangibles where Alpha, Bravo, and Foxtrot explicitly use licensing and cost sharing agreements to transfer the intangible value of identified intangible to a low-tax affiliate); *see also* DEP'T. OF THE TREASURY, REPORT TO THE CONGRESS ON EARNINGS STRIPPING, TRANSFER PRICING AND U.S. INCOME TAX TREATIES 54 (Nov. 2007) [hereinafter TREAS., EARNINGS STRIPPING] ("The Treasury Department believes that CSAs under the current regulations pose significant risk of income shifting from non-arm's length transfer pricing. In addition to the valuation and definitional problems discussed above, CSAs often involve the key value-driving intangibles of a business."). For the author's views on migration of U.S. developed intangibles to low-tax jurisdictions and how the Treasury should utilize its authority to attack these strategies, see Bret Wells, *Revisiting § 367(d): How Treasury Took the Bite Out of Section 367(d) and What Should Be Done About It,* 16 FLA. TAX REV. 519 (2014) [hereinafter Wells, *Revisiting § 367(d)*].

Royalty Stripping Transactions, the high-tax affiliate is entitled to claim a tax deduction on its royalty payments made to the low-tax affiliate while the low-tax affiliate generally benefits from a concessionary withholding tax rate[21] on its royalty income and bears a minimal income tax cost on its royalty income in its country of incorporation.

3. Lease Stripping Transactions. The low-tax affiliate leases tangible personal property (machinery and equipment) to foreign affiliates located in high-tax jurisdictions and charges rent for this equipment (Lease Stripping Transactions).[22] The high-tax affiliate claims a tax deduction on its rental payments in the Lease Stripping Transaction while the low-tax affiliate is entitled to claim a concessionary withholding rate[23] on its rental income in the source country and incurs only a minimal income tax cost on its rental income in its country of incorporation.

4. Supply Chain Transactions. The low-tax affiliate buys property from one affiliate and/or resells property to another affiliate or becomes the risk-taker in the value chain through related-party arrangements (Supply Chain Transactions).[24] The resale profit margin earned by the low-tax affiliate in these Supply Chain Transactions generally is subject to only a minimal income tax cost in its country of incorporation.

5. Service Stripping Transactions. The low-tax affiliate charges high-tax affiliates for its provision of expertise services including risk-taker services or technical support services to the

21. Tax treaties regularly provide a concessionary tax rate on royalty income. For models that afford such a reduced rate, see U.S. Model Income Tax Convention, art. 12 (Nov. 15, 2006); OECD Model Convention with Respect to Taxes on Income and on Capital, art. 12 (2014).

22. *See, e.g.*, JCT, INCOME SHIFTING, *supra* note 18, at 64, n.185 (noting in the Bravo case study that the intercompany license agreement provided the low-tax affiliate with the rights that included the right to lease or otherwise commercially exploit products obtained by the low-tax affiliate under the cost sharing agreement).

23. Tax treaties regularly provide a concessionary tax rate on rental income. For models that afford such a reduced rate, see U.S. Model Income Tax Convention, art. 7 (Nov. 15, 2006); OECD Model Convention with Respect to Taxes on Income and on Capital, art. 22(4) (2014).

24. *See, e.g.,* JCT, INCOME SHIFTING, *supra* note 18, at 11–17 (each restructuring of Alpha, Bravo, Charlie, Delta, Echo and Foxtrot provide variations of this common theme). For the author's discussion of how these transfer pricing issues should be addressed under current law, see Bret Wells & Cym Lowell, *Tax Base Erosion: Reformation of Section 482's Arm's Length Standard,* 15 FLA. TAX REV. 737 (2014) [hereinafter Wells & Lowell, *Section 482*].

high-tax affiliate (Service Stripping Transactions).[25] The high-tax affiliate claims a tax deduction on its service fee payments that arises as part of the Service Stripping Transaction while the low-tax affiliate either is not subject to a withholding tax[26] on its service fee income or alternatively is subject to a concessionary withholding tax rate, and the low-tax affiliate bears a minimal income tax cost on its service fee income in its country of incorporation.

Each of the above base erosion techniques achieves a common goal: profits from affiliates located in high-tax jurisdictions are transferred in a tax deductible manner to an affiliate located in a low-taxed jurisdiction. Not every tool in the above tax minimization toolbox will work in every country. Some countries impose significant withholding taxes on service fees. Other countries deny the ability to remit foreign exchange for cross-border royalties or subject those payments to a rigorous governmental approval process in an effort to force the multinational enterprise to contribute its know-how to its in-country subsidiary. Other countries may impose substantial withholding taxes on interest, rents and royalties.[27] Still other countries may restrict the amount of related-party interest expense that can be used to strip profits through the adoption of various thin capitalization

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25. *See, e.g.*, MARPLES & GRAVELLE, *supra* note 18, at 4 ("Royalty payments, management fees, and transfer pricing arrangements are other avenues for earnings stripping,")*;* JCT, INCOME SHIFTING, *supra* note 18, at 118 (each of the case studies contain elements of this using intercompany service arrangement to shift value to a low-tax risk-taker affiliate or to provide management support services from high-tax jurisdictions to the low-tax affiliate at a minimal cost-plus mark-up); *see also* TREAS., EARNINGS STRIPPING, *supra* note 20, at 54 (Based on the experience of the Internal Revenue Service, and in light of the critical assessment of the current transfer pricing regulations discussed above, the Treasury believes that there is some potential for income shifting from non-arm's length transfer pricing under the current regulations. This potential is perhaps most acute with respect to CSAs, but is also possible with respect to the provision of intercompany services and other transactions.").

26. Tax treaties regularly provide that a company's service income not attributable to a permanent establishment are not taxable in the source country. For models that afford such a reduced rate, see U.S. Model Income Tax Convention, art. 21 (Nov. 15, 2006); OECD Model Convention with Respect to Taxes on Income and on Capital, art. 21 (2014).

27. The U.N. Model Treaty leaves the withholding rate unspecified in the model U.N. treaty as no agreement was able to be reached on a definitive rate. *See* U.N. DEP'T OF INT'L ECON. & SOC. AFFAIRS, MANUAL FOR THE NEGOTIATION OF BILATERAL TAX TREATIES BETWEEN DEVELOPED AND DEVELOPING COUNTRIES 66–77, U.N. Doc. ST/ESA/94, U.N. Sales No. E.79.XVI.3 (1979).

regimes or asset tax regimes.[28] However, by having a variety of tax minimization strategies in one's tax planning toolbox, the multinational enterprise is in a position to design a tax minimization strategy for each particular country that is suited to navigate the ad hoc base protection measures and treaty arrangements that exist with respect to that particular source country. Thus, even though the above Homeless Income strategies oftentimes must be tailored to fit the unique source country context, the reality is that at their core these tax minimization strategies generally can be broadly categorized in the above five categories. What is more, regardless of the particular inbound Homeless Income strategy, these Homeless Income strategies are often premised on the utilization of a transactional transfer pricing methodology where only the high-tax jurisdiction is a tested party instead of relying on a profit-split analysis where all related parties are separately tested for appropriate transfer pricing outcomes.[29]

The U.S. subpart F rules serve as an ad hoc "backstop" against the profit shifting outcomes that otherwise are achievable under the U.S. transfer pricing rules. For example, the U.S. subpart F rules generally attack the Homeless Income strategies utilized by a U.S. multinational enterprise in the inbound earning stripping context if such a strategy is based on an inbound Interest Stripping Transaction, an inbound Royalty Stripping Transaction, or an inbound Rental Stripping Transaction.[30] In contrast, these U.S. subpart F provisions generally do not apply to the inbound earning stripping strategies utilized by a foreign-based multinational enterprise, and so the practical consequence of this scope limitation with respect to the U.S. subpart F rules

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28. *Id*. at 90 ¶ 48 ("To prevent corporate taxpayers from distributing their profits to their parent corporation mostly in the form of deductible interest, many countries have adopted so-called 'thin capitalization' rules").

29. For a discussion of the deficiency of the transactional transfer pricing methodologies to handle the multinational enterprise context, see Wells & Lowell, *Section 482*, *supra* note 24. Foreign multi-national corporations (MNCs) can engage in similar base erosion strategies in their dealings with U.S. affiliates subject to certain limitations, including the U.S. transfer pricing rules of section 482, the earnings stripping rules of section 163(j), the limitations imposed by newly issued proposed regulations under Section 385 that recharacterize certain debt as equity when such debt is issued as part of internal reorganizations or in certain acquisitions of U.S. companies, and U.S. withholding tax on outbound payments of interest, rentals, and royalties when not eliminated by a treaty. *See* Prop. Reg. § 1.385–3, 81 Fed. Reg. 20,931 (Apr. 8, 2016).

30. In the author's experience, U.S. MNCs do not generally use a foreign affiliate to receive rentals, interest, or royalties from the U.S. Parent or other U.S. affiliates. Presumably this is due to the subpart F rules. *See, e.g.*, I.R.C. § 952(b) (excluding U.S. source income from subpart F income only if it is effectively connected income). In addition, such payments may be subject to U.S. withholding tax when a treaty does not apply.

is to provide the foreign-based multinational enterprise with a significant inbound earning stripping tax advantage. However, even though the U.S. subpart F rules provide a backstop in the inbound U.S. multinational context, in the outbound U.S. multinational context the U.S. multinational enterprise is generally able to utilize a broader array of the Homeless Income strategies in the foreign-to-foreign base erosion context, and so in the outbound earning stripping context the U.S. multinational enterprise is more on par with their foreign-based multinational competitors.[31]

The strategic use of a low-tax jurisdiction affiliate to earn Homeless Income is in vogue today.[32] The popular press has reported that Google[33] and General Electric[34] have dodged their U.S. tax obligations by the use of low-tax affiliates located in tax haven subsidiaries, and the Obama Administration has claimed that large U.S. multinational corporations are shirking their responsibility to pay their fair share of taxes.[35] Artificial

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31. The author's analysis of the relaxation of the subpart F regime in the outbound foreign-to-foreign context is set forth in a prior work and is not separately repeated here. For a more detailed analysis of the subpart F regime and its role as a backstop for the U.S. transfer pricing rules, see Wells, *Territorial Tax Reform, supra* note 2, at 13–34.

32. *See* D. KEVIN DOLAN, ET AL, US TAXATION OF INTERNATIONAL MERGERS, ACQUISITIONS AND JOINT VENTURES ¶ 26.01 (2016).

33. Jesse Drucker, *Google 2.4% Rate Shows How $60 Billion Lost to Tax Loopholes,* BLOOMBERG (Oct. 21, 2010), https://www.bloomberg.com/news/2010-10-21/google-2-4-rate-shows-how-60-billion-u-s-revenue-lost-to-tax-loopholes.html/; *see also* John Sokatch*, Transfer-Pricing with Software Allows for Effective Circumvention of Subpart F Income: Google's "Sandwich" Costs Taxpayers Millions,* 45 INT'L LAW. 725 (2011); Jeremy Kahn & Jesse Drucker, *Google Cut Taxes by $2.4 Billion Using European Subsidiaries,* DAILY TAX REP. (BNA), Feb. 22, 2016, at I-2 (detailing how Google utilized "Double Irish" and "Dutch sandwich" structures to reduce their taxes by $2.4 billion in 2014 by shifting $12 billion in revenue to a Bermuda shell corporation); Jeremy Kahn & Thomas Penny, *Google Tells U.K. Parliament It Won't Pay 'Google Tax',* DAILY TAX REP. (BNA), Feb. 12, 2016, at I-2 (Google defended its Homeless Income strategies and indicated that it would not be subject to the U.K. diverted profits tax regime).

34. *See, e.g.*, David Kocieniewski, *At G.E. on Tax Day, Billions of Reasons to Smile,* NY TIMES, Mar. 25, 2011, at A-1.

35. The essence of his explanation of the current situation was that many American taxpayers are "shirking" their responsibilities, and that the U.S. Code is "a broken system, written by well-connected lobbyists on behalf of well-heeled interests and individuals." Press Release, White House Press Secretary, Remarks by the President on International Tax Policy Reform (May 4, 2009), https://www.whitehouse.gov/the-press-office/remarks-president-international-tax-policy-reform.

income shifting to tax haven jurisdictions is an issue that has frustrated Congress for at least fifty years and has been the flashpoint for public outrage.[36] Empirical evidence suggests that current international tax planning

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> Now, understand, one of the strengths of our economy is the global reach of our businesses. And I want to see our companies remain the most competitive in the world. But the way to make sure that happens is not to reward our companies for moving jobs off our shores or transferring profits to overseas tax havens.…And that's why today, I'm announcing a set of proposals to crack down on illegal overseas tax evasion, close loopholes, and make it more profitable for companies to create jobs here in the United States.…Now, it will take time to undo the damage of distorted provisions that were slipped into our tax code by lobbyists and special interests . . . .

Id.; see also Obama Unveils Far-Reaching Proposals to Crack Down on Offshore Tax Abuses, DAILY TAX REP. (BNA), May 5, 2009, at GG-1.

36. *See* Michael C. Durst, *The Urgency—and Challenges—of International Reform,* 131 TAX NOTES 1277 (June 20, 2011). Durst frames the case as well as anyone in the following statement:

> I believe the primary societal danger posed by shifting income to tax havens is one of public perception, particularly as to confidence in the tax system and other public institutions. The media have covered the massive shifting of taxable income by U.S. multinationals to countries in which the companies might maintain nothing more than a mailbox. That situation obviously is artificial; it can be perceived by the public only as a result of manipulation of the law by politically empowered interests that seek to shift their shares of the federal and state tax burdens onto others. Whatever economic analysis one might use to justify the diversion of income to corporate pocketbooks located in tiny tax havens, the dominant image remains that of companies avoiding their income tax obligations through means unavailable to the ordinary citizen.
>
> That image is especially harmful in the aftermath of the financial collapse of 2008, which seems largely to have been caused by socially damaging business transactions conducted on a large scale in plain view of regulators, with no effective interference from government authorities. Corporate use of tax havens seems to confirm that the kind of failure of legislative and regulatory oversight represented by the mortgage-backed securities scandal is still with us. The appearance of a congruence of interest between financially motivated parties on the one hand and legislators and government regulators on the other to protect business practices that seem plainly cynical and contrary to the public interest is reason enough to eliminate opportunities to shift income to tax havens.

has resulted in substantial income being migrated from high-tax jurisdictions into tax haven subsidiaries that may have little or no substance.[37] The European Commission has commenced an attack on these structures under the theory that the concessionary tax benefits obtained by the low-tax affiliate may represent illegal state aid.[38] SAB Miller has been pilloried in the press for allegedly using Royalty Stripping Transactions to strip earnings out

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37. OECD, MEASURING AND MONITORING BEPS: ACTION 11 FINAL REPORT, at 104–115 (2015), http://www.oecd.org/tax/measuring-and-monitoring-beps-action-11-2015-final-report-9789264241343-en.htm ; Kimberly A. Clausing, *The Effect of Profit Shifting on the Corporate Tax Base*, 150 TAX NOTES 427 (Jan. 25, 2016); Kimberly A. Clausing, *The Revenue Effects of Multinational Firm Income Shifting*, 2011 TAX NOTES TODAY 61-9 (Mar. 8, 2011); Martin A. Sullivan, *Transfer Pricing Costs U.S. at Least $28 Billion*, 2010 TAX NOTES TODAY 54-3 (Mar. 22, 2010); Harry Grubert, *Foreign Taxes and the Growing Share of Multinational Company Income Abroad: Profits, not Sales, are Being Globalized*, 65 NAT'L TAX J. 247 (June 2012).

38. *See* European Commission Press Release IP/16/42, State Aid: Commission Concludes Belgian "Excess Profit" Tax Scheme Illegal; Around €700 million to Be Recovered from 35 Multinational Companies (Jan. 11, 2016); European Commission Press Release IP/15/6221, State Aid: Commission Opens Formal Investigation into Luxembourg's Treatment of McDonald's (Dec. 3, 2015); European Commission Press Release IP/15/5880, Commission Decides Selective Tax Advantages for Fiat in Luxembourg and Starbucks in the Netherlands Are Illegal Under EU State Aid Rules (Oct. 21, 2015). All European Commission press releases are accessible through the search template at http://europa.eu/rapid/search.htm (last visited Dec. 18, 2016). The U.S. government has expressed concern that these state aid cases are unfairly targeting U.S. multinational enterprises and unfairly utilize retroactive tax assessments. *See* Jacob J. Lew, *Lew Writes European Commission on State Aid Investigations*, 2016 WORLDWIDE TAX DAILY 29-23 (Feb. 11, 2016); *see also OECD Base Erosion and Profit Shifting Project: Hearing Before the H. Ways & Means Subcomm. on Tax Policy*, 114th Cong. (Dec. 1, 2015) (statement of Robert B. Stack, Deputy Assistant Secretary, U.S. Dep't. of the Treasury). However, the European Commission has rebuffed these U.S. criticisms. *See* Margrethe Vestager, *EU Official Writes U.S. Treasury Secretary on State Aid Investigations*, 2016 WORLDWIDE TAX DAILY 40-21 (Feb. 11, 2016) (asserting that the state aid investigations are complementary to the initiative to curtail base erosion and profit shifting and aim at a "proper, non-discriminative, application of tax laws in Europe."). The Netherlands and Luxembourg have recently appealed the European Commission's determination that their tax regimes represented a form of illegal state aid to the Court of Justice of the European Union. *See* Case T-755/15 Luxembourg v. European Comm'n (Dec. 30, 2015), 2016 WORLDWIDE TAX DAILY 31-22 (Court of Justice of the European Union reference for a state aid case); Case T-760/15, Netherlands v. European Comm'n (Dec. 23, 2015), 2016 WORLDWIDE TAX DAILY 31-23 (same).

of developing nations in Africa.[39] After a multi-year study, the Organisation for Economic Co-operation and Development (OECD) has issued a series of reports on how it believes countries should respond to the base erosion and profit shifting phenomenon,[40] and scholars are only just beginning to digest the import of this project.[41] Even though scholars differ on how to address the base erosion phenomenon, at least one conclusion seems unavoidable: a U.S. international tax regime (whether a territorial tax regime or a worldwide tax regime) that allows its own source country profits to become Homeless Income, thus escaping taxation anywhere, represents a tax regime that will be subjected to repeated calls for reform.[42]

B. Inversion Phenomenon Points to the Same Base Erosion Problem

Corporate inversions represent an indictment of the U.S. tax system. Corporate inversions are often categorized as a discreet stand-alone problem, but in the author's view the corporate inversion phenomenon provides unmistakable evidence of the enormity of the inbound Homeless Income problem. The effort to engage in an inversion transaction constitutes a statement by U.S. multinational enterprises that it is more tax efficient to be a foreign-based multinational enterprise than it is to be a U.S. multinational enterprise[43] exactly because foreign-based companies have a substantial inbound earning stripping advantage in the United States. A foreign-based corporation can engage in an inbound Interest Stripping Transaction, an inbound Royalty Stripping Transaction, and an inbound Lease Stripping Transaction without concern over the U.S. subpart F backstop regime, whereas these very same transactions would create subpart F income if conducted by a U.S. multinational enterprise. Thus, a foreign-based multinational enterprise has powerful earnings stripping options to base erode their U.S. operations that are unavailable to the U.S. multinational enterprise.

Corporate inversions represent an effort by U.S. multinational enterprises to place their business activities into a corporate structure that affords them the full scope of the inbound Homeless Income strategies

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39. *See* ACTIONAID, WHY SABMILLER SHOULD STOP DODGING TAXES IN AFRICA, (2012), https://www.actionaid.org.uk/sites/default/files/doc_lib/calling_time_on_tax_avoidance.pdf.

40. *See* OECD REPORT, BASE EROSION AND PROFIT SHIFTING 1–15 (Oct. 5, 2015), http://www.oecd.org/ctp/beps-about.htm#deliverables.

41. *See* Jeffrey M. Kadet, *BEPS: A Primer on Where It Came from and Where It's Going,* 150 TAX NOTES 793 (Feb. 15, 2016).

42. *See, e.g.*, J. Richard Harvey, Jr., *U.S. MNC's Offshore Operations: An Unbiased View,* 134 TAX NOTES 121 (Jan. 2, 2012).

43. *See* TAX POLICY OFFICE, INVERSIONS, *supra* note 18.

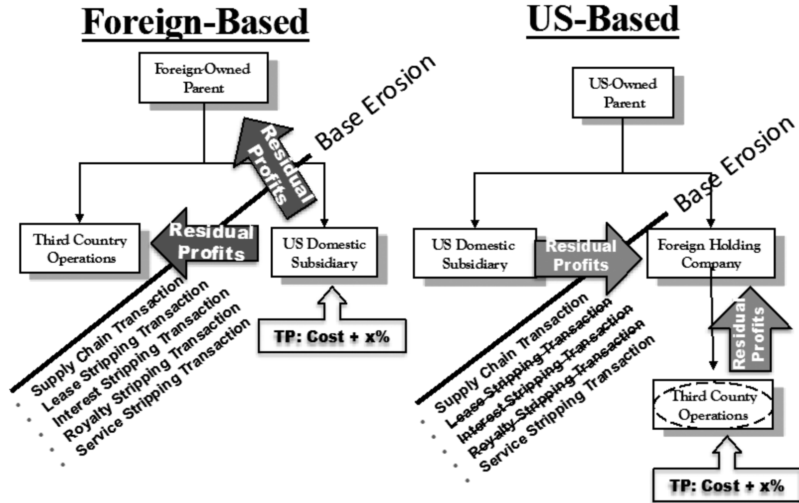
available to all foreign-based multinational enterprises without being impeded by the backstop provisions of the U.S. subpart F rules. Seen from this perspective, the inversion phenomenon sends a clear message: if the United States does not address the systemic inbound base erosions advantages afforded to all foreign-based multinational enterprises, then the inbound earning stripping tax advantages that are available only to a foreign-based multinational enterprise compel corporate officers of U.S. multinational enterprises to find a means to reposition their U.S. multinational enterprise into a foreign-based multinational corporate structure.[44] Said differently, legislation that attacks a specific type of corporate inversion transaction but does not address the fundamental inbound earning stripping advantages are doomed for failure as such reforms do not change the underlying compelling financial incentives that fuel these inversion transactions.[45]

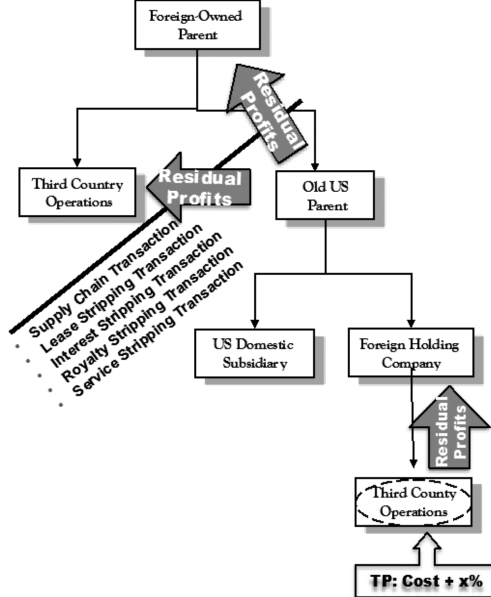
Thus, if one were to view the defense of the inbound U.S. tax base from a holistic multinational enterprise framework, then one may view the planning landscape in the manner depicted in the below Illustration #1.

44. *See* Wells, *Inconvenient Truth, supra* note 18.

45. *See* Wells, *Whack-a-Mole Tax Policy, supra* note 18.

Illustration #1





As indicated in the above Illustration #1, the foreign-based multinational enterprise generally has each of the Homeless Income strategies at its disposal in the U.S. inbound context (i.e., all five of the Homeless Income strategies are available for U.S. inbound base erosion as indicated in the above diagram).[46] In contrast, the U.S. multinational enterprise in Illustration #1 has fewer inbound earning stripping options at its disposal to strip profits from its U.S. operating subsidiaries as compared to the foreign-owned multinational enterprise (only two of the five bulleted Homeless Income strategies are available in the U.S. inbound base erosion context as indicated in the above diagram). Again, the practical elimination of three inbound earning stripping strategies occurs by reason of the application of the U.S. subpart F rules that serve as a backstop against related-party U.S. source payments made as part of an inbound base erosion strategy. As a self-help solution to this reality, as indicated in Illustration #1, the corporate inversion transaction places the inverted company into a base erosion posture that is comparable to that of the foreign-based multinational enterprise and thus unlocks all of the inbound Homeless Income strategies post-inversion.[47] In fact, the immediate opportunity to use inversion debt

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46. I.R.C. § 163(j) is a limited restriction on the Interest Stripping Transaction. There have been calls to tighten the earning stripping rules further, but as yet Congress has not chosen to do so. In any event, any effort to restrict the Interest Stripping Transaction without addressing the base erosion strategies on a holistic basis, in the end, will not solve the problem. For a discussion of various recent attempts to strengthen section 163(j), see Martin A. Sullivan, *Economic Analysis: The Many Ways to Limit Earnings Stripping,* 144 TAX NOTES 377 (July 28, 2014). The Treasury launched a separate attack on interest stripping transactions through proposed regulations issued under I.R.C. § 385 that recharacterize certain debt as equity if that debt were created in an internal reorganization, internal recapitalization, or in an acquisition of a U.S. target corporation. Prop. Reg. § 1.385–3, 81 Fed. Reg. 20,931 (Apr. 8, 2016). However, because these legislative and regulatory restrictions only selectively address inbound Interest Stripping Transactions, these responses represent a piecemeal response where a broader response is needed.

47. *See* Wells, *What Corporate Inversions Teach, supra* note 18. The right of taxpayers to seek to reduce their tax obligations in accordance with existing law is well recognized. *See* Gregory v. Helvering, 293 U.S. 465, 469 (1935); *see also* Comm'r v. Newman, 159 F.2d 848, 850–51 (2d Cir. 1947) (L. Hand, J., dissenting) ("Over and over again courts have said that there is nothing sinister in so arranging one's affairs as to keep taxes as low as possible. Everybody does so, rich or poor; and all do right, for nobody owes any public duty to pay more than the law demands: taxes are enforced extractions, not voluntary contributions. To demand more in the name of morals is mere cant."); MYRON S. SCHOLES ET AL., TAXES AND BUSINESS STRATEGY: A PLANNING APPROACH 10–14 (3d ed. 2005) (authors discuss the microeconomic effect of tax laws on firm behavior).

(thus accessing an inbound Interest Stripping Transaction) attendant with the inversion transaction has received considerable attention,[48] but the opportunity to migrate U.S. intangibles to a low tax affiliate in order to facilitate an inbound Royalty Stripping Transaction represents, over time,[49]

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48. The inbound Interest Stripping Transaction utilized by inverted companies is essentially the same as that employed by non-inverted, foreign-based multinational enterprises. *Compare* Amy S. Elliott, *Tyco's Potential $9.5 Billion Disallowance Settled for Much Less,* 150 TAX NOTES 406 (Jan. 25, 2016) (setting forth settlement of tax deficiency for Tyco's inversion push-down debt strategy), *with* Wells, *What Corporate Inversions Teach*, *supra* note 18 (describing the debt pushdown strategy of GlaxoSmithKline that was settled favorably for that foreign-based multinational enterprise). The Tyco tax planning (an inverted company) and the GlaxoSmithKline tax planning (a traditional foreign-based multinational enterprise) are set forth in cases that were docketed in the Tax Court, and so their underlying facts are transparently available and demonstrate in an unmistakable manner that the Interest Stripping Transaction employed by Tyco (an inverted company) was the same in all essential features to the inbound Interest Stripping Transactions employed by GlaxoSmithKline (a traditional foreign-based multinational enterprise).

49. The government appears now to agree that the inversion benefits extend beyond simply the inbound Interest Stripping Transaction. *See* Andrew Velarde, *Treasury Sees Tougher Inversion Problems than Interest Stripping*, 2016 TAX NOTES TODAY 30-3 (Feb. 16, 2016) (quoting Danielle Rolfes, Treasury International Tax Counsel, "I don't think that interest stripping is the whole story. Interest stripping is just the one I think I know how to solve."). The Internal Revenue Service (Service) has recently confirmed that foreign firms with significant intellectual property pay lower U.S. taxes than comparable U.S. multinational enterprises. *See* Michael Mandel et al., *Some Foreign Companies in U.S. Getting Tax Breaks, PPI Says*, 2015 TAX NOTES TODAY 96-30 (May 19, 2015). Pfizer announced that its proposed inversion would allow it to achieve a significant reduction of its effective tax rate from a worldwide tax rate of 25% to 17%, which has created considerable discussion in the tax press. *See* Andrew Velarde, *Pfizer Gives U.S. an Irish Goodbye with Allergan Inversion Deal*, 2015 WORLDWIDE TAX DAILY 227-1 (Nov. 23, 2015). Even though the inversion leverage is likely a substantial explanation for this immediate tax savings, Pfizer's inverted structure would have allowed it to engage in ongoing IP migration strategies under current law that will allow it to relocate substantial value outside of its U.S. affiliate group. For a discussion of how the existing cost sharing regulations and the Service's interpretation of section 367(d) has exacerbated the intangible migration phenomenon and what the Treasury should do to counteract this tax planning, see Wells, *Revisiting §367(d)*, *supra* note 20. However, Pfizer eventually called off its inversion after regulations were issued under section 7874 and simultaneously proposed regulations were issued under section 385 that would have adversely impacted its specific inversion transaction with Allergan. *See* Andrew Velarde, *Treasury Finally KOs Pfizer Inversion*, 2016 TAX NOTES TODAY 67-1 (Apr 7, 2016); *see also* Press Release, Pfizer Announces Termination of Proposed Combination

another powerful inbound earning stripping opportunity post-inversion. Organizations that represent the interests of foreign-based multinational enterprises have publicly admitted that foreign-based multinational enterprises would be significantly impacted if further base protection measures were applied to them,[50] and such statements represent an admission that foreign-based multinational enterprises both utilize these base erosion strategies and significantly benefit from their usage. Congress must address the inbound U.S. tax base erosion advantages afforded to foreign-based multinational enterprises or else we should expect U.S. multinational

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with Allergan (Apr. 6, 2016), http://www.pfizer.com/news/press-release/press-release-detail/pfizer_announces_termination_of_proposed_combination_with_allergan (announcing termination of merger with Allergan "due to actions announced by the U.S. Department of Treasury on April 4, 2016, which the companies concluded qualified as an 'Adverse Tax Law Change' under the merger agreement").

50. In 2002, Congress considered broader reform of the entire earnings stripping rules of section 163(j). In that process the National Association of Manufacturers lobbied on behalf of foreign-owned multinationals and told Congress, ''The types of changes [to section 163(j)] that Treasury is proposing would have *broad impact on prominent foreign-based multinationals*.'' Michael A. Baroody, *NAM Writes to Ways and Means Chair on Proposed Earnings Stripping Changes*, 2002 TAX NOTES TODAY 137-16 (July 17, 2002) (emphasis added). This statement confirms that the foreign-owned companies are significantly affected by the contours of section 163(j), and thus corroborates the assertions that the inverted companies have been making. More recently, the Organization for International Investment, which is the largest lobbying group for foreign-based businesses in the United States, has stated: "[S]ome of the proposals to curb so-called 'inversions' [by dealing with earning stripping on a broad basis] would do significantly more harm than good by inflicting considerable collateral damage on companies that have deliberately chosen to insource investment and jobs to U.S. communities across the country." Press Release, Organization for International Investment, "Inversion Fixes" Must Not Threaten Foreign Investment (Sept. 8, 2014), http://www.ofii.org/news/%E2%80%98inversion-fixes%E2%80%99-must-not-threaten-foreign-investment.

The transparency with which these foreign-based firms assert that any reduction in base erosion strategies would cause a significant impact to their base erosion planning should be taken seriously. The Treasury recently issued new proposed regulations under section 385 that recharacterize certain related-party debt as equity when such debt is created through an internal reorganization, internal recapitalization, or an acquisition of a U.S. target corporation. Prop. Treas. Reg. § 1.385–3, 81 Fed. Reg. 20,931 (Apr. 8, 2016). Although these proposed regulations attack the highest profile techniques of Interest Stripping Transactions, they do not address all inbound Interest Stripping Transactions, but rather seek to make this classification at the time the debt is created or transferred. Consequently, taxpayers are likely to seek planning techniques that allow their related-party debt to avoid the reach of the recharacterization provisions of these proposed regulations in order to preserve the financial benefits of the base erosion and earning stripping outcomes sought by an Interest Stripping Transaction.

enterprises to continue to engage in inversion transactions as doing so provides them with the same set of tax minimization tools at their disposal as their foreign-based multinational competitors.

C. Lock-Out Effect

Referring back to the diagram set forth in Illustration #1, the outbound foreign-to-foreign base erosion planning opportunities available to U.S. multinationals provides them with the opportunity to shift profits from high-tax foreign jurisdictions to a low-tax foreign intermediate holding company as the existing U.S. subpart F rules do not substantially impede the Homeless Income strategies in the outbound foreign-to-foreign base erosion context.[51] However, because the earnings and profits located in this intermediate foreign holding company are low-taxed, the U.S. multinational enterprises may elect to defer repatriating this low-taxed unrepatriated foreign earnings and profits in order to defer the residual U.S. taxation that would otherwise be due on the repatriation of these offshore foreign earnings. This phenomenon has been termed the "lock-out effect,"[52] and the proposed policy responses to counteract this "lock-out effect" have ranged from instituting a one-time tax on all unrepatriated earnings,[53] to ending deferral,[54] and to providing a permanent repatriation holiday.[55] As this debate

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51. *See* Edward D. Kleinbard, "*Competitiveness" Has Nothing To Do With It,* 144 TAX NOTES 1055 (Sept. 1, 2014); Edward D. Kleinbard, *Through a Latte Darkly: Starbucks's Stateless Income Planning*, 139 TAX NOTES 1515 (June 24, 2013) (demonstrates the foreign-to-foreign base erosion opportunities that are unreached by the current scope of the U.S. subpart F rules by looking at Starbucks as a case study); Edward D. Kleinbard, *The Lessons of Stateless Income*, 65 TAX L. REV. 99 (2011); Wells, *Territorial Tax Reform*, *supra* note 2.

52. *See* Mihir A. Desai, C. Fritz Foley & James R. Hines, Jr., *Repatriation Taxes and Dividend Distortions*, 54 NAT'L TAX J. 829 (Dec. 2001); Harry Grubert & Rosanne Altshuler, *Fixing the System: An Analysis of Alternative Proposals for the Reform of International Tax*, 66 NAT'L TAX J. 671 (Sept. 2013).

53. *See* STAFF OF THE JOINT COMM. ON TAX'N, 114TH CONG., JCX-96-15, PRESENT LAW AND SELECTED PROPOSALS RELATED TO REPATRIATION OF FOREIGN EARNINGS (2015).

54. *See* Infrastructure 2.0 Act, H.R. 625, 114th Cong. (2015). For the leading proponents for ending deferral, see, for example, Clifton J. Fleming, Jr., Robert J. Peroni & Stephen E. Shay, *Fairness in International Taxation: The Ability-to-Pay Case for Taxing Worldwide Income*, 5 FLA. TAX REV. 299 (2001); Robert J. Peroni, Clifton J. Fleming, Jr., & Stephen E. Shay, *Getting Serious About Curtailing Deferral of U.S. Tax on Foreign Source Income*, 52 SMU L. REV. 455 (1999).

55. *See, e.g.*, Invest in Transportation Act, S. 981, 114th Cong. (2015); The Foreign Earnings Reinvestment Act, S.397, 114th Cong. (2015); Bring Jobs Back to America Act of 2015, H.R. 3038, 114th Cong. (2015); Prioritizing

continues about what policy response should be adopted, the amount of the foreign unrepatriated earnings that are "locked out" continues to grow.[56]

II. INTERNATIONAL IMPLICATIONS FROM A DIVIDEND PAID DEDUCTION REGIME

The Senate Staff Report makes the statement that the dividend paid deduction regime, if coupled with a shareholder withholding tax on dividends, will yield equivalent results to an imputation credit regime as long as the shareholder withholding tax rate is equivalent to the corporate tax rate.[57] The Senate Staff Report posits an example[58] that contains the following five assumptions: (1) the corporate tax rate is 30%,[59] (2) the shareholder withholding tax rate is 30%, (3) a cash dividend distribution of $25 is made, (4) the shareholder's tax rate is 40%, and (5) the corporation's taxable income is $100. Under these assumptions, Table 5.13 of the Senate Staff Report (reproduced below) demonstrates that the tax results under a shareholder credit imputation regime are equivalent to those that arise under a dividend paid deduction regime:

Reinvestment in Infrastructure and Military While Eliminating Debt Act of 2015, H.R. 2225, 114th Cong. (2015).

56. *See* Stephen Shay, *The Truthiness of "Lockout": A Review of What We Know,* 146 TAX NOTES 1393 (Mar. 16, 2015) (positing that $2 trillion or more of unrepatriated earnings existed as of 2013). In response to a request from the Chairman Kevin Brady and ranking member Richard Neal, Thomas Barthold of the Joint Committee on Taxation estimated that the unrepatriated foreign earnings was between $2.4 trillion to $2.6 trillion through the end of 2015. See Letter from Thomas Barthold, Joint Committee on Taxation, to Chairman Kevin Brady (Aug. 31, 2016), 2016 WORLDWIDE TAX DAILY 190-27.

57. *See* S. STAFF REP., *supra* note 3, at 163–171; *see also* AM. LAW INST., *supra* note 4, at 54–55.

58. The example in the Senate Staff Report is taken from an example provided originally by the American Law Institute more than twenty years earlier. *See* AM. LAW INST., *supra* note 4, at 54–55.

59. This article assumes throughout that the business tax reform will reduce the corporate tax to 30% as assumed in the Senate Staff Report and that the withholding tax on the grossed-up dividend would be 30% of the gross dividend amount. The fundamental point is that the withholding rate on the shareholder dividend distribution is assumed to be the same as the underlying corporate tax rate for purposes of this Article.

Table 5.13[60]
Equivalence of Dividend Paid Deduction with Withholding Tax and Imputation Credit

	Dividend Paid Deduction ($)	Imputation Credit ($)
Corporation's Taxable Income	100	100
Cash Distribution (net)	25	25
Corporate Tax (30%)		
On Taxable Income	19	30
Withholding on Distribution	11	0
Total:	30	30
Retained Corporate Earnings	45	45
Taxable Dividend to Shareholder	36	36
Gross Shareholder Tax (40%)	14	14
Shareholder Credit (or Withholding)	11	11
Net Shareholder Tax Due	3	3
Net Shareholder Cash	22	22

The dividend paid deduction proposal set forth in the Senate Staff Report has been considered off-and-on for decades.[61] In 1982, the American Law Institute provided a report that considered several means of achieving corporate integration including the use of a dividend paid deduction proposal.[62] In 1984, the Treasury advocated a partial corporate integration regime by proposing a dividend paid deduction regime that provided a deduction equal to 50% of the amount of paid dividends.[63] That proposal was modified to provide a reduced partial deduction equal to 10% of the dividend paid amount,[64] but in the end this legislative proposal was never enacted. The House of Representatives considered legislation modeled on this limited dividend paid deduction proposal and added to that proposal the concept that

60. S. STAFF REP., *supra* note 3, at 204 tbl.5.13.

61. This Article attempts to build on those earlier works and not repeat the analysis of those earlier works. Thus for a detailed analysis of issues that are beyond the scope of those addressed in this Article, the reader is urged to review the materials cited in this Part II.

62. AM. LAW INST., SUB. C, *supra* note 15.

63. *See* TREAS., TAX REFORM FOR FAIRNESS, *supra* note 15.

64. U.S. PRES., TAX PROPOSAL FOR FAIRNESS, *supra* note 15.

there should be a withholding tax if the partially deductible dividend were paid to a foreign shareholder.[65] In 1989, the American Law Institute updated its earlier study and proposed a dividend paid deduction regime.[66] In 1993, the American Law Institute published another corporate integration report that would convert the corporate tax obligation into a withholding tax that would be creditable by the shareholders. The American Law Institute held open the question of how this withholding tax would apply to foreign shareholders and tax-exempt shareholders. Several more recent articles have been written in support of a dividend paid deduction regime.[67] Thus, significant scholarship and thought has gone into the design of a corporate integration regime. But, with this said, it is important to consider this dividend paid deduction regime through the prism of today's systemic international tax problems that face the country. To that end, the remainder of this Part II sets forth how a dividend paid deduction regime can be designed to solve the systemic international tax policy challenges of today.

A. Need to Expand Base Protection Measures: Base Protecting Surtax

Under the dividend paid deduction proposal advanced by the Senate Staff Report, the U.S. corporation would collect a dividend withholding tax as a necessary precondition for distributing tax deductible dividend distributions to its shareholders.[68] But a foreign-based multinational corporation could achieve a tax deductible payment without an equivalent withholding tax under each of the five inbound Homeless Income strategies set forth in Part I.A. above. Thus, utilizing a tax deductible dividend to remit earnings in lieu of stripping those earnings via an inbound Homeless Income strategy is more costly than utilizing a base erosion payment using one of the inbound Homeless Income strategies set forth in Part I.A. of this Article. This divergence in tax results is depicted in Table 5.13A below, which is a variation of the Table 5.13 that was set forth in the Senate Staff Report:

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65. *See* Tax Reform Act of 1986, H.R. 3838, 99th Cong., § 311 (1985); H.R. REP. NO. 99-426, at 239–240 (1985).

66. AM. LAW INST., SUB. C, *supra* note 15.

67. *See* Reuven S. Avi-Yonah & Amir C. Chenchinski, *The Case of Dividend Deduction* (Univ. of Mich. Pub. Law and Legal Theory Working Paper No. 220, 2010); McDonald, *supra* note 5, at 84.

68. S. STAFF REP., *supra* note 3, at 222–24.

Table 5.13A
Equivalence of Dividend Paid with Withholding Tax and Imputation Credit

	U.S. Multinational Dividend Paid Deduction ($)	Foreign Multinational Base Erosion Payment ($)
Corporation's Taxable Income	100	100
Cash Distribution	25	25
Corporate Tax (30%)		
On Taxable Income	19	23
Withholding on Distribution	11	0
Total:	30	23

As indicated in Table 5.13A, the ability of the foreign-based multinational enterprise to reduce its corporate income tax liability through a base erosion payment that is not subject to U.S. withholding allows the foreign-based multinational enterprise to achieve a 23% lower (1 - $23/$30) tax cost than what the U.S. multinational enterprise can achieve on the facts posited in Table 5.13. This is not a static relationship. If the U.S. multinational enterprise utilized a $70 dividend paid deduction and the foreign-based multinational reduced its U.S. tax obligations through a $70 base erosion payment premised on one or more of the inbound Homeless Income strategies discussed in Part I.A. above, then the results would be as set forth in Table 5.13B below:

Table 5.13B
Equivalence of Dividend Paid with Withholding Tax and Imputation Credit

	U.S. Multinational Dividend Paid Deduction ($)	Foreign Multinational Base Erosion Payment ($)
Corporation's Taxable Income	100	100
Cash Distribution	70	70
Corporate Tax (30%)		
On Taxable Income	0	9
Withholding on Distribution	30	0
Total:	30	9

Now, the foreign-based multinational, on these assumed facts, is able to achieve a 70% lower all-in tax rate (1 - $9/$30) on its U.S. business income in comparison to what the U.S. multinational enterprise is able to achieve under the dividend paid deduction regime. Tables 5.13A and 5.13B demonstrate that the dividend paid deduction regime, by itself, does not solve the financial advantage that exists for foreign-based multinational enterprises with respect to their conduct of inbound U.S. business activity.

In order to achieve parity, a tax comparable to the shareholder withholding tax imposed under the dividend paid deduction regime must be assessed on income shifted under each of the inbound Homeless Income strategies so that base erosion payments made under each of those five Homeless Income strategies do not pose an avenue to circumvent the 30% withholding tax on the grossed-up dividend. Until parity is achieved between (1) the alternative of distributing earnings as a tax deductible dividend subject to a shareholder withholding tax and (2) the alternative of stripping those earnings in the form of base erosion payments by utilizing an inbound Homeless Income strategy that avoids the shareholder's 30% withholding tax on the grossed-up dividend, then (3) the tax advantage that motivates inversion transactions will not be quashed. The dividend paid deduction regime, by itself, does not eliminate the underlying financial incentives, and so the analysis set forth in Part I.B. should cause one to be concerned that more is needed if the compelling inbound earning stripping benefits that fuel the inversion phenomenon are to be eliminated. To that end, in order to eliminate the financial incentives that fuel inversions, a further element must be added to the dividend paid deduction proposal so that the Homeless Income strategies cannot be used to create an inbound earning stripping advantage for foreign-based multinational enterprises.

In 2012, this author and a co-author proposed that the United States should apply a surtax on all base erosion payments made under an inbound Homeless Income strategy. If the United States were to adopt a base protecting surtax, parity of tax results can be achieved between the utilization of the five Homeless Income strategies detailed in Part I.A with the tax results that arise from a distribution of those earnings as a tax deductible dividend. Thus, the addition of a base protecting surtax that assesses a surtax on base erosion payments would ensure that inbound Homeless Income strategies do not create a competitive tax advantage for the foreign-based multinational enterprise. By achieving such a parity of treatment, the base protecting surtax would remove the earning stripping financial advantages that fuel inversion transactions as U.S. multinational enterprises would no longer have an inferior tax posture compared to foreign-based multinational enterprises that otherwise have the full range of inbound Homeless Income

strategies at their disposal. In that earlier work,[69] the base protecting surtax regime was proposed to have the following elements that are updated in this Article so that they serve as a backstop for the dividend paid deduction regime:

> *1. Base Protecting Surtax on Base Erosion Payments.* A related-party U.S. payer[70] of a base erosion payment would be subjected to a Base Protecting Surtax on the earnings that are transferred to a foreign affiliate[71] in an amount equal to the amount that would have been collected had those earnings been distributed as a deductible dividend under the dividend paid deduction regime.[72] The purpose of the Base Protecting Surtax is to collect, as a surtax, a tax calculated on the gross amount of the earning stripping payment so that an equivalent amount of tax is collected in comparison to the amount that would have been due if the base erosion payment instead had been remitted as a tax deductible dividend to the foreign affiliate. The rebuttable presumption is that

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69. Wells & Lowell, *Homeless Income*, *supra* note 16. The proposal set forth herein borrows from that earlier recommendation.

70. For this purpose, a U.S. payer is either (1) a U.S. affiliate of the foreign recipient entity or, potentially, or (2) an unrelated U.S. entity that regularly makes Base Erosion payments to a foreign entity.

71. A foreign entity would be any entity or group of entities that do not pay U.S. tax on a net income basis. In addition, the existing conduit regulations would should be utilized to determine whether an unrelated party was used simply as a conduit to route a base erosion payment to an ultimate beneficiary that is a related party. *See* I.R.C. § 7701(l); Reg. § 1.881–3.

72. The original proposal was simply to apply a gross 10% tax on the base erosion payment. But to achieve the same tax consequence for profits shifted through a base erosion payment with profits distributed under a dividend paid deduction regime, the required algebra to determine the amount of the base protecting surtax amount is as follows: (Base Erosion Payment * 30%) / (100%-30%). *See* Wells & Lowell, *Homeless Income*, *supra* note 16, at 569. Further, the commentary to the U.N. Model Treaty indicates that the OECD believed that ten percent was considered "a reasonable maximum" for interest, but broad agreement could not be reached within the member nations. *See* U.N. Model Double Taxation Convention Between Developed and Developing Countries, art. 11(2) and 12(2), U.N. Doc. ST/ESA/102 (1980). As a result, the rates for royalties, rents, and interest were left unspecified in the UN Model Treaty with the percentage to be established through bilateral negotiations. *Id.* However, the United Nations Ad Hoc Group of Experts on International Tax Cooperation in Tax Matters did provide guidance on how member nations should determine the appropriate gross withholding rate. *See* U.N. DEP'T OF INT'L ECON. & SOC. AFFAIRS, *supra* note 27, at 70–72, 77–79; Wells & Lowell, *Homeless Income, supra* note 16, at 567–69 (discussing history of the U.N. Ad Hoc Group).

the base erosion payment represents, in its entirety, a transfer of residual profits that should have been distributed as a tax deductible dividend subject to the shareholder withholding tax.

2. *Refund Process.* If the U.S. payer believes that the amount of the Base Protecting Surtax is in excess of the amount needed to protect the U.S. tax base because, in fact, a portion of the base erosion payment represents a reimbursement of actual third-party costs and does not represent, in its entirety, a transfer of the combined profits between affiliates, then the U.S. payer could request a redetermination by the Internal Revenue Service (Service) through a "Base Clearance Certificate" process.[73] However, the burden is on the U.S. payer to demonstrate that the Base Protecting Surtax was assessed on an amount that exceeded the amount of residual profits that were actually transferred by the U.S. affiliate to a foreign affiliate, and this burden would only be satisfied if the taxpayer demonstrated that the correct application of a profit split methodology confirmed the taxpayer's assertion.[74] Until the taxpayer meets this burden of proof, the surtax would not be refunded. So, the audit incentives for transparency in this posture are reversed as the government has collected the tax upfront and it falls to the taxpayer to develop the case for a refund, and so the taxpayer now has every incentive for transparency and expeditious handling of the audit proceeding.

The purpose of the Base Protecting Surtax, as reformulated in this Article, is to serve as a backstop to prevent circumvention of the shareholder withholding tax via utilization of the inbound Homeless Income strategies.

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73. Such a clearance process could be along the lines of the current Service Advance Pricing Agreement Program. *See* Rev. Proc. 2006–9, 2006–1 C.B. 278. In the event that such a policy was implemented, it would be necessary for the Service to expand the APA Program in a manner to facilitate efficient resolution of the influx of requests that could be anticipated. The Service could also be given authority to provisionally reduce the upfront Base Protecting Surtax to a lower upfront amount for particular taxpayers if its application would be excessive in a specific case by allowing the Service to provide an interim Base Clearance Certificate on the condition that the inbound company provide its foreign books and records and participate in a review process that utilizes an appropriate Two-Sided TP Methodology (i.e., one that considers the overall combined profits of the MNC after the year-end).

74. The author's arguments for why a profit split methodology set forth in Reg. § 1.482–6 is the preferred method over all the transactional transfer pricing methods whenever residual profits exists has been exhaustively considered elsewhere. *See* Wells & Lowell, *Section 482*, *supra* note 24; Wells & Lowell, *Homeless Income*, *supra* note 16.

By imposing a base protecting surtax on all five of the enumerated inbound Homeless Income strategies, the base protecting surtax collects an upfront tax in an amount equal to the amount that would have been collected had those earnings instead been distributed as a dividend subject to the 30% withholding tax on the grossed-up dividend. A Base Protecting Surtax is essential in a dividend paid deduction regime because without it the foreign-based multinational enterprise has inbound Homeless Income strategies at its disposal that affords it the opportunity to strip profits from its U.S. subsidiary in a manner that circumvents the shareholder 30% withholding tax on the grossed-up dividend while the U.S. multinational enterprise does not.

The proposed Base Protecting Surtax is a surtax on the payer and is not a withholding tax on the payee. The Base Protecting Surtax seeks to collect the tax that is due on the payer's share (not the payee's share) of the residual profits that are earned by the multinational enterprises from the United States. The surtax makes the following two assumptions about inbound Homeless Income strategies: (1) base erosion payments represent, in their entirety, a transfer of residual profits to the offshore recipient, and (2) the onshore payer should have reported and paid source country taxes on those residual profits that arose from the U.S. affiliate's activities within the United States. The transfer pricing penalty and documentation provisions do a fine job of ensuring that routine profits are reported by the onshore U.S. subsidiary, but these provisions have not been successful at ensuring the self-reporting of residual profits by the U.S. affiliate.

If the U.S. multinational enterprise discloses its overall books and proves that the combined profits of the multinational enterprise are less than the full gross amount of the base erosion payment, then a refund of the surtax (in whole or in part) could be made, but in this refund determination the taxpayer would be required to utilize a profit split methodology, not one of the transactional transfer pricing methodologies. The proposed Base Protecting Surtax relies on a profit split methodology (which is one of the accepted transfer pricing methods) and the surtax is refundable if it overtaxes the combined income. Moreover, the technical taxpayer for the surtax is the U.S. affiliate payer. Thus, because the surtax can be reconciled with the arm's length standard and because the surtax is not a withholding tax on the recipient, the proposal is consistent with existing treaty obligations.[75]

Although the author believes that the base protecting surtax proposal is the best means for backstopping the shareholder dividend withholding tax

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75. Withholding tax regimes represent an attempt by the source country to collect a tax on the foreign recipient's profits earned in the source country. The proposed Base Protecting Surtax attempts to assess tax on only the profits that are economically attributable to U.S. affiliate under section 482 and to collect the expected amount of that tax upfront.

imposed under the dividend paid deduction regime, the reality is that other solutions are possible, including the following:

> 1. *Comprehensive Expense Disallowance Approach.* Other scholars have argued for disallowing a deduction to the extent that an inbound Homeless Income strategy creates a tax deduction larger than the offshore third-party expenses incurred by the offshore affiliate that receives the earning stripping payment.[76] This proposal could be made to fit within a dividend paid deduction regime if one were to assume that any excess base erosion payment is in fact a dividend distribution subject to the 30% grossed-up dividend withholding tax. But this proposal does not collect an upfront assessment, so it would be left to the Service to prove the dividend equivalent amount through a Service audit process.
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> 2. *Disallow Deduction for Base Erosion Payments to Tax Havens.* Another approach would be for the United States to disallow deductions for base erosion payments made to tax haven affiliates.[77] For example, with respect to interest, this proposal would provide a more comprehensive approach to the limited earning stripping rules than exists under current law[78] and the limited reforms currently proposed by Congress.[79] However, this proposal

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76. *See* J. Clifton Fleming, Jr., Robert J. Peroni & Stephen E. Shay, *Getting Serious About Cross-Border Earnings Stripping: Establishing an Analytical Framework,* 93 N.C. L. REV. 673 (2015).

77. *See* Michael C. Durst, *Statutory Protection for Developing Countries*, 2013 TAX NOTES TODAY 18-27 (Jan. 28, 2013).

78. In this regard, section 163(j)(2)(B)(i)(II) already limits deductions for certain interest that exceeds a specified amount of adjusted taxable income. However, existing section 163(j) applies only to certain interest that is paid to or guaranteed by a related person. I.R.C. § 163(j)(3) (definition of disqualified interest). Recently, the Treasury issued proposed regulations under Section 385 that recharacterize certain debt created in an internal recapitalization, internal reorganization, or as part of an acquisition of a U.S. target corporation as equity for U.S. tax purposes, but again this solution only applies to related-party debt created in certain high-profile types of transactions and thus leaves the basic Interest Stripping Transaction available for debt created in ordinary business transactions and thus does not comprehensively address the inbound Interest Stripping Transaction. *See* Prop. Reg. § 1.385–3, 81 Fed. Reg. 20,931 (Apr. 8, 2016).

79. Tax Reform Act of 2014, H.R. 1, 113th Cong. § 4001 *et seq.* (2014) (provisions of Title IV: Participation Exemption System for the Taxation of Foreign Income); H. WAYS & MEANS COMM., 112TH CONG., TECHNICAL EXPLANATION OF THE WAYS AND MEANS DISCUSSION DRAFT PROVISIONS TO ESTABLISH A PARTICIPATION EXEMPTION SYSTEM FOR THE TAXATION OF FOREIGN

makes the source country's tax jurisdiction over its share of the residual profits conditional on the tax rate of one or more other countries. In this sense, it imperfectly protects the source-country's share of residual profits in all circumstances.

3. Other Refundable Base Erosion Withholding Tax Proposals. Other scholars have proposed implementing a withholding tax on all deductible payments of U.S. payers, including payments to treaty or OECD countries, which would be refundable when the recipient showed that tax has been paid on such income in the country of residence.[80] This proposal attempts to deal with the base erosion problem by collecting an upfront withholding tax on the base erosion payment, but this withholding is a final tax only if the country of residency does not tax this income at a sufficient level. Consequently, like the comprehensive expense disallowance proposal, this proposal makes the source country's tax jurisdiction over its share of residual profits conditional on the tax rate of another country, and this solution similarly leaves the transactional transfer pricing methodologies in place to be used wherever base erosion gaps in the withholding regime are found. Thus, this reform proposal only imperfectly protects the source country's right to tax an appropriate share of residual profits of the multinational enterprise.

4. Formulary Apportionment. Another reform proposal advanced by scholars is to disregard all intercompany transactions among affiliates and simply apply a formulary apportionment methodology.[81] In essence, a formulary approach would prescribe

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INCOME (Comm. Print 2011), http://waysandmeans.house.gov/UploadedFiles/FINAL_TE_--_Ways_and_Means_Participation_Exemption_Discussion_Draft.pdf.

80. *See* Reuven S. Avi-Yonah, *A Coordinated Withholding Tax on Deductible Payments*, 119 TAX NOTES 993, 995–96 (June 2, 2008).

81. *See Transfer Pricing Issues: Hearing Before the H. Comm. on Ways & Means*, 111th Cong. 8–10 (2010) (statement of Martin A. Sullivan, economist); Reuven S. Avi-Yonah & Ilan Benshalom, *Formulary Apportionment: Myths and Prospects*, 2 WORLD TAX J. 371 (2011); Reuven S. Avi-Yonah, Kimberly A. Clausing & Michael C. Durst, *Allocating Business Profits for Tax Purposes: A Proposal to Adopt a Formulary Profit Split*, 9 FLA. TAX REV. 497, 510–23 (2009); Ilan Benshalom, *Taxing the Financial Income of Multinational Enterprises by Employing a Hybrid Formulary and Arm's Length Allocation Method*, 28 VA. TAX REV. 619 (2009). *But see* JANE G. GRAVELLE, CONG. RESEARCH SERV., RL34115, REFORM OF U.S. INTERNATIONAL TAXATION: ALTERNATIVES 15 (2015), https://fas.org/sgp/crs/misc/RL34115.pdf (transfer pricing rules would "become more important" in a territorial system); Rosanne Altshuler & Harry Grubert, *Formulary Apportionment: Is It Better than the Current System and Are There Better Alternatives?*, 63 NAT'L TAX J. 1145, 1166–67 (2010); James R. Hines, Jr., *Income Misattribution Under Formula Apportionment*, 54 EUR. ECON. REV. 108, 117–18

factors to be used to allocate the combined income, such as the once prevailing three-factor formula used by many states: payroll, tangible assets, and sales. The use of a formulary apportionment methodology is akin to a profit split methodology except that it utilizes preset, static allocation factors without first engaging in a functional analysis to determine which functions created the residual business profits. Because formulary apportionment attempts to allocate residual profits in a systematic manner based on business factors, it has much to commend it in terms of addressing the inbound Homeless Income problem. However, formulary apportionment based on preset formulas has a number of drawbacks.[82] For example, the preset factors can be manipulated by reactive tax planning. As a result, states with formulary apportionment regimes have needed to adopt anti-avoidance rules[83] that allow adjustment to the preset

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(2010) (focusing on the proposed EU community consolidated tax proposal with such allocation among countries; allocation factors often used do not reflect how business income is generated); Susan C. Morse, *Revisiting Global Formulary Apportionment*, 29 VA. TAX REV. 593 (2010).

82. *See, e.g.,* Michael J. Graetz & Rachael Doud, *Technological Innovation, International Competition, and the Challenges of International Income Taxation*, 113 COLUM. L. REV. 347 (2013); George Mundstock, *The Borders of E.U. Tax Policy and U.S. Competitiveness*, 66 U. MIAMI L. REV. 737 (2012). The arbitrariness of preset formula apportionment regimes has been vigorously asserted. The effect of such defenses has not been to rehabilitate the wisdom of the arm's length standard so much as it has been to show that formula apportionment itself is no panacea. *See* Altshuler & Grubert, *supra* note 81; Hines, Jr., *supra* note 81; Morse, *supra* note 81, at 599; Charles E. McLure, Jr.., *State Corporate Income Tax: Lambs in Wolves' Clothing?* (U.S. Treasury Dep't Office of Tax Analysis, Working Paper No. 25, 1977), https://www.treasury.gov/resource-center/tax-policy/tax-analysis/Documents/WP-25.pdf. But, for a defense of section 482 and how to make it work to solve the Homeless Income problem, see Wells & Lowell, *Section 482*, *supra* note 24; Wells & Lowell, *Homeless Income*, *supra* note 16.

83. In the state tax context, throwback rules reassign (or ''throw back'') receipts from sales of tangible personal property from the destination state, when the taxpayer is not taxable there, to the state from which the goods were shipped, where the taxpayer is taxable. A "throw out rule" eliminates (or ''throws out'') from both the numerator and the denominator of the sales factor the receipts that would ordinarily be assigned to states in which the taxpayer is not taxable. A "throw around rule" distributes (or ''throws around'') receipts that would ordinarily be assigned to states in which the taxpayer is not taxable to all the states in which the taxpayer is taxable. The nuances of these distinctions are beyond the scope of this Article but are addressed by other scholars. *See, e.g.*, Eugene F. Corrigan, *Interstate Corporate Income Taxation—Recent Revolutions and a Modern Response*, 29 VAND. L. REV. 423, 430–431 (1976); William D. Dexter, *Taxation of Income from Intangibles of Multistate-Multinational Corporations*, 29 VAND. L. REV. 401, 406–

factors when a wooden application of the preset factors does not accurately reflect the underlying economic reality. Thus, even in a pure formulary apportionment paradigm, state revenue departments and taxpayers are having to grapple with the question of which "factor planning" is distortive and which "factor planning" is inherent in the business.[84] In other words, state experience demonstrates that even formulary apportionment regimes require a facts-and-circumstances approach to work appropriately.[85] Once one believes that a functional analysis is needed to determine which factors should be considered in order to perform an appropriate profit split allocation, then one is very close to supporting the more flexible profit split methodology utilized in the base protecting surtax proposal set forth in this Article.

Viewed in its totality, the existing scholarship sets forth a plethora of proposals for how to address the base erosion and earning stripping problem in the inbound context. Although the policy prescriptions diverge in their detail, the body of existing literature recognizes that further inbound reform is required in order to protect the U.S. tax base from base erosion and profit shifting strategies. A corporate integration regime will be similarly plagued by the inbound Homeless Income strategies because inbound foreign-based multinational enterprises will continue to have a financial incentive to circumvent the shareholder withholding tax imposed under the dividend paid deduction regime. Thus, to ensure horizontal equity among all participants

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07 (1976); Walter Hellerstein, *The Quest for Full "Accountability" of Corporate Income*, 61 ST. TAX NOTES 627 (Sept. 5, 2011) [hereinafter Hellerstein, *Quest for Accountability*]; William J. Pierce, *The Uniform Division of Income for State Tax Purposes*, 35 TAXES 747, 748 (1957). *See generally* Walter Hellerstein, *Construing the Uniform Division of Income for Tax Purposes Act: Reflections on the Illinois Supreme Court's Reading of the 'Throwback' Rule*, 45 U. CHI. L. REV. 768, 786–88 (1978). As has been pointed out by others, the European Commission's proposal is analogous to the "throw-around rule" posited in the state tax context. *See* Hellerstein, *Quest for Accountability*, *supra*, at 638.

84. *See, e.g.*, Statement of Decision, Microsoft Corp. v. Franchise Tax Board, No. CGC08-471260 (Calif. Super. Ct. 2011), *rev'd*, 212 Cal. App. 4th 78 (1st Dist. 2012).

85. The Multistate Tax Commission announced in 2012 that it was considering a state transfer pricing model based on section 482. *Multistate Tax Commission Considering Section 482 State Model Regulation Project*, 21 TAX MGM'T TRANSFER PRICING REP. (BNA) 473 (2012). A suggestion that the factors need to be adapted to the facts and circumstances in question is close to our position that a two-sided transfer pricing methodology can be adapted to satisfactorily address the Homeless Income problem has been exhaustively considered in an earlier work. *See* Wells & Lowell, *Section 482*, *supra* note 24.

that conduct business activity within the United States, a corporate integration proposal must holistically address the base erosion problem.[86] This author believes that a base protecting surtax on all related-party base erosion payments is the best means to address the inbound Homeless Income strategies, but the main point of this Part II.A is that Congress must craft a holistic solution to the base erosion problem or else the systemic inbound earning stripping advantages afforded to foreign-based multinational enterprises will continue to fuel the corporate inversion phenomenon.

B. Shareholder Withholding Tax Should Not Be Reduced by Treaty

The concessionary withholding tax rate specified in U.S. tax treaties for dividends must not reduce the shareholder withholding tax assessed as part of the dividend paid deduction regime or else the corporate integration regime would fail to collect any tax on the business profits generated by a business held by foreign owners. This is a critical issue because, under current law, treaty-based foreign persons[87] and tax-exempt shareholders[88] are either largely exempt or entirely exempt from U.S. taxation at the shareholder level. Under a corporate integration paradigm, it is appropriate to collect a withholding tax on these shareholders so that that the corporate profits allocable to these shareholders does not escape U.S. taxation entirely.[89] Thus, the adoption of a dividend paid deduction regime must

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86. This base erosion problem is not unique to the dividend paid deduction regime. If the United States were to adopt a territorial tax regime, it would face the same need to address the inbound Homeless Income strategies in that context as well. *See* Wells, *Territorial Tax Reform*, *supra* note 2.

87. *See* U.S. Model Income Tax Convention, art. 10(2)(a) (Nov. 15, 2006) (provides a 5% withholding rate in certain events); *see also* Convention for the Avoidance of Double Taxation and the Prevention of Fiscal Evasion with Respect to Taxes on Income and Capital Gains, U.K. -U.S., art. 10(3) (July 24, 2001) (same zero withholding in certain events); Convention for the Avoidance of Double Taxation and the Prevention of Fiscal Evasion with Respect to Taxes on Income, Netherlands-U.S., art. 10(3) (Dec. 31, 1993) (providing zero withholding in certain events).

88. *See* I.R.C. § 512(b)(4*); see also* Avi-Yonah & Chenchinski, *supra* note 67 (identifies the need for revising UBTI provisions if a corporate dividend paid deduction regime were imposed).

89. *See* Anthony P. Polito, *A Proposal for an Integrated Income Tax*, 12 HARV. J. L. & PUB. POL'Y 1009, 1032 n.106 (1989); McDonald, *supra* note 5, at 84. This need to not provide the benefits of corporate integration to foreign shareholders with the consequence of creating in effect non-taxation of business income has been long recognized by earlier integration studies. *See, e.g.*, TREAS., INTEGRATION, *supra* note 15.

trump any concessionary dividend withholding rates that exist under existing U.S. tax treaties.

The United States faced a similar problem when it enacted the Foreign Investment in Real Property Tax Act of 1980 (FIRPTA).[90] In enacting that legislation, the United States simply adopted a domestic tax regime that imposed a gross withholding tax and a U.S. net basis tax obligation that overrode the results afforded by the existing U.S. tax treaties at that time, and the Treasury thereafter worked to modify its treaties to conform them to the FIRPTA legislation.[91] Under the U.S. Constitution, domestic legislation and treaties have equal status under the nation's laws,[92] and so in resolving a conflict between a treaty and a domestic statute the courts have held that the latest to be enacted controls if there is a conflict between domestic law and a treaty.[93] So, in a sense, this problem of treaty override does not represent a substantive barrier to Congressional action.

However, before reaching that ultimate option, a good argument can be made that the shareholder withholding tax imposed as part of a dividend paid deduction regime can be assessed at the full withholding rate without violating any U.S. treaty obligations. In this regard, U.S. tax treaties typically provide that the treaty "applies to any identical or substantially similar taxes that are imposed after the date of signature of this Convention in addition to, or in place of, the existing taxes."[94] If the United States were to enact an entirely new dividend paid deduction regime that is not "identical or substantially similar" to any earlier U.S. tax regime, then the United States could argue that the dividend paid deduction regime represents a new and dissimilar tax and as such could notify its treaty partner that "significant changes . . . have been made in [the U.S.] taxation laws . . . that relate to the application of this convention."[95] As long as that threshold were met, the model U.S. tax treaty provides the United States with the right to not apply

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90. Omnibus Reconciliation Act of 1980, Pub. L. No. 96-499, § 1121 *et seq.*, 94 Stat. 2599, 2682 (1980).

91. *See id.* at § 1125(c), 94 Stat. at 2690 (sets forth in an uncodified provision that FIRPTA would override all U.S. tax treaties after a transition period). For a further discussion of other examples where Congress has elected to unilaterally override existing treaty obligations, see JOEL D. KUNTZ & ROBERT J. PERONI, U.S. INTERNATIONAL TAXATION ¶ C4.03 (2015).

92. *See* Whitney v. Robertson, 124 U.S. 190, 194 (1888) ("By the Constitution a treaty is placed on the same footing, and made of like obligation, with an act of legislation.").

93. *See* Chae Chan Peng v. United States, 130 U.S. 581, 600 (1889); *see also* Rev. Rul. 80–223, 1980–2 C.B. 217, 217–218 (enactment of sections 901(f) and section 907 overrode the results afforded under earlier ratified treaty provisions that were inconsistent).

94. *See* U.S. Model Income Tax Convention, art. 2(4) (Feb. 17, 2016).

95. *See id.*

any concessionary dividend withholding rates in its tax treaty to the withholding taxes arising under the new and substantially dissimilar dividend paid deduction regime. Thus, existing U.S. tax treaties provide a mechanism to not apply its treaty concessionary rates to new domestic tax regimes that are dissimilar to the tax regimes that existed at the time that the tax treaty was signed.

A recent example of a major U.S. trading partner taking this same position with respect to new legislation is provided by the United Kingdom. In this regard, the United Kingdom has taken the position that its new diverted profits regime is a new tax that is not "identical or substantially similar" to any earlier U.K. income tax, and accordingly the United Kingdom has taken the position that its new diverted profits tax regime can be applied in preference to any treaty provision without violating its treaty obligations.[96] Using this same logic, the United States could argue that a dividend paid deduction regime, along with its shareholder withholding tax, is not substantially similar to the classic corporate tax regime that the United States has historically utilized and as such this new tax regime represents a new and dissimilar tax that can be applied without regard to existing U.S. treaty obligations.

C. Lock-Out Effect and Interaction with U.S. Foreign Tax Credit Regime

Several economic studies indicate that the prior foreign dividends received deduction that was temporarily enacted under old section 965 allowed U.S. multinational enterprises to repatriate approximately $312 billion.[97] Furthermore, it appears that substantially all of these repatriated earnings were used for share buy-backs.[98] Thus, this prior repatriation holiday provides empirical evidence for the proposition that the offshore excess cash, if repatriated, would likely be distributed to shareholders. Thus, the practical effect of implementing a dividend paid deduction regime would be to eliminate the lock-out effect with respect to offshore earnings that will

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96. Mindy Herzfeld, *News Analysis: Is the United Kingdom a Rogue State or Bold Leader?*, 2015 WORLDWIDE TAX DAILY 12-2 (Jan. 20, 2015).

97. Melissa Redmiles, *The One-Time Received Dividend Deduction*, STAT. OF INCOME BULL., Spring 2008, at 102, http://www.irs.gov/pub/irs-soi/08codivdeductbul.pdf.

98. *See* DONALD J. MARPLES & JANE G. GRAVELLE, CONG. RESEARCH SERV., R40178, TAX CUTS ON REPATRIATION EARNINGS AS ECONOMIC STIMULUS: AN ECONOMIC ANALYSIS 3, 8–10 (2011) (noting that the inverted company "can engage in 'earnings stripping'); Jennifer Blouin & Linda Krull, *Bringing It Home: A Study of the Incentives Surrounding the Repatriation of Foreign Earnings Under the American Jobs Creation Act of 2004*, 47 J. ACCT. RES. 1027 (2009).

be distributed to shareholders as the U.S. repatriation tax cost would be offset by a dividend paid deduction in this scenario.

1. Expense Allocation Implications of the Dividend Paid Deduction Regime

However, the lingering question is how the dividend paid deduction regime and the existing U.S. foreign tax credit regime should interact. Assuming the United States does not adopt a territorial tax regime, it has been generally recognized that the foreign tax credit regime should be retained even within the construct of a corporate integration regime.[99] At the same time, it has been commonly argued that the benefits of the foreign tax credit regime should not extend to the shareholders.[100] In addition, if the foreign tax credit benefits were not passed through to the shareholder level under a corporate integration proposal, the result would be to create a higher overall tax cost for foreign income subjected to foreign tax than would occur from domestic income because the domestic corporate tax cost can be completely eliminated under the dividend paid deduction regime whereas the foreign tax levy would not be refunded. A recent article has touted this result as a benefit for U.S. investment activity.[101] Finally, others have argued that retaining shareholder taxation of foreign source income does not impact competitiveness concerns and that providing a reduction of shareholder level taxation for the corporate level foreign taxes would create a significant revenue loss to the U.S. government.[102]

This Article accepts these shareholder level consequences and does not seek to reconsider those policy judgments. However, the original foreign tax credit question still remains, namely what corporate level modifications must be made to the existing foreign tax credit limitation regime so that the addition of a dividend paid deduction at the corporate level does not create a double tax benefit? Stated differently, if a U.S. multinational enterprise earns both U.S. source income and foreign source income, benefits from foreign tax credit relief, and then distributes only a portion of its earnings to its

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99. *See* McDonald, *supra* note 5, at 80. For a recent effort to argue that the United States should only provide a deduction for foreign taxes and not a credit under existing law, see Kimberly Clausing & Daniel N. Shaviro, *A Burden-Neutral Shift from Foreign Tax Creditability to Deductibility?* 64 TAX L. REV. 431 (2011); Daniel N. Shaviro, *The Case Against Foreign Tax Credits*, 3 J. LEGAL ANALYSIS 65 (2011).

100. *See, e.g.*, TREAS., INTEGRATION, *supra* note 15.

101. *See* Martin A. Sullivan, *Economic Analysis: Corporate Integration Would Tilt Investment to the U.S.,* 150 TAX NOTES 739 (Feb. 15, 2016).

102. *See* S. STAFF REP., *supra* note 3, at 192–93.

shareholder as a dividend, how should the foreign tax credit limitation calculation be modified at the corporate level?

This Article takes the position that the dividend paid deduction regime should not work to allow the same foreign earnings to create a dividend paid deduction and also provide for foreign tax credit limitation benefits as this duplicative result creates a double tax benefit. The economic equivalent of a double tax benefit occurs if the corporation's taxable income is sheltered from U.S. corporate level tax by reason of its U.S. foreign tax credit relief and if those very same foreign earnings then provide the corporation with a dividend paid deduction in the United States. The Senate Staff Report recognizes that "difficult issues" arise under a dividend paid deduction regime with respect to "the treatment of foreign source income that has been shielded from U.S. tax by foreign tax credits."[103] To illustrate the problem, the following Example One uses the same numbers set forth in Table 5.13 of the Senate Staff Report but now modifies those facts to highlight the potential foreign tax credit double benefit scenario:

> *Example One*. C Corp. earns $40 of net foreign source income (after all expenses other than the dividend paid deduction are allocated and apportioned), bears $12 of foreign tax on that income, and is entitled to claim $12 of U.S. foreign tax credit relief. C Corp. earns an additional $60 of net U.S. source income (after all expenses other than the dividend paid deduction are allocated and apportioned). Thus, from all sources, C Corp. has taxable income of $100 before considering the dividend paid deduction. C Corp. is subject to a 30% corporate tax rate, and shareholders are subject to a 30% withholding tax on the grossed-up dividend paid to them. C Corp. remits a $25 cash dividend to its shareholder that on a grossed-up basis represents a $35.71 taxable dividend to its shareholders.
>
> *Result*. C Corp. arguably is entitled to claim a dividend paid deduction of $35.71, thus reducing its taxable income from $100 to $64.29. The corporate tax liability would therefore equate to $19.29 (30% of $64.29), which is reduced by the $12 of foreign tax to leave a remaining $7.29 of corporate tax. Thus, even though the residual U.S. tax on the $40 of foreign source income was fully offset by U.S. foreign tax credit relief, a proportionate amount of these foreign earnings and profits are available to support a dividend paid deduction. The net effect is that a double tax benefit has been created as indicated in the chart below.

103. *See id.* at 226–27.

Example 1 Chart
Illustration of Double Benefit

	Net Foreign Source Income	Net U.S. Source Income	Total
Corporation's Taxable Income	40.00	60.00	100.00
Dividend Amount (DPD)	-14.29	-21.43	-35.71
Cash Paid to Shareholder	-10.00	-15.00	-25.00
Shareholder Withholding Tax (30%)	-4.29	-6.43	-10.71
Corporate Taxable Income	25.71	38.57	64.29
Tentative U.S. Tax Before Credits (30%)	7.71	11.57	19.29
FTC Limitation (no DPD allocation)	12.00		
Foreign Taxes	12.00		
Eligible FTC Relief	12.00		-12.00
Corporate Tax Liability			7.29

The Senate Staff Report recognizes that this double tax benefit should not be obtained and proposes the following solution:

> Under the dividends paid deduction, an account would need to be maintained by the corporation to limit the amount of deductible dividends equal to the amount of income of the corporation that is subject to full taxation. . . . The account would operate to disallow a dividends paid deduction for dividends paid out of preference income or foreign source income sheltered from U.S. tax by foreign tax credits. Without such an account, a corporation could pay deductible dividends out of preference income and use the deductions to offset income that would otherwise be subject to the corporate income tax.[104]

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104. *See* S. STAFF REP., *supra* note 3, at 198–99. Senator Hatch issued an accompanying press release where he stated that the Senate Staff Report

However, this author believes that the better approach is to handle this complexity through the foreign tax credit limitation regime as the above proposal conceptually represents a duplicative effort to handle what section 904 is capable of handling. In this regard, in order to protect the U.S. tax jurisdiction's right to tax U.S. source income, Congress since 1921 has limited the use of foreign tax credits in order to avoid the use of foreign tax credits as a means to create a double benefit, and to this end the existence of the U.S. foreign tax credit regime along with the limitation regimes of section 904(a), section 904(d), and section 904(f) can be summarized as follows: the U.S. foreign tax credit regime is intended to prevent worldwide double taxation except to the extent necessary to protect the U.S. taxing jurisdiction on U.S. domestic source income and to the extent necessary to protect against prohibited cross-crediting of taxes against low-taxed passive foreign source income.[105]

Consistent with this longstanding policy of protecting the U.S. tax base with respect to U.S. source income, Congress should take steps to ensure that any newly enacted dividend paid deduction regime does not provide the equivalent of a double tax benefit such that the U.S. tax jurisdiction's right to tax U.S. source income is inappropriately reduced. The most readily apparent solution is for the corporation to apportion its dividend paid deduction between its net U.S. source income and its net foreign source income (determined for each separate foreign tax credit basket) based on the ratio that the corporation's net U.S. source income and net foreign source income (determined for each separate foreign tax credit basket) each bear to the corporation's current year net taxable income.[106] This net income apportionment methodology should be done after all other expenses have been allocated and apportioned to each category of U.S. and foreign source income (determined for each separate foreign tax credit basket) so that the net U.S. source income and net foreign source income (by basket) is calculated before the dividend paid deduction is considered. By apportioning the dividend paid deduction using a net income apportionment methodology, the dividend paid deduction will be allocated proportionately to each of the

represented an open invitation for all parties to work on these critical issues. *See* Hatch Press Release, *supra* note 3.

105. I.R.C. §§ 904(a), (d).

106. Others have seen this same problem and have argued that the dividends received deduction should be allocated in the same manner as interest expense is allocated. *See* McDonald, *supra* note 5, at 80 ("If dividends are deductible, those expenses would presumably have to be apportioned in the same manner as interest expense"). However, apportioning based on relative worldwide asset values as required by Temp. Reg. § 1.861–9T does not correlate with where those earnings were derived. The better approach is to apportion the dividend paid deduction in accordance with net income as net income.

net U.S. and net foreign source income (by basket). Once the dividend paid deduction is apportioned to the various foreign tax credit baskets on a proportionate basis, the taxpayer will not be able to claim foreign tax credit relief with respect to the foreign source earnings that have already generated a tax deduction benefit. This reduction in the foreign tax credit limitation protects against the allowance of a double tax benefit, and the following Example Two sets forth the relevant analysis.

> *Example Two*. Same facts as in Example One, namely that there is $40 of net foreign source income (after all expenses other than the dividend paid deduction are allocated and apportioned). C Corp. bears $12 of foreign tax on its foreign source income. C Corp. earns an additional $60 of net U.S. source income from its U.S. operations (after all expenses other than the dividend paid deduction are allocated and apportioned). Thus, from all sources, C Corp. has taxable income of 100x. C Corp. is subject to a 30% corporate tax rate, and shareholders are subject to a 30% withholding tax on the grossed-up dividend paid to them. C Corp. remits a $25 cash dividend to its shareholder that on a grossed-up basis represents a $35.71 taxable dividend to its shareholders.
>
> *Result*. Because 40% of the net taxable income represents net foreign source income before consideration of the dividend paid deduction, 40% of the $35.71 dividend paid deduction (or $14.29) should be apportioned to C Corp.'s general basket under a net income apportionment methodology. Thus, the general basket income used in the calculation required under section 904(d)(1)(B) would be $25.71 (i.e., $40 - $14.29) after apportionment of the dividend paid deduction to this category of foreign income, resulting in a general basket foreign tax credit limitation of approximately $7.71 ($25.71 x 30%). So, C Corp. would be entitled to utilize only $7.71 of its $12 of foreign tax credits on a current basis. By allocating a pro rata portion of the dividend paid deduction under a net taxable income methodology, the chart below demonstrates that this apportionment methodology ensures that the foreign earnings that provided a deduction benefit does not then provide a duplicative foreign tax credit benefit with respect to those distributed foreign earnings.

Example 2 Chart
FTC Allocation of DPD to Avoid Double Benefit

	Net Foreign Source Income	Net U.S. Source Income	Total
Corporation's Taxable Income	40.00	60.00	100.00
Dividend Amount (DPD)	-14.29	-21.43	-35.71
Cash Paid to Shareholder	-10.00	-15.00	-25.00
Shareholder Withholding Tax (30%)	-4.29	-6.43	-10.71
Corporate Taxable Income	25.71	38.57	64.29
Tentative U.S. Tax Before Credits (30%)	7.71	11.57	19.29
FTC Limitation (with DPD allocation)	7.71		
Foreign Taxes	12.00		
Eligible FTC Relief	7.71		-7.71
Corporate Tax Liability			11.57

As a general rule, the existing Treasury regulations generally apportion expenses on a gross income basis.[107] However, the Treasury regulations provide exceptions to this rule for specific types of expenditures and thus already recognize that a gross-to-gross apportionment methodology is not necessarily the best methodology in all cases. Furthermore, when it comes to apportioning state income taxes that include both foreign and U.S. source income, existing Treasury regulations already suggest that this tax should be apportioned on a net taxable income methodology along the lines set forth in Example 2.[108] The dividend paid deduction is directly attributable to the current year net taxable income that gives rise to those earnings and profits, and so the best methodology for apportioning the dividend paid deduction is by utilizing a net taxable income methodology like the one

107. *See* Reg. § 1.861–8(c)(3).
108. *See* Reg. §§ 1.861–8(e)(6), –8(g), Ex.29.

utilized to apportion state income taxes in the existing Treasury regulations.[109]

2. Trade-Offs Inherent Between Dividend Paid Deduction Regime and the Foreign Tax Credit Regime

The effect of (1) not allowing, at the corporate level, the duplicative benefit of both foreign tax credit relief and a dividend paid deduction with respect to the very same foreign earnings coupled with (2) the imposition of the shareholder withholding tax on all dividends translates into the following: (3) the U.S. ultimately would collect at least a 30% tax on all distributed earnings regardless of the source of those underlying earnings and regardless of whether or not the recipient shareholder is a U.S. taxable individual, U.S. tax-exempt investor, or a foreign individual. At first blush, the elimination of all corporate level tax on distributed earnings via a dividend paid deduction coupled with an offsetting shareholder level withholding tax creates a tax parity given the general economic equivalence of a corporate tax deduction that provides a 30% tax benefit[110] and a 30% withholding tax.

However, this apparent symmetry masks important areas of divergence. In particular, symmetry does not exist if one assumes that the U.S. corporate level tax on the distributed earnings would have been partially or fully eliminated from the U.S. corporate level tax without regard to the dividend paid deduction (e.g., due to foreign tax credit relief or some other corporate level tax attribute). In this scenario, the dividend paid deduction is only a partial (or no additional) corporate level tax benefit whereas the imposition of the shareholder level withholding tax imposes a 30% U.S. tax at the shareholder level in all events. Because the dividend paid deduction regime imposes a single 30% shareholder level withholding tax regardless of whether the distributed earnings were fully or partially sheltered from corporate level taxation, the utilization of the dividend paid deduction that triggers a 30% shareholder level withholding tax may be less beneficial to a particular shareholder depending (1) upon the amount of the pre-existing

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109. The author understands that if a dividend were paid out of accumulated earnings and profits and not out of current earnings and profits and if those accumulated earnings and profits had a different ratio of foreign source taxable income and U.S. source taxable income, then arguably a methodology that reflects that accumulated earnings and profits profile may be appropriate if the theoretically accurate result were desired.

110. Consistent with S. STAFF REP., *supra* note 3, this Article assumes a corporate tax rate of 30% throughout. If current law were used, then the corporate level tax benefit would be a 35% benefit and the withholding tax would be a 35% withholding rate.

duplicative corporate level tax attribute that would partially eliminate corporate level tax on the distributed earnings and (2) upon the status of the particular shareholder (i.e., whether the shareholder is a U.S. taxable individual shareholder, foreign shareholder subject to treaty withholding rates, or a tax-exempt investor that would not have been subject to any further U.S. shareholder taxation on the receipt of a dividend).

To unpack this issue, this Article assumes the following three categories of shareholders[111] in order to illustrate the interplay that can exist when the dividend paid deduction regime is utilized with respect to distributed earnings that would not have borne full corporate level taxation:

1. *Taxable Shareholders.* This Article assumes that taxable shareholders are individuals who would have been subjected under current law to capital gains rates[112] (assumed to be 20% for this paper) and would have been subjected to the 3.8% excise tax imposed under section 1411. Under the dividend paid deduction regime, these taxable individual shareholders now would be subject to ordinary income rates on their dividend income (assumed to be 39.6%) but are entitled to claim a credit for the 30% shareholder withholding tax on the grossed-up dividend.
2. *Tax-Exempt Shareholders.* This Article assumes that tax-exempt shareholders bear no shareholder level taxation under current law.[113] Under the dividend paid deduction regime, the tax-exempt shareholder now would be subject to the 30% shareholder withholding tax, and this shareholder withholding tax would be a final tax.
3. *Foreign Individual Investor.* This Article assumes that foreign shareholders under current law would have been subject to a 15% dividend withholding rate, which withholding rate is the dividend withholding rate specified for shareholders who own less than 10% of the stock of the dividend-paying corporation.[114] Under the dividend paid deduction regime, these foreign shareholders now would be subject to the 30% shareholder withholding tax, and this

111. The author readily admits that these three categories do not cover the entire universe of all potential classes of shareholders and their particular tax positions, but these three categories do provide cases where a shareholder would otherwise be subject to full U.S. taxation, partial U.S. taxation at the shareholder level, or no further taxation at the shareholder level. These three broad categories are sufficient to provide an overview of the fundamental divergence.

112. For this paper, the analysis was done using the capital gain rate specified in section 1(h)(D).

113. *See* I.R.C. § 512(b)(1).

114. *See* U.S. Model Income Tax Convention, art. 12(2)(b) (2016).

new shareholder withholding tax would be a final U.S. tax that may or may not be fully creditable in the foreign investor's country of residence.

The corporation and its officers and directors are ultimately in the position to decide whether the corporation should avail itself of the dividend paid deduction regime. So, how will these corporate fiduciaries approach this decision and what are the ramifications of such a decision?

In evaluating the interplay between the dividend paid deduction regime in the scenario where corporate level tax on the distributed earnings would have been partially offset by other corporate level tax attributes, it is helpful to contrast the dividend paid deduction tax results with the following alternative: (1) forgoing dividend distributions and thus foregoing the dividend paid deduction regime, (2) utilizing foreign tax credits or other corporate level tax attributes to reduce the U.S. corporate level tax on the corporate level earnings, and (3) using those earnings to engage in a section 302 redemption transaction instead of a dividend distribution (hereinafter, this alternative strategy for distributing cash to shareholders is referred to as the Section 302 Redemption Alternative). Under the section302 Redemption Alternative, the corporation would forgo the corporate level dividend paid deduction and would instead utilize the foreign tax credit regime to the extent available under current law. Moreover, at the shareholder level, the redemption transaction provides capital gains treatment, a basis offset, and the incurrence of the 3.8% tax imposed under section 1411 for U.S. taxable, individual shareholders.[115] Foreign shareholders[116] and U.S. tax-exempt shareholders[117] are nontaxable at the shareholder level from a U.S. tax perspective (effectively an alternative form of integration for them) albeit for different reasons. Thus, even though the dividend paid deduction regime creates an integrated tax result and only one level of U.S. taxation on active business income, the determination of whether or not this particular form of corporate integration is better or worse in comparison to the Section 302 Redemption Alternative must be analyzed on a case-by-case basis. In this regard, as a general statement, for U.S. taxable individual shareholders, the relative attractiveness of the dividend paid deduction regime versus the foreign tax credit regime increases as the percentage of the corporation's U.S. taxable income is increasingly subject to residual U.S. corporate level taxation. However, foreign shareholders are likely to prefer the Section 302 Redemption Alternative in a broader array of fact patterns than U.S. taxable

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115. *See* I.R.C. § 1(h)(11).

116. *See* I.R.C. § 871(a) (definition of fixed, determinable, annual, and periodical does not include gains); U.S. Model Income Tax Convention, art. 10(2)(b) (2016).

117. *See* I.R.C. § 512(b)(5).

individuals, and U.S. tax-exempt investors are likely to prefer the Section 302 Redemption Alternative any time the underlying earnings would not have been subject to full U.S. corporate level taxation.

Although by no means exhaustive, the following Example Three, Example Four, and Example Five, in combination, illustrate the complex trade-offs that can exist between the dividend paid deduction regime and the Section 302 Redemption Alternative for these three distinct categories of shareholders.

> *Example Three.* A U.S. corporation earns $100 of net foreign source general basket income and pays a 30% foreign income tax. This net foreign source general basket income represents the entirety of the corporate distributee's net taxable income before considering the additional benefit of the dividend paid deduction. C Corp. is subject to a 30% corporate tax rate in the United States, and shareholders are subject to a 30% withholding tax on the grossed-up dividend paid to them.
>
> *Result*. C Corp. incurs $30 of foreign tax and thus has $70 of earnings that remain to be distributed to its shareholders. If the corporation remits its $70 of earnings (which represent all foreign source income) as a dividend, then the corporation for U.S. tax purposes will have no net corporate level taxable income in the United States but must withhold $21 (30% of $70) with respect to its distribution to its shareholders. Thus, after withholding $21 from the $70 distribution, the corporation can remit a cash dividend of the remaining $49 to its shareholders regardless of whether the shareholders are U.S. taxable individuals, U.S. tax-exempt investors, or foreign shareholders. For U.S. taxable individual shareholders, a combined $51 of tax is either incurred at the corporate level or withheld at the corporate level, but even so these U.S. taxable individual shareholders would be subject to a maximum additional shareholder level tax of $9.38 (([39.6% + 3.8%] x 70) – 21 withholding) for a total worldwide tax liability of $60.38.
>
> If C Corp. instead decides to use its $70 of cash to engage in share repurchases eligible for Section 302 treatment, then the corporation would be subject to foreign tax of $30 but would not bear a U.S. corporate level tax cost as it will have the opportunity to utilize the $30 of U.S. foreign tax credit to fully offset the 30% U.S. corporate level tax under these facts. Thus, in this example, the loss of the dividend paid deduction provided no detriment at the corporate level given the availability of sufficient U.S. foreign tax credit relief. What is more, the section 302 redemptions will not subject the shareholder to the new dividend withholding tax imposed

> under the dividend paid deduction regime, and the redemptions will provide capital gains treatment to shareholders. Thus, for the U.S. taxable shareholder, a section 302 redemption transaction will afford taxable shareholders with a basis offset, favorable capital gain treatment of potentially a 20% tax rate at the shareholder level, and will subject them to an additional 3.8% tax on their net capital gain under section 1411. On these facts, the maximum additional shareholder tax cost under the Section 302 Redemption Alternative would be $16.66 for U.S. taxable individuals resulting in a combined corporate level and shareholder level tax cost of $46.66. The foreign individual shareholder would not be subject to any taxation on her redemption proceeds, and so her tax cost would be limited to only $30 of corporate level tax plus the shareholder level tax cost, if any, arising in their country of residency. U.S. tax-exempt investors would be exempt from any further U.S. shareholder level taxation, and so the incidence of U.S. taxation on their portion of income would be $30.

The facts posited in Example Three demonstrate that the inapplicability of a foreign tax credit relief at the shareholder level for foreign taxes paid at the corporate level creates a double tax result under the dividend paid deduction regime due to the imposition of a combination of the following: (1) foreign income taxes at the corporate level and the (2) shareholder withholding tax imposed on the distributed after-tax earnings. Thus, a $51 all-in tax cost (i.e., $30 of foreign tax on pre-tax corporate profits of $100, plus $21 of shareholder withholding tax imposed on the distribution of the $70 of after-tax earnings to shareholders) is paid in this context. Faced with this fact pattern, it is preferable for the corporation to use the partial integration result that is achievable with the Section 302 Redemption Alternative in lieu of relying on the dividend paid deduction regime, and in fact all shareholders prefer the Section 302 Redemption Alternative in this factual scenario. The following two charts set forth a more detailed summary of the outcome for U.S. taxable individual shareholders under the assumption that the dividend paid deduction regime applies (see Example 3A) and contrasts that outcome with the benefit of utilizing the Section 302 Redemption Alternative (see Example 3B).

Example 3A Chart
High Foreign Tax & DPD

	Net Foreign Source Income	Net U.S. Source Income	Total
Corporation's Taxable Income	100.00	0	100.00
Dividend Amount (DPD)	-70.00		-70.00
Cash Distribution	-49.00	0	-49.00
Gross-Up Distribution	-21.00	0	-21.00
Corporate Taxable Income	30.00	0	30.00
Tentative U.S. Tax Before Credits (30%)	9.00	0	9.00
FTC Limitation (with DPD allocation)	9.00		
Foreign Taxes	30.00		
Eligible FTC Relief	9.00		-9.00
Corporate Tax Liability: U.S.			0
Corporate Tax Liability: Foreign			30.00
Shareholder Withholding Tax Liability			21.00
U.S. Taxable Individual Shareholder Liability Above Withholding			9.38
Total Tax Cost			60.38

Example 3B Chart
High Foreign Tax & Redemption

	Net Foreign Source Income	Net U.S. Source Income	Total
Corporation's Taxable Income	100.00	0	100.00
Cash Used in Redemption	70.00	0	70.00
Corporate Taxable Income	100.00	0	100.00
Tentative U.S. Tax Before Credits (30%)	30.00	0	30.00
FTC Limitation (with DPD allocation)	30.00		
Foreign Taxes	30.00		
Eligible FTC Relief	30.00		-30.00
Corporate Tax Liability: U.S.			0
Corporate Tax Liability: Foreign			30.00
Shareholder Withholding Tax Liability			0
U.S. Taxable Individual Shareholder Liability Above Withholding			16.66
Total Tax Cost			46.66

In contrast, Example Four illustrates the other extreme.

Example Four. A U.S. corporation earns $100 of net U.S. source income and has no foreign source income. This net U.S. source income represents the entirety of the corporate distributee's net taxable income before any dividend paid deduction. C Corp. is subject to a 30% corporate tax rate in the United States, and shareholders are subject to a 30% withholding tax on the grossed-up dividend paid to them.

Result. If the corporation remits its net income as a dividend, then the corporation will have no corporate level taxable income but must withhold $30. Thus, the corporation can remit $70

> to its shareholders regardless of whether the shareholders are U.S. taxable individuals, U.S. tax-exempt investors, or foreign investors. Total shareholder level tax on a $100 of corporate level profits would be a maximum of $43.40 (39.6% + 3.8%) for taxable individual shareholders.
>
> If the corporation forgoes the dividend paid deduction, it will incur $30 of corporate level tax on its pre-tax profits of $100. If the corporation then used its after-tax earnings of $70 for share repurchases that are eligible for section 302 treatment, then the section 302 redemptions will subject U.S. taxable individuals to capital gains treatment (presumed to be a 20% tax rate), a basis offset, and the potential imposition of the additional 3.8% tax on their capital gain per section 1411. On these facts, the maximum additional shareholder level tax cost under the Section 302 Redemption Alternative would be $16.66 (70 x [20% + 3.8%]), resulting in a combined corporate level and shareholder level tax cost of $46.66. The foreign individual shareholders and the U.S. tax-exempt shareholders would not be subject to any taxation on their receipt of the redemption proceeds, and so the Section 302 Redemption Alternative leads to identical results for them as compared to the results afforded under the dividend paid deduction regime.

As the below chart indicates, this Example Four represents the other end of the spectrum where foreign investors and U.S. tax-exempt investors are indifferent in the underlying choice between the dividend paid deduction approach versus the Section 302 Redemption Alternative. However, assuming that basis recovery is considered a timing difference and not a permanent difference, U.S. taxable individuals are likely to prefer the dividend paid deduction regime as it entirely eliminates double taxation as to them in this scenario and thus provides a significant reduction in the incidence of their tax liability ($43.40 under the dividend paid deduction regime compared to $46.66 under the Section 302 Redemption Alternative).

Example 4A Chart
U.S. Source Income & DPD

	Net Foreign Source Income	Net U.S. Source Income	Total
Corporation's Taxable Income	0	100.00	100.00
Dividend Amount (DPD)		-100.00	-100.00
Cash Distribution	0	-70.00	-70.00
Gross-Up Distribution	0	-30.00	-30.00
Corporate Taxable Income	0	0	0
Corporate Tax Liability: U.S.			0
Corporate Tax Liability: Foreign			0
Shareholder Withholding Tax Liability			30.00
U.S. Taxable Individual Shareholder Liability Above Withholding			13.40
Total Tax Cost			43.40

Example 4B Chart
U.S. Source Income & Redemption

	Net Foreign Source Income	Net U.S. Source Income	Total
Corporation's Taxable Income	0	100.00	100.00
Cash Used in Redemption	0	70.00	70.00
Corporate Taxable Income	0	100.00	100.00
Corporate Tax Liability: U.S.			30.00
Corporate Tax Liability: Foreign			0
Shareholder Withholding Tax Liability			0
U.S. Taxable Individual Shareholder Liability Above Withholding			16.66
Total Tax Cost			46.66

Finally, Example Five provides only one of many scenarios where the trade-offs can be made more nuanced between the two extremes posited in Example Three and Example Four, but even so, Example 5 is sufficient to show that the shareholders are likely to have competing interests as to which approach the corporation ultimately chooses.

> *Example Five.* A U.S. corporation earns $100 of net taxable income before any dividend paid deduction. Of this $100 of net taxable income, $40 is net foreign source general basket income subject to $4 of foreign tax. The remaining $60 is U.S. source income that would otherwise be subject to U.S. corporate taxation if there were no dividend paid in the year. C Corp. is subject to a 30% corporate tax rate in the United States, and shareholders are subject to a 30% withholding tax on the grossed-up dividend paid to them.
>
> *Result.* If the corporation decides to remit $95.12 as a dividend to its shareholders, then the corporation must withhold $28.54 (30% of $95.12) and can remit $66.58 as a cash dividend to its shareholders. For U.S. taxable individual shareholders, a combined $33.41 (0.87 + 4.00 + 28.54) of tax would be incurred or withheld at the corporate level, and these U.S. taxable individual

shareholders would be subject to a maximum additional shareholder level tax of $12.75 for a total combined U.S. tax liability of $46.16, as indicated in the below chart labeled Example 5A.

If the corporation instead forgoes the dividend paid deduction and opts for the Section 302 Redemption Alternative, then the incremental corporate level tax would be $22 after claiming the benefit of the $8 of foreign tax credit. The corporation would be left with $70 of after-tax earnings, and those earnings could then be used for share buybacks. For U.S. taxable individual shareholders, the redemption transactions create potential capital gains (presumed taxed at a 20% rate), a basis offset, and a potential exposure to the 3.8% tax specified in Section 1411.[118] On these facts, the maximum additional shareholder level tax cost under the Section 302 Redemption Alternative would be $16.66 for U.S. taxable individual shareholders, resulting in a combined corporate level and shareholder level tax cost of $46.66, as indicated in the below chart labeled Example 5B. The foreign individual shareholder would not be subject to any additional U.S. taxation on her receipt of the redemption proceeds, and so the incidence of tax on her share of the earnings would only be the $30 of corporate level tax plus the shareholder level tax, if any, arising in her country of residency. U.S. tax-exempt investors would be exempt from any further shareholder level taxation, and so the incidence of U.S. taxation on their portion of the earnings would be limited to only the corporate level tax of $30. These results for U.S. taxable individual shareholders are summarized in the below charts.

118. For U.S. taxable individuals subject to the top marginal rate for ordinary income of 39.6% and the 3.8%, the dividend paid deduction regime would subject the shareholder to a total tax of 43.4% tax on the $91.14 distribution, leaving the shareholder with $51.59.

Example 5A Chart
Low Foreign Tax / 40% Foreign Source Alternative

	Net Foreign Source Income	Net U.S. Source Income	Total
Corporation's Taxable Income	40.00	60.00	100.00
Dividend Amount (DPD)	-38.05	-57.07	-95.12
Cash Distribution	-26.63	-39.95	-66.58
Gross-Up Distribution	-11.42	-17.12	-28.54
Corporate Taxable Income	1.95	2.93	4.88
Tentative U.S. Tax Before Credits (30%)	0.59	0.88	1.46
FTC Limitation (with DPD allocation)	0.59		
Foreign Taxes	4.00		
Eligible FTC Relief	0.59		-0.59
Corporate Tax Liability: U.S.			0.87
Corporate Tax Liability: Foreign			4.00
Shareholder Withholding Tax Liability			28.54
U.S. Taxable Individual Shareholder Liability Above Withholding			12.75
Total Tax Cost			46.16

Example 5B Chart
Low Foreign Tax / 75% Foreign Source Alternative

	Net Foreign Source Income	Net U.S. Source Income	Total
Corporation's Taxable Income	75.00	25.00	100.00
Cash Used in Redemption	52.50		52.50
Corporate Taxable Income	75.00	25.00	100.00
Tentative U.S. Tax Before Credits (30%)	22.50	7.50	30.00
FTC Limitation (with DPD allocation)	38.25		
Foreign Taxes	8.00		
Eligible FTC Relief	8.00		-8.00
Corporate Tax Liability: U.S.			22.00
Corporate Tax Liability: Foreign			8.00
Shareholder Withholding Tax Liability			0
U.S. Taxable Individual Shareholder Liability Above Withholding			16.66
Total Tax Cost			46.66

Thus, Example Five indicates that the dividend paid deduction regime provides the opportunity to reduce corporate level taxation by an additional $25.12 versus the Section 302 Redemption Alternative (i.e., $4.88 instead of $30). Furthermore, the incremental U.S. taxable shareholder cost turns out to be smaller in this factual scenario in comparison to the Section 302 Redemption Alternative as the additional shareholder level capital gains tax coupled with the 3.8% tax imposed by section 1411 creates a larger overall tax cost, assuming that the inability to claim a shareholder basis offset is viewed as simply a timing difference and not a permanent difference. In contrast, under the Example Five fact pattern, tax-exempt and foreign investors prefer the Section 302 Redemption Alternative as that approach provides a partial corporate level tax offset and thus a $30 foreign

plus U.S. corporate level tax and avoids any further shareholder level taxation. So, from their perspective, the loss of the corporate integration result is not a detriment and they prefer avoiding the shareholder withholding tax in this factual scenario. Again, numerous other scenarios can be modeled, but Example 5A and Example 5B are sufficient to demonstrate that the divergent U.S. tax treatment at the shareholder level afforded to U.S. taxable shareholders, U.S. tax-exempt investors, and foreign shareholders may cause the interplay of the dividend paid deduction regime and the Section 302 Redemption Alternative to create conflicting shareholder-level interests among the various categories of shareholders as to whether the corporation should utilize the dividend paid deduction regime or the Section 302 Redemption Alternative. What is more, the facts can be made even more nuanced if the corporation remits only a portion of its current year earnings so that the dividend paid deduction regime only partially applies. In this scenario, the corporation's foreign tax credit limitation is only partially reduced for the year, thus affording an opportunity for the corporation to incorporate its excess foreign tax credit limitation into its dividend paid deduction planning.[119]

The above analysis is made all the more interesting due to recent scholarship that suggests that a substantial majority of the owners of U.S. corporate stock are tax-exempt investors and foreign investors.[120] So, when it comes to maximizing "shareholder value," C corporation officers and boards of directors could chose to frame their duties in any of the following: (1) minimize the corporate level taxation and to not seek to address the divergent shareholder tax considerations; (2) implement dividend strategies that seek to minimize the combined corporate level and shareholder level taxation from the vantage point of U.S. taxable individual shareholders; (3) minimize the combined U.S. corporate level and shareholder level tax consequences from the vantage point of tax-exempt and/or foreign shareholders; or (4) some combination of the above approaches. The dividend paid deduction regime allows corporations to achieve corporate integration at the C corporation's option, but Congress has left the ultimate choice to the corporation and its fiduciaries to decide whether, and to what extent, to distribute dividends in lieu of utilizing a Section 302 Redemption Alternative. Consequently, as the forgoing analysis demonstrates, the decision matrix between the dividend

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119. If the corporation has excess foreign tax credit limitation under section 904 before considering the dividend paid deduction, the corporation may well find that it can best maximize the benefits of both regimes by utilizing the dividend paid deduction at least to the extent that the dividend deduction simply eliminates excess limitation and does reduce the usage of available credits.

120. *See* Steven M. Rosenthal & Lydia S. Austin, *The Dwindling Taxable Share of U.S. Corporate Stock,* 151 TAX NOTES 923 (May 16, 2016) (claiming that only 24.2% of corporate stock is held by taxable accounts).

paid deduction regime and the Section 302 Redemption Alternative may not be as straightforward as one might initially imagine. What is more, the different categories of shareholders will want to understand the corporation's dividend philosophy prior to investing in the corporation as that strategy takes on added significance when the corporation has competing alternatives for remitting cash to its shareholders.

D. Shareholder Withholding Tax Should Be Non-Refundable and Subject to Holding Period and Beneficial Ownership Requirements

The pressure point for the dividend paid deduction regime is the imposition of the shareholder withholding tax. This tax must be non-refundable and broadly applicable or else one would expect transactions that will attempt to park this withholding tax obligation into the hands of a taxpayer who could claim a refund of these taxes. Even when the shareholder withholding tax is nonrefundable, Congress should expect, absent prohibitions, that the market will develop tax strategies that seek to place the withholding tax credit with taxpayers who can utilize those credits but then attempt to transfer the economic benefits of those dividend payments to others. Analogous withholding tax washing transactions have been the subject of considerable legislative[121] and judicial consideration[122] historically. Dividend withholding washing transactions is a significant issue within European countries as well, thus indicating that this is not a solely U.S. phenomenon.[123] To mitigate against this risk, one could condition the shareholder's right to claim a credit for these withholding taxes on the requirement that the shareholder must meet minimum holding period requirements.[124] Furthermore, the shareholder's right to claim a tax credit for the dividend withholding tax should be limited to only the taxpayer's net

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121. *See Dividend Tax Abuse: How Offshore Entities Dodge Taxes on U.S. Stock Dividends: Hearing Before the Permanent Subcomm. on Investigations, Comm. on Homeland Sec. and Governmental Affairs of the U.S. Senate*, 110th Cong. (2008). After these hearings, the Service responded by issuing Notice 2010–46, 2010–1 C.B. 757. Congress eventually enacted legislation to impose section 1441's withholding tax on dividend equivalent amounts. *See* Hiring Incentives to Restore Employment Act (HIRE), Pub. L. No. 111-147, § 541, 124 Stat. 71, 115–17 (2010) (enacted section 871(*l*) that was later redesignated as section 871(m)).

122. *See, e.g.*, Compaq Computer Corp. v. Comm'r, 277 F.3d 778 (5th Cir. 2001) (foreign tax credit arbitrage case where foreign withholding taxes were parked into a taxpayer that had excess limitation to utilize those credits), *rev'g* 113 T.C. 214 (1999); IES Indus. v. U.S., 253 F.3d 350 (8th Cir. 2001) (same).

123. *See* Lee A. Sheppard, *News Analysis: Dividend Stripping and Derivatives to Avoid Withholding Challenged,* 150 TAX NOTES 961 (Feb. 29, 2016).

124. *Cf.* I.R.C. § 901(k).

investment income.[125] The shareholder's ability to claim a tax credit for the withholding tax should only be allowed for transactions that have economic substance and a substantial business purpose.[126] And the shareholder's ability to claim a credit for the dividend withholding tax should only be allowed if the shareholder is not contractually obligated to make a dividend equivalent payment to another person.[127] Finally, the shareholder's credit for the dividend withholding tax should not be able to be cross-credited against the residual U.S. tax liability with respect to income derived from other separate activities.[128]

In summary, Congress should be concerned about arbitrage transactions that attempt to use the shareholder withholding tax credit to reduce the residual U.S. tax on other income. It is appropriate to allow the shareholder to claim a credit for the dividend withholding tax to offset the shareholder's U.S. tax obligation with respect to the dividend to which it relates, but that shareholder level dividend withholding tax credit should not be allowed to be creditable to the extent that the amount of the withholding tax credit exceeds the net shareholder tax liability attributable to the underlying net tax liability attributable to the dividend. If precautions to limit the cross-crediting potential were not incorporated into the final legislation, then tax arbitrage transactions will be sought. Thus, even though the

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125. Section 163(d) may need to be expanded so that this restriction applies not only to restrict the deductibility of investment interest to investment income but to restrict the deductibility of interest incurred on dividend-paying stocks so that debt-financed stock cannot generate a dividend withholding tax on a minimally profitable debt-financed stock investment that utilizes the gross withholding tax to reduce its tax obligation on nonfinancial business income.

126. *See* I.R.C. § 7701(o). The author's views on how the economic substance doctrine should be applied to financial arbitrage transactions is beyond the scope of this Article but is expressed elsewhere. *See* Bret Wells, *The Foreign Tax Credit War*, 2016 BYU L. REV. 101 (discussing the application of the economic substance doctrine to the STARS foreign tax credit cases); Bret Wells, *Economic Substance Doctrine: How Codification Changes Decided Cases,* 10 FLA. TAX REV. 411 (2010).

127. For purposes of determining whether the person who bore the shareholder withholding tax is contractually obligated to transfer a dividend equivalent amount to another person, Congress could reference the standards utilized in section 871(m) and its implementing regulations. *See* I.R.C. § 871(m); Temp. Reg. § 1.871–15T; Prop. Reg. § 1.871–15, 80 Fed. Reg. 56,415 (Sept. 18, 2015).

128. An analogous concern of ring fencing tax attributes from one activity and not allowing those attributes to reduce the U.S. tax with respect to other activities is a key feature of section 469, and one would expect that similar concepts to those employed in section 469 would be needed to prevent financial arbitrage transactions that seek to cross-credit the shareholder withholding tax against the shareholder tax liability related to active business income generated elsewhere.

shareholder withholding tax must be nonrefundable and must generally apply to all shareholders, that design feature by itself is not a sufficient feature. The dividend paid deduction regime would also need to ensure that the shareholder is not able to cross-credit that dividend withholding tax against the shareholder's U.S. tax obligations on other income or else tax arbitrage transactions will be the natural evolution in the law.

III. CONCLUSION

If properly structured, a dividend paid deduction regime provides a pathway for resolving the systemic international tax problems that have plagued the extant U.S. international tax regime. The dividend paid deduction regime, if adopted, also fundamentally changes the incentives between U.S. and foreign investment. In addition, such a regime eliminates the lock-out effect with respect to unrepatriated foreign earnings that will be repatriated and distributed to shareholders as a dividend. And the U.S. tax base can be protected if a base protecting surtax were enacted as part of the dividend paid deduction regime with the consequence that the financial incentives that motivate corporate inversion transactions can be eliminated. When viewed in combination, the international tax benefits of a properly designed dividend paid deduction regime are impressive.

But as good as the above conclusions appear to be, a warning must be heard, namely that Congress must still address the inbound Homeless Income problem even under a corporate integration proposal. Whether through a corporate integration proposal or otherwise, the United States simply must institute base protection measures to better defend its U.S. tax base from erosion, and the corporate integration proposal does not change this reality. Thus, until such base protection measures are put into place, one would expect that any actual reform legislation will be destined to suffer the same repeated calls for reform that have plagued the current U.S. international tax regime, because the public will not accept a tax regime that fails the Homeless Income test. Furthermore, the methodology for calculating the foreign tax credit limitation will need to be adjusted so that foreign earnings that are distributed as a dividend are not able to create a double tax benefit. And Congress must be concerned with inappropriate shareholder efforts to cross-credit the shareholder withholding tax against the shareholders residual U.S. tax liability on other non-dividend income. Thus, even though there is much to commend a corporate integration proposal, one cannot let those benefits blind oneself to the reality that the dividend paid deduction regime must be properly designed in order to appropriately handle the systemic international tax problems that plague the United States.