

2023

## Designing a 21st Century Corporate Tax—An Advance U.S. Minimum Tax on Foreign Income and Other Measures to Protect the Base

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### Recommended Citation

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# FLORIDA TAX REVIEW

Volume 17

2015

Number 9

## DESIGNING A 21<sup>ST</sup> CENTURY CORPORATE TAX— AN ADVANCE U.S. MINIMUM TAX ON FOREIGN INCOME AND OTHER MEASURES TO PROTECT THE BASE\*

by

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### ABSTRACT

*The 21<sup>st</sup> Century has seen unprecedented levels of corporate tax aggressiveness and avoidance. This Article continues our exploration of second-best international tax reforms that would protect the U.S. corporate tax base and*

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have some likelihood of adoption. In this case, we consider how a U.S. minimum tax on foreign income earned by a controlled foreign corporation should be designed to protect the United States against erosion of its corporate income tax base and to combat tax competition by low-tax intermediary countries. In the authors' view, a minimum tax should be an interim levy that preserves the residual U.S. tax on foreign income, as distinguished from a final minimum tax that partially eliminates the U.S. residual tax. An interim minimum tax would be a significant improvement over current law and would more effectively limit incentives to seek low-taxed foreign income while ameliorating pressure to retain excess earnings abroad.

To achieve the objectives of such a minimum tax, corresponding changes should be made to the U.S. corporate resident definition, the source taxation of foreign multinational corporations, and the residence taxation of U.S. portfolio investors in foreign corporations to reduce tax advantages under current law for investments in foreign corporations. These changes would reduce tax advantages for foreign parent corporate groups and thereby further protect the U.S. tax base, as well as reduce incentives for U.S. corporations to expatriate as a consequence of increased U.S. taxation of foreign income under an interim minimum tax.

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## I. INTRODUCTION

This Article continues our exploration of second-best international tax reforms, namely, how the U.S. controlled foreign corporation (CFC) rules could be modernized and strengthened through adoption of an interim

minimum tax on foreign income.<sup>1</sup> We outline a minimum tax that would substantially increase the effectiveness of the CFC rules in protecting the United States against erosion of its corporate income tax base and in combatting tax competition by low-tax intermediary countries.<sup>2</sup> We also

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1. We have explained in other works why worldwide taxation without deferral or significant cross-crediting would be a preferred alternative to a territorial system. *See, e.g.*, J. Clifton Fleming, Jr., Robert J. Peroni & Stephen E. Shay, *Perspectives on the Worldwide vs. Territorial Taxation Debate*, 125 TAX NOTES 1079, 1082-1104 (Dec. 7, 2009) [hereinafter Fleming, Peroni & Shay, *Perspectives*]; Robert J. Peroni, J. Clifton Fleming, Jr. & Stephen E. Shay, *Getting Serious About Curtailing Deferral of U.S. Income Tax on Foreign Source Income*, 52 SMU L. REV. 455 (1999) [hereinafter Peroni, Fleming & Shay, *Getting Serious About Curtailing Deferral*]. In recent articles, we have articulated how a principled exemption system should be designed so as to protect the U.S. tax base and we have evaluated two current exemption system proposals. *See* J. Clifton 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 (2013) [hereinafter Fleming, Peroni & Shay, *Designing a U.S. Exemption System*]; Stephen E. Shay, J. Clifton Fleming, Jr. & Robert J. Peroni, *Territoriality in Search of Principles and Revenue: Camp and Enzi*, 141 TAX NOTES 173 (Oct. 14, 2013) [hereinafter Shay, Fleming & Peroni, *Territoriality in Search of Principles*]. Finally, we have explained how a new subpart F income category for low-taxed foreign income would combat the distortive incentive of deferral as well as the incentive to shift income from high-tax to low-tax countries. *See* J. Clifton Fleming, Jr., Robert J. Peroni & Stephen E. Shay, *Formulary Apportionment in the U.S. International Income Tax System: Putting Lipstick on a Pig?*, 36 MICH. J. INT'L LAW 1, 50-52 (2014) [hereinafter Fleming, Peroni & Shay, *Formulary Apportionment*].

2. Under current U.S. deferral rules, a U.S. multinational corporation is not taxed on active foreign income earned through a controlled foreign corporation (CFC) until the earnings are distributed as a dividend or are deemed included in income under the rules of subpart F of the Code, or stock of the CFC is sold at a price that reflects accumulated earnings. *See* I.R.C. §§ 61(a)(3), 61(a)(7), 951-964, 1248. A CFC is a foreign corporation that is more than 50 percent owned by vote or value, directly, indirectly, or under certain constructive ownership rules, by U.S. shareholders. I.R.C. §§ 957(a), 958, 318. For this purpose, a U.S. shareholder is a U.S. person that owns directly, indirectly, or under certain constructive ownership rules 10 percent or more of the voting power of the foreign corporation. I.R.C. §§ 951(b), 958, 318. Also, under current U.S. tax rules, it is possible for a CFC to make substantial sales of tangible and intangible property to U.S. customers without incurring U.S. taxation at the source while qualifying for deferral. *See* I.R.C. §§ 864(c)(3)-(5), 865(b), (e)(2) (a foreign corporation that does not have a U.S. office directly or by attribution under Reg. § 1.864-7 can generate foreign-source sales income by passing title to U.S. customers outside the United States and thereby avoid U.S. effectively connected income); *see also, e.g.*, STAFF OF THE J. COMM. ON TAX'N, JCX-37-10, PRESENT LAW AND BACKGROUND RELATED TO POSSIBLE INCOME SHIFTING AND TRANSFER PRICING, (2010) (sales of manufactured products to U.S. affiliate for sale to U.S. customers in

identify associated reforms to U.S. corporate residence rules and U.S.-source taxation rules that are necessary to protect U.S. tax interests.<sup>3</sup>

We contrast our interim minimum tax proposal with minimum tax proposals that would exempt from U.S. tax active foreign income taxed at or above a minimum rate. We use as an example the Obama Administration's Fiscal Year 2016 minimum tax budget proposal. We conclude that deferral subject to an interim (or tentative) minimum tax is superior to the Obama Administration's proposal for a reduced rate of U.S. tax on foreign business income (which may also be described as exemption for income taxed at a foreign effective tax rate of at least 22.35 percent).<sup>4</sup>

Adopting an interim minimum tax under the CFC rules is second best to ending deferral of U.S. tax on income earned through a foreign corporation (thereby eliminating the need for much of the current U.S. CFC regime).<sup>5</sup> In the current political environment, however, ending deferral does not appear to be a realistic near-term policy outcome, and strengthening the CFC rules and associated source taxation rules in the manner described in this Article would materially improve the existing U.S. tax system.<sup>6</sup> Identifying a preferred approach to adapting the U.S. CFC rules to modern business practices in the global economy also would be consistent with including strengthened CFC rules as part of the Organization for Economic Cooperation and Development

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Bravo case study example). If the income would not otherwise be subpart F income, the protection of a bilateral income tax treaty's business profits article materially reduces the execution risk of such a strategy. *See* I.R.C. §§ 894(a), (b), 952(b); *cf.* Jeffrey M. Kadet, *Attacking Profit Shifting: The Approach Everyone Forgets*, 148 TAX NOTES 193 (July 13, 2015) (arguing that the IRS should attack offshore profit shifting by pursuing claims that a CFC's income is taxable as effectively connected income).

3. These associated reforms are needed even under current law, i.e., whether or not the taxation of foreign business income is modified by enactment of any of the international tax reform proposals. *See* TESTIMONY OF STEPHEN E. SHAY, BEFORE THE U.S. SENATE COMMITTEE ON FINANCE, HEARING ON BUILDING A COMPETITIVE U.S. INTERNATIONAL TAX SYSTEM 8–9 (Mar. 17, 2015).

4. *See infra* text accompanying note 111.

5. We have previously described why ending deferral is the preferred policy option. *See* Peroni, Fleming & Shay, *Getting Serious About Curtailing Deferral*, *supra* note 1. In making an updated proposal to end deferral, we would take account of subsequent changes in circumstances and changes in our thinking about the relevant issues.

6. In 2011, Senators Wyden and Coats introduced the Bipartisan Tax Fairness and Simplification Act of 2011, S. 727 (2011), which would have dramatically reduced tax rates with revenue raised from ending deferral and adopting a per-country foreign tax credit limitation as well as cutting back numerous other tax breaks. We would generally support the foreign income taxation elements of the Wyden-Coats proposal.

(OECD) Base Erosion and Profit Shifting (BEPS) project.<sup>7</sup>

The Article proceeds as follows. In Part II, we state our assumptions and observe that the realistic scope for tax reform is constrained and that the United States will continue to maintain a corporate income tax. We also explain why a corporate income tax should apply to foreign business income and why international competitiveness considerations do not contradict this conclusion. In Part III, we examine how modern business realities impose practical limitations on the ability of countries to tax cross-border income. In Part IV, we describe our interim minimum tax proposal and contrast it with the Obama Administration's partial exemption proposal. In Part V, we outline

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7. The Organization for Economic Cooperation and Development (OECD) has included strengthening CFC rules in its plan to combat tax base erosion and profit shifting (BEPS). See OECD, OECD/G20 BASE EROSION AND PROFIT SHIFTING PROJECT—EXPLANATORY STATEMENT—2015 FINAL REPORTS 6, 13-14 (2015) [hereinafter OECD, EXPLANATORY STATEMENT], <http://www.oecd.org/ctp/beps-explanatory-statement-2015.pdf>; see also OECD, ACTION PLAN ON BASE EROSION AND PROFIT SHIFTING 16 (2013) [hereinafter OECD, BEPS ACTION PLAN], <http://dx.doi.org/10.1787/9789264202719-en>. While it clearly furthers U.S. interests regarding the problems of corporate expatriation and profit shifting for other developed countries to adopt broadly comparable CFC rules, the ability of European Union (EU) member countries to adopt meaningful CFC legislation in relation to other EU countries is, currently, severely constrained by European Court of Justice (ECJ) case law. Under that case law, CFC rules may target “wholly artificial arrangements which do not reflect economic reality.” Case C-196/04, *Cadbury Schweppes plc, Cadbury Schweppes Overseas Ltd v. Commissioners of Inland Revenue*, 2006 ECR I-7995. There is speculation that the ECJ articulation of this standard may evolve in light of the degree of support for moderating corporate tax avoidance. Nevertheless, the BEPS discussion draft released in May 2015 went so far as to suggest that a minimum standard for CFC rules should be made consistent with EU restrictions, a point with which we disagree. OECD, BEPS ACTION 3: STRENGTHENING CFC RULES 9–11 (May 12, 2015) (“The purpose of this discussion draft is to set out recommendations for effective CFC rules that can be implemented in all jurisdictions.”). The final report adopts this position. See Amanda Athanasiou, *BEPS Action 3: Final CFC Report Leaves Options Open*, 149 TAX NOTES 188 (Oct. 12, 2015). We disagree. The ECJ applies a highly formalistic approach to consider a controlled foreign company regime an impermissible restriction on freedom of establishment when it is applied beyond a wholly artificial arrangement without economic reality because a shareholder of the controlled foreign company is taxed on undistributed income whereas it would not be taxed on undistributed income of a home country subsidiary. This disregards the difference in tax position of the home country subsidiary, which generally is taxed currently by the home country on its income, and that of a controlled foreign company subject to a meaningfully lower level of corporate tax in the host country. The OECD BEPS project should avoid enshrining the current (and we would argue incoherent) ECJ case law approach to CFC rules.

associated reforms that are needed today, but will be more important under any reform that increases the taxation of foreign income. Part VI concludes.

## II. BACKGROUND

### A. *A Realistic Context for Tax Reform*

We assume for purposes of this Article that current U.S. fiscal and political realities and their constraints on tax policy alternatives will continue for the reasonably foreseeable future. These constraints include that the United States will continue to rely on the personal income tax for the largest portion of its revenue and also will continue to rely on a partially integrated corporate income tax both to protect the U.S. individual income tax base and to collect corporate-level tax revenue from U.S. tax-exempt and foreign shareholders.<sup>8</sup> In addition, we anticipate that, even after taking account of recent spending limits and revenue increases, the United States will continue to run a deficit, which, absent increased revenues and spending reductions, is projected to expand after 2019 to nearly 4 percent of gross domestic product (GDP) in 2025.<sup>9</sup> Finally, we assume that the distribution of income and wealth in the United States will continue to shift toward the wealthy and that the political significance of income and wealth inequality issues will grow over time.<sup>10</sup>

Although global economic integration will continue, we do not foresee an analog to the emergence of China, India, and Brazil as new major economic participants, with the resulting effects of adding over a billion potential new workers to global labor markets and creating extraordinary infrastructure investment, commodity demand, and economic growth. In coming years, the global market will expand more as a result of population growth and increased trade among the current actors than from new entrants. The world will continue to “shrink” in the sense that technological change will reduce barriers to communication and commerce. There will be further expansion of the reach and efficiency of wireless and electronic communications and increased

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8. In form, the payroll tax is a part of the personal income tax. Because social security benefit formulas are tied to a beneficiary’s payroll taxes, however, and U.S. budget processes segregate payroll from general revenues using a “trust fund” accounting mechanism to support social security and Medicare [Part A], we do not treat the payroll tax as part of the personal income tax for purposes of this article. We thank Alan Viard of the American Enterprise Institute for articulating this observation at a meeting of the University of Virginia Tax Study Group.

9. See CONG. BUDGET OFFICE, THE 2015 LONG-TERM BUDGET OUTLOOK, 9–10 (2015).

10. See CONG. BUDGET OFFICE, THE DISTRIBUTION OF HOUSEHOLD INCOME AND FEDERAL TAXES, 2011, 2–3 (2014).



reliance on the Internet as a means of commerce. The effects of globalization on national tax systems will continue, but how much and how fast is uncertain.

We also assume that cross-border investment will continue to be dominated by multinational corporations (MNCs) and that intercompany transfer pricing will be based on separate accounting.<sup>11</sup> It is likely that there eventually will be changes in the scope of internationally accepted source country taxation, but that is not the primary focus of this Article.<sup>12</sup> Instead, this Article focuses on how the United States can protect its residence tax interests in a manner that is complementary to mechanisms that should be adopted to protect U.S.-source taxation interests.<sup>13</sup>

### B. *Taking Theoretical Bearings—The Role of an Income Tax*

The work of Thomas Piketty and others shows that the industrial revolution brought with it economic growth and, with that growth, pressure on societies to manage the allocation of public goods and their costs in a way that

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11. The G20-endorsed OECD Final BEPS Report also calls for steps to assure that transfer pricing outcomes in a source or residence country are in line with value creation in that country. OECD, EXPLANATORY STATEMENT, *supra* note 7, at 15. So long as there remain material effective tax rate differentials between countries, no country's transfer pricing rules can do more than restrict relatively extreme income shifting. Thus, it is important to use a multi-prong approach to international tax reform that includes provisions that moderate tax rate differentials to adequately protect a country's income tax base.

12. For example, in the United States, the phenomenon of corporate inversions has focused attention on the advantages of having a foreign-parented group for reducing U.S.-source taxation. The attention this advantage has received may result eventually in increased U.S.-source-based taxation of non-U.S. groups through adoption of stronger earnings stripping-type rules. 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) [hereinafter Fleming, Peroni & Shay, *Cross-Border Earnings Stripping*]. The United Kingdom's new diverted profits tax likely is a precursor to efforts by other strong market countries to expand the scope of source taxation to reach offshore sales into their domestic markets. See Philip Wagman, *The U.K. Diverted Profits Tax: Selected U.S. Tax Considerations*, 147 TAX NOTES 1413 (June 22, 2015) (explaining the U.K. diverted profits tax). The United States likely will conclude that it should join these efforts, subject to continued coordination of new approaches to source taxation by the OECD or other international mechanisms.

13. The United States has substantial source country as well as residence country interests. The OECD reports that in 2012, the U.S. stock of inbound foreign direct investment (FDI) was \$3.1 trillion. OECD, FACTBOOK 89 (2014). The U.S. stock of outbound FDI was \$5.1 trillion. *Id.*

is fair and promotes broader social well-being.<sup>14</sup> The income tax continues to play a key role around the globe in helping to attempt a fair distribution of social benefits among national populations.<sup>15</sup> The central feature of an income tax is to calculate individuals' worldwide income, from labor and capital, and to tax individuals based on their ability to pay measured by their respective worldwide incomes.<sup>16</sup>

As mentioned above, we start with the premise that for the reasonably foreseeable future, the United States will continue to supplement the individual income tax by imposing a separate corporate income tax for publicly traded and most large private companies.<sup>17</sup> Taxing corporate income

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14. See, e.g., THOMAS PIKETTY, *CAPITAL IN THE 21ST CENTURY* (2014).

15. *Id.* at 498–502.

16. We have emphasized this feature of the income tax in prior works. See, J. Clifton 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) [hereinafter Fleming, Peroni & Shay, *Fairness in International Taxation*]. Academic work in the tax field in recent years has emphasized efficiency and relies on optimal tax theory (OTT), which seeks to maximize the aggregate of individuals' welfare, to address concerns regarding allocating the burden of public expenditures. As Professor Raskolnikov has observed, OTT adopts as a baseline a nonlinear tax on labor income and largely disregards taxes on capital as inefficient. He also points to more recent efforts to extend OTT to develop socially optimal capital taxation. There does not appear to be at this point a policy-relevant economic analysis that is robust enough to serve as a foundation on which to base proposals to abandon a tax on capital income of individuals or, its partial surrogate, the tax on corporate income. See generally Alex Raskolnikov, *Accepting the Limits of Law and Economics*, 98 CORNELL L. REV. 523 (2013). For a commentator who questions the weight given to efficiency in tax policy making, see Neil H. Buchanan, *The Role of Economics in Tax Scholarship*, in BEYOND ECONOMIC EFFICIENCY IN THE UNITED STATES TAX LAW 11 (David A. Brennan, Karen B. Brown & Darryl K. Jones eds., 2013).

17. Under current law, the corporate and individual income taxes are integrated only to the limited extent that section 1(h)(11) treats certain dividends as taxable at the lower capital gains rates (even though such dividends remain ordinary income in character). We do not consider here the alternative of fully integrating the corporate and individual taxes. See, e.g., Michael J. Graetz & Alvin C. Warren, Jr., *Unlocking Business Tax Reform*, 145 TAX NOTES 707 (Nov. 10, 2014). While we agree that there could be advantages to be obtained from greater integration of the corporate and individual income taxes, on a revenue neutral basis, at present there appears to be little appetite for this, irrespective of political leanings, in the relevant business and political communities. *But see* REPUBLICAN STAFF OF S. COMM. ON FINANCE, STAFF REPORT ON COMPREHENSIVE TAX REFORM FOR 2015 AND BEYOND, S. PRT. 113-31, at 123–238 (Comm. Print 2014) (discussing alternative mechanisms to eliminate the second tax on corporate earnings). It remains to be seen whether the bipartisan Senate Finance Committee working group on tax reform will pursue corporate integration.

is important to achieve the desired ability-to-pay objectives of the U.S. federal income tax.<sup>18</sup> There is a dispute among economists regarding the extent to which the corporate tax is borne by capital or by labor (and if by capital, how much is borne by shareholders). Under the methodology recently adopted by the Staff of the Joint Committee on Taxation, however, over 75 percent of the burden of the corporate tax is allocated to capital owners, and, in turn, under the Joint Committee Staff's method for allocating this burden, a high percentage is attributed to holders of stock.<sup>19</sup> Whether the corporate tax is serving as a backstop to avoidance of the individual income tax or is a crude proxy for taxing shareholders' income,<sup>20</sup> its role in maintaining a degree of parity in the taxation of labor and capital is unlikely to be replaced or improved upon by any U.S. tax reform. This is sensible because real world tax systems should not relinquish working tax instruments to claims of inefficiency or otherwise, unless and until there is evidence that the harm outweighs the benefit and, if it does not, that the net benefit can be replaced by an alternative.<sup>21</sup> It is easy to reduce taxes; it is far harder to raise them.

### C. Why Tax Foreign Income?

#### 1. Worldwide Taxation of Resident Individuals and Corporations

The United States taxes the worldwide income of U.S. resident individuals, as well as the worldwide income of domestic corporations. Taxing

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See William R. Davis, *Finance Working Groups Making Progress on Tax Reform Reports*, 2015 TAX NOTES TODAY 45-21 (Mar. 9, 2015).

18. See generally Fleming, Peroni & Shay, *Fairness in International Taxation*, *supra* note 16.

19. See STAFF OF THE J. COMM. ON TAX'N, JCX 14-13, MODELING THE DISTRIBUTION OF TAXES ON BUSINESS INCOME 4-5, 30 (2013).

20. See Fleming, Peroni & Shay, *Formulary Apportionment*, *supra* note 1, at 18-21 (discussing various rationales for the corporate income tax and concluding that the tax is best justified as a "crude substitute for a current tax on the shareholders.").

21. It is outside the scope of this article to fully explain why consumption taxation is not a panacea for the ills of taxing income, including international income, notwithstanding the breadth of support for consumption taxation in the tax academy. We would point out, however, that it is important not only to consider the ideal consumption tax but also the form of consumption tax likely to be adopted. The efficiency claims for taxing consumption dwindle rapidly when realistic assumptions are made about the need for transition (efficiency gains arise from imposing tax on pre-effective date, after-tax savings) and the percentage of aggregate consumption covered by the tax (as the scope of the tax decreases, distortions from disparate treatment of goods and services increase). Based on experiences in Canada, the

income earned abroad is necessary to prevent avoidance of U.S. residence taxing jurisdiction through the simple expedient of carrying on business and investment activities in foreign countries.<sup>22</sup> Taxing foreign income of a C corporation also furthers the ability-to-pay norm if domestic corporations are primarily owned by U.S. persons. Available evidence suggests that this is

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intergovernmental consequences of a federal-level consumption tax are resolvable, but actually achieving an integrated federal-state system likely would involve a substantial period of transition. The administrative costs, for taxpayers, the federal government, and state and local governments, of adding a new federal tax instrument and the time that it would take to implement also are significant. The enforcement of a federal consumption tax would require new mechanisms and additional personnel. In sum, the issues to be resolved are material and have not been critically reviewed in the context of the U.S. economy for almost two decades. *See, e.g.*, AM. BAR ASS'N SECTION OF TAX'N, TAX SYSTEMS TASK FORCE, A COMPREHENSIVE ANALYSIS OF CURRENT CONSUMPTION TAX PROPOSALS (1997) (considering issues raised by proposals to substitute a consumption tax for the income tax); J. Clifton Fleming, Jr., *Scoping Out the Uncertain Simplification (Complication?) Effects of VATs, BATs and Consumed Income Taxes*, 2 FLA. TAX REV. 390 (1995) (questioning the simplicity of consumption tax regimes); Stephen E. Shay & Victoria P. Summers, *Selected International Aspects of Fundamental Tax Reform Proposals*, 51 U. MIAMI L. REV. 1029 (1997) (reviewing international design and coordination issues of substituting consumption taxation for income taxation). For a symposium issue on consumption taxation, see the articles in volume 63, issue number 2, of the Tax Law Review. This review issue is summarized in Reuven Avi-Yonah, *Summary and Recommendations*, 63 TAX L. REV. 285 (2010). For a discussion of the practical problems of implementing a consumption tax, see Michael J. Graetz, *Implementing a Progressive Consumption Tax*, 92 HARV. LAW REV. 1575 (1979). For a practically-focused proposal to impose a consumption tax on the wealthy, see Victor Thuronyi, *Progressive Corporate Tax Reform*, 130 TAX NOTES 1303 (Mar. 14, 2011) (advancing a supplemental expenditure tax or SET). There could be advantages to using additional tax instruments in achieving objectives that are in tension. *See* David Gamage, *How Should Governments Promote Distributive Justice?: A Framework for Analyzing the Optimal Choice of Tax Instruments*, 68 TAX L. REV. 1 (2014) (favoring choice of multiple tax instruments to achieve revenue and distributive justice objectives). In addition, there have been well-promoted proposals to add a federal consumption tax as a supplement to the federal income tax to provide revenue to relieve some of the pressure on the income and payroll taxes and to reduce the numbers of persons needing to file a tax return. *See* MICHAEL J. GRAETZ, 100 MILLION UNNECESSARY RETURNS: A SIMPLE, FAIR, AND COMPETITIVE TAX PLAN FOR THE UNITED STATES (2008). In our judgment, given current U.S. political realities, adding an additional federal tax instrument is not likely in the reasonably foreseeable future.

22. *See* DANIEL N. SHAVIRO, FIXING U.S. INTERNATIONAL TAX 20–21 (2014). Taxing worldwide income of U.S. citizens and residents has been upheld by the Supreme Court since the earliest days of the income tax. *See* *Cook v. Tait*, 265 U.S. 47 (1924).

indeed the case. U.S. residents are reported to own well over three-fourths of the aggregate value of firms traded on U.S. stock markets.<sup>23</sup>

In terms of economic realities, there is little reason to differentiate between foreign income earned directly by a domestic C corporation and that earned through its foreign subsidiary.<sup>24</sup> Nevertheless, the U.S. corporate tax only applies to a foreign corporation to the extent it earns (1) business income connected (or treated as connected) with the conduct of a U.S. business, and (2) limited categories of U.S.-source nonbusiness income.<sup>25</sup> Even in the case of foreign corporations that are wholly owned by U.S. residents, the United States does not tax a foreign corporation directly on its foreign income.<sup>26</sup> Under accepted international practice, it is possible to tax indirectly foreign income of a foreign corporation that is controlled by a domestic corporation by treating the income as though it were distributed to the domestic corporation, but this is done only to a limited extent under the current U.S. CFC rules.<sup>27</sup> Nonetheless, the normative basis to tax foreign income is clear,

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23. At the end of the third quarter of 2014, about 16 percent of the equity in U.S. corporations was owned by foreign residents. This percentage is derived from BOARD OF GOVERNORS OF THE FEDERAL RESERVE SYSTEM, FINANCIAL ACCOUNTS GUIDE, TABLE L. 213 CORP. EQUITIES, <http://www.federalreserve.gov/releases/z1/current/z1r-4.pdf>. Professor Sanchirico has questioned the ability to identify beneficial ownership of equities as a result of limitations in existing data sources and disclosures. See Chris William Sanchirico, *As American as Apple Inc.: International Tax and Ownership Nationality*, 68 TAX L. REV. 207 (2015). The issues Professor Sanchirico raises are important and the exact percentage of U.S. beneficial ownership of U.S. equities in fact is unclear. Moreover, even in the Federal Reserve data U.S. ownership has been trending slowly downward in recent years, though it remains to be seen whether this will continue. Based on the data available, however, it nonetheless is likely that U.S. residents own a high percentage of shares in U.S. corporations.

24. U.S. parent MNCs report their income for financial statement purposes on a worldwide consolidated basis and investors value their stock in such MNCs taking into account the global ability of the group to generate cash flows for the benefit of shareholders. See generally TIM KOLLER, MARC GOEDHART & DAVID WESSELS, VALUATION: MEASURING AND MANAGING THE VALUE OF COMPANIES (5th ed. 2010). Jack Cummings has concluded that a CFC could be consolidated with a U.S. parent and its active foreign income included in a U.S. consolidated return consistent with the U.S. Constitution. Jasper L. Cummings, *Consolidating Foreign Affiliates*, 11 FLA. TAX REV. 143, 198–206 (2011).

25. See I.R.C. §§ 881, 882, 864(c).

26. See, e.g., *Moline Properties v. Commissioner*, 319 U.S. 436 (1943) (holding that a corporation is treated as a separate taxable entity if it is formed for a business purpose or it carries on any business activity. However, this holding was based on the Court's interpretation of the income tax statute rather than the Constitution or international law. Thus, there is no legal obstacle to modifying *Moline Properties* by congressional action or under statutorily delegated authority).

27. See *infra* note 60 (describing the limited scope and effectiveness of the current subpart F rules).

as is the jurisdictional ability to do so in relation to a multinational group controlled by a domestic C corporation (a U.S. MNC). Thus, a decision to exempt foreign business income in this situation is primarily driven by choice, rather than by any norm or jurisdictional limitation.

Full current taxation of worldwide income at the same rate as domestic income and exemption of foreign business income are the two ends of a spectrum. The various minimum tax proposals are second-best solutions that lie within this spectrum. The spectrum, however, is not linear. A key decision point on this spectrum is whether to bolster the weak base protection role of deferred U.S. taxation by imposing an interim minimum tax, or whether to further favor foreign income by relinquishing U.S. taxation of foreign income that meets a minimum tax threshold. This design decision has normative and practical implications.

In the next section, we address the competitiveness rationale for favoring foreign income and find that rationale wanting in both normative and empirical support.

## 2. *U.S. International Competitiveness*

Although competitiveness is referred to frequently in international tax policy discussions as a reason for giving preferential U.S. tax treatment to foreign-source income, it rarely is defined. We start the search for a definition with the premise that Americans seek a standard of living that allows them to lead a fulfilling life. The role of government is to assist in achieving this objective by providing public goods that lead to high-wage jobs, innovation, and productive investment, and that support income security for those in need and personal security from domestic and international threats. Competitiveness, however defined, should support these objectives.

Eric Toder observes that economic theory does not support a view that economic relations among countries is a zero-sum game like that among sports teams or even companies.<sup>28</sup> He looks at competitiveness in terms of competition for inputs, such as labor or capital, or for tax revenue. This is still one step removed from the objectives described above, but can lead to those objectives.

Advocates of preferential treatment for foreign-source income use a notion of competitiveness that is narrower and only tangentially related to the overall U.S. policy objectives referred to above. Their version of competitiveness typically refers to a comparison of the tax burden borne by residents of different countries for the same investment in a given (foreign) location. To be more specific, competitiveness comparisons generally focus

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28. Eric Toder, *International Competitiveness: Who Competes Against Whom and for What?* 65 TAX L. REV. 505, 507–08 (2012).

on the U.S. residual tax that would be imposed on a U.S. MNC's foreign income.<sup>29</sup> The argument is that with regard to investments in low-tax countries, U.S. MNCs are disadvantaged by the deferred U.S. residual tax under current law compared with MNCs from countries with territorial or exemption systems. Among other defects, this limited analysis would be an incomplete basis on which to compare taxation of foreign MNC groups, as it disregards taxation of the foreign MNC's home country income, as well as shareholders' income from investment in the MNC.

Kim Clausing observes that a concept of competitiveness revolving around MNC taxation is quite restricted:

One should take a moment to note that “competitiveness” is an inherently ill-defined concept. Here, the term is being used to capture only a very narrow aspect of competitiveness, the corporate tax facet of the overall ability of a multinational firm to compete in foreign markets. Of course, there are many other variables that affect a firm's ability to compete, including, but not limited to, the exchange rate, the firm's financial constraints, and the unique organization and internalization advantages of particular firms. In addition, the attractiveness of a particular country as a location for production depends on much else aside from their corporate tax environment: their market size, infrastructure, government services, legal institutions, regulation, labor productivity, labor costs, geography, and other factors. Indeed, these other aspects of a country's (or a firm's) competitiveness may be far more important for national welfare than the tax facet of multinational firm competition.<sup>30</sup>

Moreover, although U.S. MNCs play an important role in the U.S. and global economy, it does not make sense to equate the competitiveness of the United States as a country with the competitiveness of U.S. versus non-U.S. MNCs in foreign markets.

Nonetheless, some argue that a U.S. MNC's foreign income should not be taxed (whether or not a foreign tax credit is granted) because it will

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29. See Kimberly Clausing, *Beyond Territorial and Worldwide Systems of International Taxation*, at 17–20 (Feb. 2015), [http://papers.ssrn.com/sol3/papers.cfm?abstract\\_id=2567952](http://papers.ssrn.com/sol3/papers.cfm?abstract_id=2567952) (last viewed June 17, 2015); [hereinafter Clausing, *Beyond Territorial and Worldwide*]; see also Michael S. Knoll, *The Connection between Competitiveness and International Taxation* 65 TAX L. REV. 349 (2012) (reviewing different conceptions of competitiveness including MNC and national competition for capital).

30. Clausing, *Beyond Territorial and Worldwide*, supra note 29, at 18.

disadvantage U.S. MNCs in relation to foreign-parent MNCs (foreign MNCs) whose foreign income is beyond U.S. taxing reach. The argument is made that U.S. MNCs' foreign investments provide special benefits to the United States that would not be achieved if the U.S. MNCs' foreign income were taxed by the United States. The economic literature is at bottom inconclusive as to the extent to which the U.S. economy benefits from foreign investments of U.S. MNCs, though strong views are held by economists on both sides of the issue.<sup>31</sup> As would be expected, there is reason to believe that the answer is contextual and differs by industry and nature of the business.<sup>32</sup>

As discussed at Part III.A, below, pending a more definitive resolution of the empirical debate, there is little firm-level evidence that U.S. MNCs are disadvantaged in fact under current law by reason of U.S. taxes on foreign business income.<sup>33</sup> We do not see either a normative or an empirical basis to reform current law to reduce the present level of U.S. taxation of foreign business income. Indeed, under recent reform proposals, there would be

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31. See, e.g., Mihir A. Desai & James R. Hines Jr., *Old Rules and New Realities: Corporate Tax Policy in a Global Setting*, 57 NAT'L TAX J. 937 (2004); Harry Grubert, *Comment on Desai and Hines, Old Rules and New Realities: Corporate Tax Policy in a Global Setting*, 58 NAT'L TAX J. 263 (2005); Mihir A. Desai & James R. Hines Jr., *Reply to Grubert*, 58 NAT'L TAX J. 275 (2005).

32. See THE PRESIDENT'S ECONOMIC RECOVERY ADVISORY BOARD, THE REPORT ON TAX REFORM OPTIONS: SIMPLIFICATION, COMPLIANCE, AND CORPORATE TAXATION 85–86 (Aug. 2010) (reviewing arguments whether foreign investment complements or substitutes for domestic investment).

33. See *infra* text accompanying notes 46–50; see also J. Clifton Fleming, Jr., Robert J. Peroni & Stephen E. Shay, *Worse than Exemption*, 59 EMORY L.J. 79, 85 (2009) [hereinafter Fleming, Peroni & Shay, *Worse Than Exemption*] (combination of deferral, defective source rules, foreign tax credits, weak transfer pricing, and current use of branch losses give U.S. MNCs a net tax advantage over exemption country competitors); Edward D. Kleinbard, “*Competitiveness*” *Has Nothing to Do With It*, 144 TAX NOTES 1055 (Sept. 1, 2014) [hereinafter Kleinbard, *Competitiveness*]. The position of U.S. MNCs in relation to foreign income is distinct from the clear advantages under current law of being a non-U.S. MNC in relation to U.S. business income and being able to strip the U.S. tax base using deductible payments and also avoid the restrictions on using foreign earnings in a U.S. business without first incurring a residual U.S. tax. See Fleming, Peroni & Shay, *Cross-Border Earnings Stripping*, *supra* note 12. These have been among the reasons why U.S. MNCs have sought to shift their corporate residence outside the United States. See Stephen E. Shay, *Mr. Secretary, Take the Tax Juice Out of Corporate Expatriations*, 144 TAX NOTES 473, 479 (July 28, 2014) [hereinafter Shay, *Mr. Secretary*]; U.S. DEP'T OF THE TREAS., REPORT TO THE CONGRESS ON EARNINGS STRIPPING, TRANSFER PRICING AND U.S. INCOME TAX TREATIES 21–22 (Nov. 2007) [hereinafter U.S. TREAS. DEP'T, EARNINGS STRIPPING]; Willard B. Taylor, Letter to the Editor, *A Comment on Eric Solomon's Article on Corporate Inversions*, 137 TAX NOTES 105, 105 (Oct. 1, 2012).



increased taxation of foreign income for many U.S. MNCs compared with current law.<sup>34</sup>

Under current law, and under any of the reforms to taxing foreign income under current consideration, U.S. MNCs will face a nominally higher global tax burden than foreign MNCs with the same business and having the same geographic footprint. For this reason, we support taking steps to redress the current-law advantage in taxation of U.S. income accorded to foreign MNCs.<sup>35</sup> Moreover, even if these changes were made, under any of the current reforms, there would continue to be pressure on U.S. MNC parent corporations to shift from U.S. to non-U.S. tax residence. Addressing this issue through adjustments to the relevant corporate residence rules would seem to be a more logical approach than to surrender corporate tax base by shifting to a exemption system or other form of territorial or exemption system. Proposals to strengthen U.S. corporate residence rules (and also earnings stripping rules) are discussed in Part V, below.<sup>36</sup>

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34. Both the Obama Administration minimum tax proposal and the Camp dividend exemption proposal would raise revenue during the ten-year budget period from U.S. MNCs. The Administration's minimum tax proposal is estimated by the Treasury to raise \$206 billion over FY 2016–2025, but it would lose \$103 billion from extending the active finance exception to subpart F and other taxpayer-favorable changes, for a net revenue gain of roughly \$103 billion (before taking account of \$268 billion from a one-time tax on pre-effective date earnings). U.S. DEP'T OF THE TREAS., GENERAL EXPLANATIONS OF THE ADMINISTRATION'S FISCAL YEAR 2016 REVENUE PROPOSALS 292 (Table 2) (2015) [hereinafter U.S. TREAS. DEP'T, FY 2016 GENERAL EXPLANATIONS]. The Camp proposal for a 95 percent dividend exemption territorial system was estimated to lose \$212 billion for the period 2014–2023, but its subpart F reforms would raise \$116 billion over the same period, for a net revenue loss of \$96 billion over the period. With \$170 billion of revenue from a one-time tax on pre-effective date earnings, however, the Camp proposal would levy in the budget period an estimated \$68 billion in additional tax on U.S. MNCs (compared with the Administration's roughly \$371 billion of additional tax over the same period). STAFF OF THE J. COMM. ON TAX'N, 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 650–651 (2014). While the Camp proposal likely loses revenue beyond the ten-year budget period, one could argue that these proposals represent a consensus that in the near term U.S. MNCs should pay more tax on foreign income with the only remaining issues being how much more, how the rules for increasing the tax on U.S. MNCs should be designed, and what the increased revenue should be spent on.

35. See Fleming, Peroni & Shay, *Cross-Border Earnings Stripping*, *supra* note 12, at 680–88 (explaining the earnings stripping advantage enjoyed by foreign MNCs that do business in the United States through U.S. subsidiaries).

36. See *infra* text accompanying notes 145–151.

In addition to corporate-level reforms, it is appropriate to reexamine shareholder-level portfolio income taxation. If the objective of strengthening taxation of foreign income ultimately is to protect the U.S. individual tax base, portfolio investments in a foreign corporation should not be advantaged, as often is the case today, over a portfolio investment in a domestic corporation carrying on exactly the same global business. As explained below,<sup>37</sup> today a U.S. individual or tax-exempt portfolio shareholder in a foreign corporation operating in Ireland is more favorably taxed than the shareholder would be when investing in the same business through a domestic corporation. This encourages U.S. individual and tax-exempt ownership of foreign rather than domestic equities and the shifting of corporate tax residence outside the United States. The taxation of dividends and gains from foreign portfolio equity investments should be adjusted under any of the reform proposals and a proposed method for doing such adjustment is discussed in Part V, below.<sup>38</sup>

### 3. *Other Countries' Tax Systems*

Most major U.S. trading partners have adopted some form of territorial system, which exempts most active foreign-source income of their resident MNCs.<sup>39</sup> In practice, however, the difference between U.S. international tax rules and those of major trading partners is not as great as the labels “worldwide” and “territorial” suggest.<sup>40</sup> All existing international tax systems are hybrid systems that, to a greater or lesser extent, tax at reduced effective rates some foreign business income. The United States allows its MNCs to defer tax on most income of foreign subsidiaries until that income is repatriated as a dividend to the U.S. parent company and allows a liberal credit for foreign income taxes paid. And, most countries that exempt dividends from foreign affiliates impose tax on some foreign-source income as accrued in order to protect their domestic corporate tax base. The differences can be important, but they often are in the details.<sup>41</sup>

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37. *See infra* text accompanying notes 151-152.

38. *See infra* text accompanying notes 152-155.

39. Within the past five years, both the United Kingdom and Japan have enacted territorial systems by exempting either all or 95 percent of the dividends their resident MNCs receive from their foreign affiliates. *See* ROSANNE ALTSCHULER, STEPHEN SHAY & ERIC TODER, LESSONS THE UNITED STATES CAN LEARN FROM OTHER COUNTRIES' TERRITORIAL SYSTEMS FOR TAXING INCOME OF MULTINATIONAL CORPORATIONS 1 (Tax Policy Center 2015) [hereinafter ALTSCHULER, SHAY & TODER, LESSONS].

40. *Id.* at 1.

41. *See* MARK P. KEIGHTLY & JEFFREY M. STUPAK, CORPORATE TAX BASE EROSION AND PROFIT SHIFTING (BEPS): AN EXAMINATION OF THE DATA 17 (Cong. Res. Serv. Apr. 30, 2015) (“Among the major economies, no country has either a pure

One of us, with different co-authors, has found in a separate study that the reasons countries adopt their international income tax rules are related to the nature of their economies, their legal culture and context, and the historical development of their tax systems. For example, European Union (EU) member countries today are subject to material constraints on tax system design under EU law that as a practical matter have prevented them from adopting rules to tax foreign business activity other than in cases of “wholly artificial” arrangements or in a manner that is effectively the same as taxation of domestic income.<sup>42</sup> In Japan, a stronger culture of compliance than exists in the United States has significantly affected the design of Japanese international rules.<sup>43</sup> In short, the *sui generis* circumstances of other countries’ adoption of a form of dividend exemption system do not lead to a conclusion that the United States should take the same path.<sup>44</sup> But, even if the reasons other countries have shifted to a dividend exemption system do not pertain to the United States, must the United States nevertheless follow their lead and respond by also shifting to an exemption system? The U.S. economy is sufficiently different from the economies of other countries that it does not appear necessary for the United States to adopt similar rules.<sup>45</sup> Among other material differences is a different mix of taxing instruments on the revenue side that, under current political constraints, require the United States to rely on the income tax, including its corporate tax, to meet budgetary needs. The United States should adopt the international taxing regime that best addresses its overall interests.

As discussed in the next Part of this Article, in a global economy of increasing transactional sophistication and efficiency, it is difficult to protect geographic boundaries in an income tax. We explain why these pressures make it necessary to neither exempt foreign corporate income from tax, nor tax foreign income at a rate that is materially lower than the U.S. corporate rate.

#### D. *The Way Forward*

To recapitulate, the analysis and proposals in the remainder of this Article are based on the premises that (1) the United States will continue to employ a corporate income tax that is only partially integrated with the individual income tax, (2) continuing U.S. deficits mean that the revenue from

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worldwide or territorial system—they are all hybrid systems . . . . Labeling a system as worldwide or territorial without considering where on the ‘spectrum’ it lies is too simplistic and can lead to mislabeling.”)

42. See *Cadbury Schweppes plc and Cadbury Schweppes Overseas Ltd v. Commissioners of Inland Revenue* ECJ, 12 Sep. 2006, C-196/04 (CFC rules may target “wholly artificial arrangements, which do not reflect economic reality”).

43. ALTSHULER, SHAY & TODER, LESSONS, *supra* note 39, at 34–35.

44. *Id.*

45. *Id.* at 35–38.

the corporate income tax cannot be materially reduced, (3) MNCs will continue to dominate cross-border business activity, (4) applying the corporate income tax to foreign-source income is necessary to protect the individual income tax and to uphold the principle of ability to pay, and (5) neither the unduly narrow competitiveness concept commonly used by exemption system advocates nor the proliferation of territorial systems in the world economy means that the United States has lost the power to choose a path that is different from territoriality. These propositions provide the background for the following Parts of this Article.

### III. PROBLEMS OF TAXING BUSINESS INCOME IN A 21<sup>ST</sup> CENTURY GLOBAL ECONOMY

#### A. *Profit Shifting in the Face of Anachronistic Cross-Border Tax Paradigms*

##### 1. *Successful Avoidance of Foreign Taxation*

Existing international tax rules, in the United States and other developed countries, have their origins in the first half of the 20th century, at a time when international trade and commerce were a smaller fraction of the U.S. economy, and international business conducted by MNCs utilized relatively straightforward structures. The reigning cross-border business paradigm that motivated the design of these rules generally assumed that companies manufactured goods in physical plants and sold them to customers in other countries through distributors. Under that paradigm, an MNC evolved from solely exporting to engaging in foreign direct investment (FDI). Typically, the MNC would use a local subsidiary to carry on marketing and distribution in each country in which it had material customers. The implicit assumption underlying the structure of the international tax rules was that the other country taxed its companies in generally the same way and at generally the same effective rates (and if the other country did not, the risk to the domestic fisc was too modest to worry about). This state of the world has changed considerably. Among other changes, cross-border services and development and licensing of intangibles now play a larger role than when international tax norms were originally developed.

A related change is the reduced significance for taxation of legal forms generally, including the classification and treatment of business organizations. U.S. tax rules, like those of most countries, generally treat an entity classified as a foreign corporation the same as a U.S. domestic C corporation, subject to the limitation that the United States does not have the jurisdiction or, in most cases, the ability to impose a corporate tax directly on a foreign corporation's foreign income. In addition, some domestic corporate tax preferences do not

apply to foreign-located assets or activity.<sup>46</sup> In most other respects, U.S. tax rules treat a foreign corporation the same as a domestic corporation in terms of taxing distributions to shareholders, engaging in reorganizations, and so on, with relatively weak adjustments to account for transactions that transfer assets into or out of U.S. taxing jurisdiction.<sup>47</sup>

In the post-World War II period, use of foreign tax haven subsidiaries became more common so the United States bolstered its protection of the U.S. tax base. From 1962, when subpart F was enacted, until 1993, when the section 956A excess passive asset rules were adopted (until their repeal in 1996), the general direction of legislative changes was to strengthen these protections. This included adoption of increasingly specific transfer pricing rules.<sup>48</sup> From 1996 until 2010, however, the United States generally moved in the opposite direction, lessening the taxation of multinational business rather than increasing it. Throughout, a foreign corporation has continued to be treated structurally substantially the same as a domestic corporation.

But foreign corporations do not pay a U.S. corporate tax on foreign income. Moreover, increasingly, the implicit premise that a CFC pays a foreign corporate income tax comparable to a U.S. corporate tax is not just wrong, but very wrong, for most CFC earnings. Tax return data from year 2006 Form 5471s for CFCs discloses that 45.9 percent of earnings of CFCs that reported positive income, at least some of which was foreign, were taxed at a foreign effective rate of less than 10 percent.<sup>49</sup> Furthermore, less than one-fourth of CFC income was taxed at a foreign effective rate of 30 percent or more.<sup>50</sup>

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46. See, e.g., I.R.C. § 168(g)(1)(A) (requiring use of slower alternative depreciation system for tangible property used predominantly outside the United States).

47. See I.R.C. § 367.

48. See, e.g., Michael C. Durst & Robert E. Culbertson, *Clearing Away the Sand: Retrospective Methods and Prospective Documentation in Transfer Pricing Today*, 57 TAX L. REV. 37 (2003); Stanley I. Langbein, *Cognitive Capture, Parliamentary Parentheses, and the Rise of Fractional Apportionment*, 39 TAX MGM'T INT'L J. 567, 569–570 (2010).

49. Harry Grubert & Rosanne Altshuler, *Fixing the System: An Analysis of Alternative Proposals for the Reform of International Tax*, 66 NAT'L TAX J. 671, 699 (Table 3) (2013) [hereinafter Grubert & Altshuler, *Fixing the System*]. More than half (i.e., 53.9 percent) of these CFCs' income was taxed at a foreign effective rate of 15 percent or less. *Id.*

50. *Id.*

Aggregate and firm-level financial data evidence substantial U.S. base erosion under current law.<sup>51</sup> Harry Grubert's review of Treasury corporate tax files from a panel of 754 large MNCs showed the foreign income share increasing by 14 percentage points between 1996 and 2004, with the shift being related to the differential between the U.S. and foreign effective tax rates. At the same time, lower foreign effective tax rates did not translate into higher domestic sales or growth in pre-tax profits.<sup>52</sup>

Another change is the aggressiveness with which MNCs, not just from the United States, pursue profit shifting and base eroding tax minimization strategies. As one firm-level example, the Staff of the Senate Permanent Subcommittee on Investigations found that Microsoft had transferred rights to software developed in the United States to a subsidiary operating in Puerto Rico so that the software could be "transformed"<sup>53</sup> and digital and physical copies made for sale to customers in the United States. Essentially, cost sharing permitted the Puerto Rican operation to retain 47 percent of the operating profit on the U.S. sales. In fiscal year 2011, Microsoft's Puerto Rican subsidiary, with 177 employees (whose compensation averaged \$44,000), booked \$4 billion of operating income under the arrangement for financial statement purposes and paid 1.02 percent in tax (after paying \$1.9 billion in cost sharing payments).<sup>54</sup> This income shifting from the United States is invited under the current U.S.-source taxation, transfer pricing, and subpart F rules.

The Microsoft example involves what is sometimes referred to pejoratively as "round tripping." That is, both significant productive activity and the customer are in the United States, but the process is structured so that at a key point the product or service is sold from outside the United States by a CFC into the United States. The resulting profit from the sale is claimed to be non-subpart F income earned outside of the United States. Round tripping has been the target of political attention because it is the most visible form of

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51. See Harry Grubert, *Foreign Taxes and the Growing Share of U.S. Multinational Company Income Abroad: Profits, Not Sales, Are Being Globalized*, 65 NAT'L TAX J. 247 (2012) [hereinafter Grubert, *Foreign Taxes*].

52. *Id.*

53. Income from sales of "transformed" property is not foreign base company sales income or any other category of subpart F income. See Reg. § 1.954-3(a)(4); I.R.C. § 952(a).

54. See U.S. SENATE PERMANENT SUBCOMM. ON INVESTIGATIONS OF THE COMM. ON HOMELAND SEC. AND GOV'T AFFAIRS, HEARING ON OFFSHORE PROFIT SHIFTING AND THE U.S. TAX CODE, Exhibit 1, Memorandum from Chairman Carl Levin and Senator Tom Coburn to Subcommittee Members, *Offshore Profit Shifting and the Internal Revenue Code*, 20–22 (Sept. 20, 2012) [hereinafter Levin & Coburn, *Memorandum on Microsoft and HP*], <http://www.hsgac.senate.gov/subcommittees/investigations/hearings/offshore-profit-shifting-and-the-us-tax-code>.

income shifting from the United States. This had led some to claim that because transfer pricing rules require arm's-length prices, income shifting from U.S. parent corporations to their CFCs does not occur and only U.S. sales by foreign subsidiaries should be the target of CFC rules.<sup>55</sup> This claim is refuted by the evidence of substantial income shifting from the United States that is unlikely to be explained solely by round tripping.<sup>56</sup> Moreover, this argument assumes the legitimacy of the systemic anomaly that imposes a current U.S. tax on all business income of U.S. MNCs except when the income is earned through a CFC. As explained in our earlier work, this anomaly is unjustifiable and creates substantial openings for profit shifting.<sup>57</sup>

## 2. Ubiquitous Intermediary Structures

As noted earlier, existing international tax rules were developed at a time when international business of MNCs was dominated by a manufacturer-distributor-customer paradigm in which the involved countries imposed similar levels of tax. Today, however, there is widespread use of intermediary legal entities that do not bear a meaningful corporate tax because they are located in countries that do not tax income or that facilitate very low effective tax rates on the income.<sup>58</sup> Locations friendly to such intermediary entities

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55. Indeed, Apple CEO Tim Cook cloaked Apple's massive income shifting to Ireland with the claim that no Irish income was from sales to the United States as though that meant the United States should have not have any claim to the income booked in Ireland. But Cook also testified that substantially all of Apple's innovative activity was in the United States. *See* TESTIMONY OF TIMOTHY D. COOK, CHIEF EXECUTIVE OFFICER, APPLE, INC., BEFORE THE U.S. SENATE PERMANENT SUBCOMM. ON INVESTIGATIONS OF THE COMM. ON HOMELAND SECURITY AND GOV'T AFFAIRS, HEARING ON OFFSHORE PROFIT SHIFTING AND THE U.S. TAX CODE – PART 2 (APPLE INC.) (May 21, 2013), [http://www.hsgac.senate.gov/subcommittees/investigations/hearings/offshore-profit-shifting-and-the-us-tax-code\\_-part-2](http://www.hsgac.senate.gov/subcommittees/investigations/hearings/offshore-profit-shifting-and-the-us-tax-code_-part-2). Apple presumably was taking the position that none of the return from Apple's non-U.S. sales should be attributed to the United States as a result of Apple's longstanding cost sharing arrangement.

56. *See* Grubert, *Foreign Taxes*, *supra* note 51.

57. *See* Shay, Fleming & Peroni, *Territoriality in Search of Principles*, *supra* note 1, at 197.

58. *See, e.g.*, STAFF OF THE J. COMM. ON TAX'N, JCX-37-10, PRESENT LAW AND BACKGROUND RELATED TO POSSIBLE INCOME SHIFTING AND TRANSFER PRICING 122–127 (2010) (in each of the six case studies, taxpayers used numerous intermediary legal entities to effect their tax-avoidance strategies); Leslie Wayne, Kelly Carr, Marina Walker Guevara, Mar Cabra & Michael Hudson, *Leaked Documents Expose Global Companies' Secret Tax Deals in Luxembourg*, THE INT'L CONSORTIUM OF INVESTIGATIVE JOURNALISTS (Nov. 5, 2014) [hereinafter Wayne, Carr, Guevara,

include countries that do not tax income (Bermuda, the British Virgin Islands, the Cayman Islands, and the Channel Islands), countries that purport to tax income but do not tax international business income (Cyprus and Malta), countries that allow structures that deliberately under-tax income (Ireland, Luxembourg, Mauritius, the Netherlands, Switzerland, and the United Kingdom), and countries that do not tax income outside the jurisdiction and either allow holidays from tax or impose low tax on domestic income (Hong Kong and Singapore). Intermediary or conduit structures are a manifestation of what Professor Ed Kleinbard refers to as the “distillery” of international tax planning, designed to provide a path for income out of high-tax countries, including the United States, its major trading partners, and developing countries, into enabling countries that, as noted above, are no longer limited to traditional zero-tax havens.<sup>59</sup>

This form of base company structuring once was the target of U.S. CFC rules, but those rules have ceased to be an effective barrier to stripping income from the United States or other countries.<sup>60</sup> They are modestly effective at preventing a CFC’s deferred income from being made available for use in the U.S. business of the U.S. MNC of which the CFC is a member, but “workarounds” exist, including those employing group financing companies, reorganizations inserting debt, and basis recovery transactions.<sup>61</sup>

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Cabra & Hudson, *Tax Deals in Luxembourg*] (Luxembourg tax rulings for U.S. and non-U.S. MNC structures show multiple layers of companies), <http://www.icij.org/project/luxembourg-leaks/leaked-documents-expose-globalcompanies-secret-tax-deals-luxembourg>.

59. Edward D. Kleinbard, *Stateless Income*, 11 FLA. TAX REV. 699, 725 (2011) [hereinafter Kleinbard, *Stateless Income*]; see also Wayne, Carr, Guevara, Cabra & Hudson, *Tax Deals in Luxembourg*, *supra* note 58.

60. We have previously pointed out that the reasons for subpart F’s loss of effectiveness include: “(1) subpart F is based on a country of incorporation paradigm that disregards other bases for corporate tax residency and in most cases does not take appropriate account of branches; (2) elective U.S. entity classification rules, including the ability to elect to disregard foreign legal entities, allow transactions and income between related entities to be eliminated (‘disappear’) for U.S. tax purposes; and (3) successive legislative and regulatory changes have limited subpart F’s scope to the point that it is readily avoided for business income shifted to a base company.” Moreover, examples of legislative, regulatory, and administrative developments further limiting the scope of the anti-deferral rules of subpart F include: “[t]he active finance and active insurance exceptions of § 954(h) and (i), the look-through exception of § 954(c)(6) . . . the reduction in scope for foreign base company services income in Notice 2007-13, 2007-1 C.B. 410, and the contract manufacturing regulations adopted in 2008.” See T.D. 9438, 73 Fed. Reg. 79,344 (Dec. 29, 2008). Shay, Fleming & Peroni, *Territoriality in Search of Principles*, *supra* note 1, at 185–86, n. 63.

61. See Stephen E. Shay, *The Truthiness of “Lockout:” A Review of What We Know*, 146 TAX NOTES 1493 (Mar. 16, 2015) [hereinafter Shay, *Truthiness of*



If deferral is retained in part, straightforward changes to current law that are described below would substantially curb these workarounds.

Some would argue that U.S. MNCs, when compared with non-U.S. MNCs, are tax disadvantaged by the current law combination of deferral and CFC rules. In fact, there is little credible evidence that U.S. multinationals are tax disadvantaged.<sup>62</sup>

### B. *The Intersection of Source and Residence Taxation*

An important systemic reason to impose residence taxation of foreign income earned through a CFC lies in the general inability of income tax systems to police source-based taxation. This is because source taxation is based on income categorization, income source, and transfer pricing rules, which can be, and regularly are, manipulated through contractual arrangements. Absent meaningful CFC rules, an MNC is able to take advantage of these systemic weaknesses to avoid source taxation, including by the MNC parent's home country, of income earned by the MNC's foreign subsidiaries. The example above describing how Microsoft's Puerto Rico affiliate shifts income from the United States is paradigmatic. The following subsections of this Article explore this point in more detail.

#### 1. *Difficult Margins: Income Character, Income Source, and Transfer Pricing*

The international tax rules are based on a series of questionable assumptions:

- a country can identify income by legal category (i.e., as sales, royalty, or services) and assign it a source so that the country can tax the income attributable to economic activity in that country and appropriately

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*Lockout*]; Levin & Coburn, *Memorandum on Microsoft and HP*, *supra* note 54, at 24–27 (discussing HP use of staggered short-term loans from financing company). Note that these largely are timing transactions. Analytically, under the usual assumptions, including constant tax rates, deferral of earnings that are subject to eventual taxation generally results in a heavier tax burden than does exemption, also assuming that eventually earnings must be repatriated. Financial accounting's indefinite reinvestment rule and previous relaxations of U.S. residual taxation of offshore earnings, however, appears to materially blunt the effect of this difference between deferral and exemption. See *infra* text accompanying notes 91–96. A clear governmental commitment not to provide relief for old earnings, if one could be credible, would change the current repatriation calculus.

62. See Fleming, Peroni & Shay, *Worse than Exemption*, *supra* note 33, at 85; Kleinbard, *Competitiveness*, *supra* note 33.

- avoid double taxation of income earned in another country;
- the geographical source of income assigned to a particular legal category of income is robust in the first instance, and it is possible to protect against manipulation of the income category rules so that the assigned source is always appropriate; and
  - transfer prices among members of a global group can be effectively regulated using an arm's-length standard so that a country not only can identify income attributable to that country, but also determine the appropriate amount of the income as well.

As discussed in succeeding paragraphs below, these assumptions are either weak or wrong. The evidence is that there is very substantial income shifting, and some shifting of real investment, because taxpayers take advantage of weaknesses in rules that rely too heavily on these questionable assumptions.

*a. Source of Income*

International tax discussions are framed in terms of source and residence, or in the functionally equivalent nomenclature of host and home countries. The source-host country is where the income originates; the residence-home country is where the owner resides. An underlying reason for the difficulty in identifying whether income has a source in one country or another is that the source of a person's income is not well-grounded in economics. The core economic disciplines of microeconomics and macroeconomics do not associate income directly with a geographic location.<sup>63</sup> Net income from a transaction may be based on value added in multiple places and, for taxation purposes, the net income of a person involves combining value from multiple transactions. The geographic assignment of income is fundamentally instrumental, not intrinsic, in the sense that income should first be assigned to a particular country on the basis of all relevant facts and circumstances as well as the purposes of the applicable taxing rule. Only then should a country be labeled the "source" of income. Deductions should

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63. See Hugh J. Ault & David F. Bradford, *Taxing International Income: An Analysis of the U.S. System and Its Economic Premises*, in TAXATION IN THE GLOBAL ECONOMY 11, 12–16 (Assaf Razin & Joel Slemrod eds., 1990). See generally Stephen E. Shay, J. Clifton Fleming, Jr. & Robert J. Peroni, *The David R. Tillinghast Lecture: "What's Source Got to Do with It?"—Source Rules and International Taxation*, 56 TAX L. REV. 81 (2002).

be associated with the income they generate to arrive at taxable net income.

The U.S. approach generally is to assign income to a source according to the classification of income to one of several legal categories.<sup>64</sup> For example, interest income generally is sourced to the residence of the debtor.<sup>65</sup> The source of income from sales of tangible inventory property generally is based on where legal title to the good is passed.<sup>66</sup> Income from the manufacture and sale of a tangible inventory good generally is sourced 50 percent according to the place of manufacture and 50 percent to where legal title to the good is passed.<sup>67</sup> Services are sourced according to where the services are performed.<sup>68</sup> Rents are sourced according to where tangible leased property is used, and royalties are sourced according to where legal protection is afforded intangible property.<sup>69</sup>

A quick consideration of these most basic of the U.S.-source rules shows that they are arbitrary, readily subject to manipulation, and untied to a unifying principle. For example, is the services income a U.S. law professor earns from teaching a class in France with materials prepared and developed in years of teaching in the United States really all value added in France merely because that is the final step in the provision of the services? Does the place where legal title to a good passes have any meaningful relation to where

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64. See I.R.C. §§ 861, 862, 863, 865. If income is not described in one of these categories or in one of the specialized statutory source rules for particular types of income (e.g., international transportation income or international communications income), the source of income is determined by reference to the category that appears most analogous to the income in question. See, e.g., *Bank of America v. United States*, 680 F.2d 142 (Ct. Cl. 1982) (acceptance and confirmation commissions both analogized to interest income and sourced under the residence-of-the-debtor interest income statutory source rule; negotiation commissions analogized to service income and sourced under the place-of-performance personal service income statutory source rule); Rev. Rul. 69-108, 1969-1 C.B. 192 (alimony obligation analogized to a debt obligation and, consequently, alimony income sourced under the residence-of-the-payor-debtor interest income source rule). See generally CHARLES H. GUSTAFSON, ROBERT J. PERONI & RICHARD CRAWFORD PUGH, *TAXATION OF INTERNATIONAL TRANSACTIONS* 117–28 (4th ed. 2011); [hereinafter GUSTAFSON, PERONI & PUGH, *INTERNATIONAL TRANSACTIONS*] (discussing nonstatutory source rules developed under the Treasury regulations, court decisions, and revenue rulings).

65. See I.R.C. §§ 861(a)(1), 862(a)(1).

66. See I.R.C. §§ 865(b), 861(a)(6), 862(a)(6); Reg. § 1.861-7(c). But see I.R.C. § 865(e)(2) (source of income from sales by a nonresident attributable to a U.S. office not determined under title passage rule: however, a U.S. office is readily avoidable under the rules of I.R.C. § 864(c)(5) and Reg. § 1.864-7).

67. See I.R.C. § 863(b); Reg. § 1.863-3.

68. See I.R.C. §§ 861(a)(3), 862(a)(3).

69. See I.R.C. §§ 861(a)(4), 862(a)(4); Rev. Rul. 68-443, 1968-2 C.B. 304 (discussing the place-of-legal-protection source rule for royalties).

economic value is added to the good? The obvious negative answers to these questions show that the U.S. geographic source rules for income are arbitrary and unrealistic. As explained in the next subsection, the arbitrariness is worsened to the extent that income is classified according to legal categories that result in different tax treatment for items that can be economic substitutes.

*b. Income Categories for Tax Purposes*

For tax purposes, receipts are classified according to legal category, i.e., as sales, services, or royalty income, to determine the amount as well as source of gross income. For example, gross income from sales of goods is determined by subtracting cost of goods sold from gross sales receipts.<sup>70</sup> In contrast, gross income from services and royalties is equal to the associated gross receipts without any reduction for the cost of inputs. Instead, related expenditures are allowed as trade or business deductions if they satisfy the requirements of the governing statutory provisions.<sup>71</sup> The lines between sales, services, and royalty income, however, often are blurry, and determining which category income falls within is often a matter of taxpayer choice.

For example, income from the sale of property that is benefited by an intangible is classified as sales income. Income from licensing an intangible, however, is classified as royalty income. If a taxpayer selling property that is benefited by an intangible (e.g., a patent, copyright, or trademark) charges a separate arm's-length royalty for the right to use the intangible, the taxpayer will realize both sales and royalty income. However, a taxpayer need not separately charge a royalty for the license, but may grant a royalty-free license and earn an arm's-length return as sales income (increased in amount to compensate the taxpayer for the licensed intangible).<sup>72</sup>

A taxpayer selling a service that benefits from an intangible also can embed the return to the intangible in the (arm's-length) price of the service or unbundle the sale of the service from the intangible transfer and charge a separate (arm's-length) royalty for the intangible right and a commensurately reduced price for the service. Similarly, in a range of circumstances, fees for services may be charged separately, or may be embedded in the price of a good. Warranty services are an example. Manufacturing can be structured to constitute a service. While these legal categories of income are fundamental

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70. See Reg. 1.61-3(a).

71. See, e.g., I.R.C. §§ 162, 174.

72. For subpart F purposes, if the character of the income or gain is not separately determinable, such as the return to an embedded intangible, the income or gain is characterized according to the predominant character of the transaction. See Reg. § 1.954-1(e)(3).

in assigning income a geographic source, they are readily substitutable. This is especially true for transactions within multinational groups.<sup>73</sup>

The legal characterization of income by category cannot sustain the pressure resulting from substantial differences in taxation of the different categories. Taxpayer electivity is the unavoidable outcome. Therefore, as a matter of tax system design, it is unwise to make the application of materially different tax results turn on categorization of income. The preceding examples show that current law creates substantial opportunities to elect the classification of income and the attendant tax treatment. Elections, whether formal or de facto, are one-way ratchets that almost always operate to the detriment of the fisc.

*c. Transfer Pricing*

A third “weak” margin is pricing in transactions between related parties.<sup>74</sup> There are multiple sources of difficulty in related party transfer pricing, including a lack of market comparable transactions for many intra-group dealings. Even where there are comparable forms of market transactions, under current rules and practice, taxpayers are allowed great freedom to contractually allocate risk (and returns allegedly based on risk taking) even though risk allocation within a commonly controlled group has little or no economic substance. This in essence allows a controlling taxpayer to shift income according to how it writes a purely internal contract over which it has complete control. A related research and development provider, manufacturer, or distributor may be made subject to all the risk of engaging in an activity and so earn a full return, or its risk may be limited (e.g., to that of a contract researcher, contract manufacturer, or just-in-time strip distributor) and earn a modest mark-up over costs or other similarly limited return. The choice is largely elective on the part of the controlling taxpayer.

It is possible, then, to locate an activity in a jurisdiction and attribute more or less income to that activity according to how the contractual

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73. For an example of how the categorization of income can be manipulated, see Shay, Fleming & Peroni, *Territoriality in Search of Principles*, *supra* note 1, at 187-88.

74. See SHAVIRO, *supra* note 22, at 20, 39-43, 45-47 (observing the weaknesses of transfer pricing rules). *But see* Bret Wells & Cym Lowell, *Tax Base Erosion: Reformation of Section 482’s Arm’s Length Standard*, 15 FLA. TAX REV. 737 (2014) (arguing that transfer pricing deficiencies can be explained by reliance on one-sided transfer pricing methods (i.e., traditional arm’s-length methods) that use separate accounting methods; also arguing that two-sided transfer pricing methodologies that look to the combined income and utilize a substantive functional analysis (i.e., profit split and residual profit split methods) do not deserve this same criticism and can better protect against the homeless income phenomenon).

arrangements are structured. Thus, a business operation in a low-tax country, such as Ireland, will be structured to earn a full return. Arrangements with such an operation in Germany or Japan, however, will be structured to earn a low-risk return with the “risk” retained by a “principal” in a low-tax country. Indeed, even Ireland is base stripped, in its case willingly, so that income ends up in even lower-tax countries, or in no country at all.<sup>75</sup>

## 2. *CFC Rules Protect a Residence Country’s Source Taxation Interests*

Because of treatment of CFCs as separate taxpayers and weaknesses in the source and transfer pricing rules, a U.S. MNC can set up in a low-tax country and earn foreign-source income that is attributable to value added in the United States. The Microsoft case is an illustration of rules permitting Microsoft Puerto Rico to strip substantial income from the United States to Puerto Rico.<sup>76</sup> While CFC rules are a second-best solution to the problem of weak source taxation of U.S. income (as well as to defending U.S. residence taxation of foreign income), a robust CFC regime that applies broadly to low-taxed foreign income would materially restrict the use of CFCs like Microsoft Puerto Rico to erode the U.S. corporate tax base.<sup>77</sup> The need to protect U.S.

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75. At a hearing involving Apple, Inc., it was disclosed that certain of Apple’s nonresident Irish subsidiaries took the position that these companies were not tax residents anywhere. *See* U.S. SENATE PERMANENT SUBCOMM. ON INVESTIGATIONS OF THE COMM. ON HOMELAND SEC. AND GOV’T AFFAIRS, HEARING ON OFFSHORE PROFIT SHIFTING AND THE U.S. TAX CODE – PART 2 (APPLE INC.), Exhibits: Excerpt from July 6, 2012 information supplied by Apple to the Permanent Subcommittee on Investigations, APL-PSI-000100 (reporting Apple Operations Ireland’s “location for tax purposes” as “-”). Income not attributable to Ireland would be untaxed, so the effective rate on Apple’s Irish income in these companies was under 2 percent. U.S. SENATE PERMANENT SUBCOMM. ON INVESTIGATIONS OF THE COMM. ON HOMELAND SEC. AND GOV’T AFFAIRS, HEARING ON OFFSHORE PROFIT SHIFTING AND THE U.S. TAX CODE – PART 2 (APPLE INC.), Memorandum from Chairman Carl Levin and Senator John McCain to Subcommittee Members, *Offshore Profit Shifting and the Internal Revenue Code – Part 2 (Apple Inc.)*, 25–31 (May 21, 2013); *see also* Kleinbard, *Stateless Income*, *supra* note 59; 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*].

76. *See supra* text accompanying notes 53–54. For a critique for how § 367(d) can be elicited to counter-act the Microsoft, Apple, and other intellectual property migration 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).

77. Indeed, this appears to have been the case in relation to CFC insurance companies earning income from the United States. The Obama Administration

taxation at source has been highlighted by the inversion controversy but, as we have pointed out in other work, is not limited to U.S. companies that expatriate.<sup>78</sup> In order to prevent advantages going to foreign MNCs, it is necessary to strengthen U.S.-source taxation of income earned on behalf of foreign parent companies. Commentators have only started to address source base protection issues, which are a critical part of any effective U.S. international tax reform.<sup>79</sup>

### 3. CFC rules and BEPS—Coordinating Source and Residence Taxation

As discussed above, CFC rules historically have been designed to be unilateral. Nonetheless, the OECD BEPS project includes an action item that would encourage countries to adopt or strengthen CFC rules. If this action is taken by other countries, which remains an open question, it would reduce the asserted disadvantage to U.S. MNCs of application of U.S. CFC rules.

The OECD BEPS project has proposed rules for protecting source taxation from hybrid instrument and hybrid entity planning by having the source country take into account whether a deductible payment is taxed in the beneficial owner's residence country and, in order to avoid double nontaxation, deny the deduction if it were not so taxed. The OECD hybrid proposal recommends CFC income inclusion in the event that the source country does not deny the deduction because the income is not taxed at the level of the intermediary CFC. This highlights the relationship between residence and source taxation, and it is also relevant to the United States in its role as a source country.

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proposal to tax excess reinsurance income would redress the advantage offered to foreign insurers as a result of weak source taxation of the income. With respect to Puerto Rico, the Commonwealth is arguing that Puerto Rico's difficult fiscal situation and risk of debt defaults is a reason to provide relief from any minimum tax. See Martin A. Sullivan, *Economic Analysis: U.S. Tax Reform and Puerto Rico*, 148 TAX NOTES 22 (July 6, 2015) (observing that unlike repeal of § 936, the minimum tax would affect all foreign investment of U.S. MNCs and suggesting possible wage credit instead of relief from international reform); see also Letter from Senate Finance Committee Chairman Orrin G. Hatch to Secretary of Treasury Jacob J. Lew, July 17, 2015 (asking whether Treasury intends to apply its proposed minimum tax on foreign income to CFCs operating in Puerto Rico the same way it would apply to CFCs operating elsewhere).

78. See Fleming, Peroni & Shay, *Cross-Border Earnings Stripping*, *supra* note 12.

79. See, e.g., Fleming, Peroni & Shay, *Cross-Border Earnings Stripping*, *supra* note 12; Wells & Lowell, *Homeless Income*, *supra* note 75.

In this circumstance, CFC rules operate in relation to the taxation of the CFC by a source country. This is consistent with a minimum tax approach to CFC rules and does not raise difficult issues.<sup>80</sup> Indeed, adoption of a CFC minimum tax rule operates in tandem with the BEPS proposals. The CFC rules play a key structural role in defending erosion of the U.S. corporate tax base and should not be limited to cases where a source country fails to employ a defensive measure, but should have general applicability subject to allowing a credit for appropriate source country taxation.<sup>81</sup>

The effects of globalization increase the need for an income tax, and the need for it to be applied to the broadest base possible with as few effective rate differences as possible. This observation reflects the reality that modern business practices allow large companies to exploit even modest effective tax rate differences. Residence country tax competition may be addressed unilaterally through strengthening CFC rules; however, it is in the interest of the United States to coordinate with and encourage other countries to adopt parallel rules.

#### IV. MODERNIZING CFC RULES

##### A. Objectives for CFC Rules

###### 1. Protect U.S. Tax Base—Limit Incentive for Foreign over U.S. Investment

If the United States imposes tax on the U.S.-source income of both foreign and domestic corporations, whether to protect the individual income tax base, to tax firm-level rents, or for other purposes, the same reasons also

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80. This concept already is found in U.S. tax law. *See* I.R.C. § 267(a)(3)(B)(i); Reg. § 1.267(a)-3(c)(4)(ii).

81. The OECD's BEPS project likely will lead to increased assertions of source taxation claims. *See* OECD, EXPLANATORY STATEMENT, *supra* note 7. Because the standards being proposed move into areas that are heavily fact dependent, there also is an increased likelihood that source taxing jurisdiction will be claimed with respect to income that a residence country may not agree is appropriately treated as within source taxing jurisdiction. A current example of an expansive source taxation claim is the U.K.'s 25 percent tax on diverted profits. There is a question whether this is a creditable tax generally and, even if the tax were creditable, whether the income would be permitted to be taxed by the United Kingdom under the U.S.–U.K. income tax treaty. The OECD's BEPS project also appears to have accepted under-taxation of income through tax competition with patent box incentives that satisfy minimal nexus standards. This should not inoculate the patent box income from the reach of CFC income rules any more than income from any other tax expenditure. There is no requirement in international law, nor is it rational policy, to abide by other countries' efforts to use subsidies and indirect state aid to attract investment at the expense of the residence country.



justify taxing foreign income. Indeed, failure to do so invites avoiding U.S. tax by investing and earning income outside the United States. Thus, the United States taxes even the foreign income of foreign corporations when the foreign earnings are distributed as a dividend to a U.S. resident, and certain undistributed foreign income of a CFC is taxed currently to the CFC's U.S. shareholders under the subpart F rules.

The countervailing consideration that has limited full current U.S. taxation of foreign income earned through a CFC is the argument that U.S. MNCs' CFCs need the benefit of deferral from U.S. taxation of earnings to compete with foreign corporations operating in the same foreign host country, whether these foreign corporations are owned locally in the host country, or by foreign MNCs.

We have expressed doubts about this claim in Part II.C.2, above. Moreover, deferral from U.S. taxation has not been extended to income from foreign businesses, such as that of banks and resource exploration companies, which are operated through a branch of a U.S. corporation. An unincorporated branch of a U.S. corporation is not treated as a separate legal entity for federal income tax purposes, and the income and deductions of the branch are included on the tax return of its U.S. corporate owner. As a result, taxpayers selectively use foreign corporations to carry on foreign business activity where it is feasible and deferral is advantageous<sup>82</sup> and use foreign branches of U.S. corporations for loss operations to obtain the advantage (which generally is a timing benefit) of claiming loss deductions against U.S. income.

The evidence of U.S. revenue loss under the current CFC rules is strong and is exacerbated by permitting elective use of foreign branches and allowing full current deductions for expenditures benefitting deferred income.<sup>83</sup>

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82. See, e.g., GUSTUFSON, PERONI & PUGH, INTERNATIONAL TRANSACTIONS, *supra* note 64, at 302–03. Although our discussion is directed at U.S. MNCs, U.S. investment funds, including private equity and hedge funds, also electively use foreign corporations when deferral is beneficial without the ability to claim a so-called indirect foreign tax credit under § 902 for corporate-level foreign taxes.

83. The scope of the deferral privilege has been generous, allowing U.S. MNCs to individually shelter billions of dollars from taxation by the United States (as well as from taxation by other countries). See KEIGHTLY & STUPAK, *supra* note 41, at 4–7; Grubert, *Foreign Taxes*, *supra* note 51; Kimberly A. Clausing, *The Revenue Effects of Multinational Firm Income Shifting*, 130 TAX NOTES 1580 (Mar. 28, 2011). There also is evidence of base erosion in other countries that is facilitated by the absence of residence taxation of foreign subsidiary income. See generally ORGANIZATION FOR ECONOMIC CO-OPERATION AND DEVELOPMENT, ADDRESSING BASE EROSION AND PROFIT SHIFTING, 61–71 (Annex B) (2013) [hereinafter OECD, ADDRESSING BASE EROSION]; Edward D. Kleinbard, *Through a Latte Darkly*:

## 2. *CFC Rules as a Unilateral Backstop to Second-Best Taxation of Foreign Income*

To the extent that income shifted from the United States to foreign countries is caught by U.S. CFC rules, it is returned to the U.S. tax base. Those rules are, however, inherently complex and have important exceptions. Thus, CFC rules are a second-best solution to the problem of defending U.S. residence taxation against both weak transfer pricing rules and opportunistic foreign governments that enable tax avoidance by offering special rulings and so-called “patent boxes” for ill-defined categories of intangible income and that attract investment and profit shifting through tax competition without requiring real economic activity.<sup>84</sup> Adopting an interim minimum tax to limit deferral would be a valuable supplement to the U.S. CFC rules and would mitigate somewhat the revenue loss and distortions that result from overly generous treatment of U.S. MNCs’ foreign income.

## 3. *Deferral and Lockout*

A politically powerful objection to deferral is the claim that it provides an incentive to postpone residence taxation by retaining earnings in low-taxed foreign subsidiaries (often referred to as the “lockout problem”). As commentators have demonstrated, however, under standard modeling

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*Starbucks’s Stateless Income Planning*, 139 TAX NOTES 1515 (Jun. 24, 2013). The United States, in turn, is not immune from erosion of its own source tax base by foreign parent companies, including by companies that have “expatriated” (i.e., changed the parent company from a U.S. to a foreign company). Jeremiah Coder, *IRS Concedes Dividend Treatment Issue With Glaxo*, 126 TAX NOTES 150 (Jan. 11, 2010) (“But in an unexpected filing, the IRS dropped its claims against Glaxo. ‘Respondent concedes, in full, all income tax deficiencies, withholding tax deficiencies, and penalties arising from his recharacterization, from debt to equity, of the \$13.5 billion intercompany obligation at issue in the above docketed case,’ the filing reported.”); Tom Bergin, *Irish tax cocktail gets German twist* (Sept. 20, 2013) (SAP uses Irish structure to avoid U.S. taxes), <http://www.reuters.com/article/2013/09/20/us-tax-sap-special-report-idUSBRE98J04220130920> (last viewed October 17, 2013). The Treasury Department observed in a 2007 study of “earnings stripping” that expatriated U.S. companies had elevated levels of intercompany debt. See U.S. TREAS. DEP’T., EARNINGS STRIPPING, *supra* note 33, at 8, 21–22.

84. Compared to eliminating deferral, CFC rules are second best because they inevitably involve compromises regarding the definition of a CFC, the U.S. shareholders for whom deferral is restricted, and the affected nondeferred income, all of which create tax-avoidance opportunities. One of the objectives of the OECD’s BEPS project is to better align the location of income with the conduct of real economic activity. See OECD, EXPLANATORY STATEMENT, *supra* note 7, at 5, 15.

assumptions of a constant tax rate, constant returns, and unavoidable ultimate earnings repatriation, the incentive to retain CFC earnings abroad in low-taxed countries arises from the ability to earn a higher after-tax return on reinvestment of those earnings that reflects the difference between the home and low host country taxes. Moreover, the same incentive occurs under an exemption system, so that U.S. adoption of an exemption system would not end this accumulation incentive.<sup>85</sup>

In addition, the 2004 repatriation tax relief and, now, the prospect of a future exemption system without full taxation of previously deferred earnings, support taxpayers' expectations that there may indeed be a lower tax on repatriation in the future. These expectations create an incentive for U.S. multinationals to accumulate earnings offshore.<sup>86</sup> While several low- or no-tax repatriation strategies have been foreclosed in recent years through case law challenges,<sup>87</sup> regulation changes,<sup>88</sup> or legislation,<sup>89</sup> work-around schemes continue to be attempted.<sup>90</sup> Thus, overall, deferral of earnings repatriation has been a relatively low-risk strategy.

Recently, there has been an increasing recognition that financial accounting rules have played a significant role in decisions whether to distribute excess foreign earnings. For financial statement purposes, the earnings of a foreign subsidiary are consolidated with those of its U.S. parent corporation.<sup>91</sup> The general rule is that the tax on those earnings should be accounted for as an expense, thereby reducing reported financial statement

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85. See Alvin C. Warren, Jr., *Income of Foreign Subsidiaries: A Review of the Basic Analytics*, 145 TAX NOTES 321, 322–23 (Oct. 20, 2014); [hereinafter Warren, *Basic Analytics*] see also Fadi Shaheen, *On Fixing U.S. International Taxation*, 9 JRSLM. REV. LEGAL STUD. 125, 129 (2014); Lee A. Sheppard, *Debunking the Overseas Cash Meme*, 147 TAX NOTES 847 (May 25, 2015).

86. See George K. Yin, *Reforming the Taxation of Foreign Direct Investment by U.S. Taxpayers*, 118 TAX NOTES 173, 174 n.5 (Jan. 7, 2008).

87. See, e.g., *Schering-Plough Corp. v. United States*, 651 F. Supp. 2d 219 (D.N.J. 2009), *aff'd sub nom. Merck & Co. Inc. v. United States*, 652 F.3d 475 (3d Cir. 2011).

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

89. See, e.g., I.R.C. § 960(c) (added by Pub. L. No. 111–226, § 214(a), 124 Stat. 2389, 2399 (2010)).

90. A 2012 congressional hearing disclosed Hewlett Packard's use of revolving short-term loans in an effort to end run around the deemed dividend rules of § 956. See Levin & Coburn, *Memorandum on Microsoft and HP*, *supra* note 54, at 24–27.

91. See Barry Jay Epstein & Lawrence G. Macy, *The Differential Influence of U.S. GAAP and IFRS on Corporations' Decisions to Repatriate Earnings of Foreign Subsidiaries*, 37 INT'L TAX J. 29, 34–35 (Mar.-Apr. 2011), <http://ifrsaccountant.com/media/pdfs/foreign-earnings-repatriation-accounting-gaap-ifrs.pdf>.

earnings.<sup>92</sup> An accounting rule exception, however, allows the reporting company to not record the residual U.S. tax on un-repatriated foreign subsidiary earnings as an expense if the reporting company (1) represents to auditors that the earnings will be invested abroad indefinitely and (2) evidences specific plans for reinvestment of the undistributed earnings demonstrating that remittance, indeed, will be postponed indefinitely.<sup>93</sup> This accounting treatment is another significant inducement for CFCs of publicly traded U.S. MNCs to retain foreign earnings.<sup>94</sup> If an important source of the “lockout” problem is attributable to a financial accounting standard, the solution to this problem should not be adoption of a revenue-losing change to the tax law, but instead should be modification of the accounting standard.<sup>95</sup> As one of us has discussed in a separate article, when the scope of the “investment in U.S. property” tax rules of section 956 and financial accounting rules that underlie lockout are properly understood, and the available evidence on the uses of offshore earnings are examined, the evidence does not support

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92. *See id.*

93. *See id.*; STAFF OF THE J. COMM. ON TAX’N, JCX-96-15, PRESENT LAW AND SELECTED PROPOSALS RELATED TO THE REPATRIATION OF FOREIGN EARNINGS, 6–7 (2015) [hereinafter JOINT COMM., REPATRIATION PROPOSALS].

94. Recent work regarding the intersection of taxation and accounting treatment in economic analysis of corporate behavior examines whether investment decisions are enhanced because they provide managers with discretion over the timing of book income (or taxable income). *See* Douglas A. Shackelford, Joel Slemrod & James N. Sallee, *Financial Reporting, Tax and Real Decisions: Toward a Unifying Framework*, 18 INT’L TAX & PUB. FIN. 461 (2011) (pointing to discretion offered by accounting treatment of permanently reinvested earnings and ability to reverse treatment, which has the effect of increasing book earnings in the year the accounting treatment is changed); *see also* JOINT COMM., REPATRIATION PROPOSALS, *supra* note 93, at 7 (“To the extent that a firm’s managers are concerned with increases in the firm’s [financially] reported U.S. tax expense, and the corresponding decrease in the firm’s earnings per share, managers may delay the repatriation of foreign earnings.”).

95. *See* Patrick Driessen, *Fix Financial Distortions Before Considering Obama’s Minimum Tax*, 146 TAX NOTES 1135 (Mar. 2, 2015). Because of its role in allowing earnings management, it would seem appropriate to not allow (or at least limit management discretion to claim) indefinite reinvestment treatment for foreign earnings in circumstances where the balance sheet of the business suggests that such earnings are not retained for needs of the business. As a possible example, one approach might be to disallow indefinite reinvestment treatment for earnings to the extent that the consolidated foreign subsidiary holds cash, cash equivalents, and other passive investments in an amount that materially exceeds the reasonable liquidity needs of the business for a succeeding period (say two years). The pressure for excessive foreign earnings retention would be materially reduced by such a tightening of the accounting standard that deals with recognition of tax expense on deferred earnings.

an assertion that lockout is a “primary” reason to exempt multinationals’ foreign dividends from active business income.<sup>96</sup>

As discussed below, an interim minimum tax on deferral would reduce the pressure to delay earnings repatriation by creating additional previously taxed earnings that could be distributed without further taxation. The availability of such an alternative is another reason why the supposed lockout problem should not be a reason to adopt an exemption or partial exemption system for taxing foreign business income.

Lockout, with its “trapped offshore cash” narrative, is the Trojan horse of international tax reform. U.S. MNCs have exploited the opportunity of deferral to employ tax reduction strategies against U.S. and foreign-source country taxation and hold trillions of dollars of retained earnings offshore, much of it in passive investments, including cash and cash equivalents. Now proponents of exemption would claim that the residual U.S. tax on repatriation is too much to pay to use this cash in the MNCs’ U.S. businesses or to pay out to shareholders. A narrative has been constructed that would suggest that the offshore earnings invested in passive assets are “trapped” such that they are not available to the U.S. economy.<sup>97</sup> MNCs argue from this premise that exemption is necessary to unshackle this cash, even though evidence suggests that substantial amounts of the earnings held in cash or cash equivalents are held in U.S. financial institutions or accounts through exceptions to section 956 and presumably already are intermediated into the U.S. economy.

To further its objective of taxing the existing stock of offshore earnings to fund infrastructure, the Obama Administration participates in the “trapped cash” narrative, albeit in a slightly more modest fashion.<sup>98</sup> The Administration justifies its *de facto* exemption proposal discussed in Part IV.B.2, below, in part on grounds that it would eliminate the distortion of the tax on repatriation. The Administration correctly eschews the more distortive effects of a repatriation tax holiday, but the ironic consequence is that the Administration only obtains the revenue from pre-effective date earnings by signing on to a *de facto* exemption system.

Obtaining a lower rate of U.S. residual tax on pre-effective date earnings is the major political driver of shifting to a *de facto* exemption system. In the case of U.S. MNCs, the goal is freedom from the tax on repatriation of old earnings and the resulting financial flexibility. In the case of the Administration, the goal is dedicated revenue to fund on a one-time basis a

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96. Shay, *Truthiness of “Lockout,” supra* note 61, at 1398.

97. *See id.*

98. The 2015 Economic Report of the President states: “While the harms of so-called trapped cash can be over-stated, under the President’s minimum tax proposal there would no longer be any reason for it to exist, provided the existing stock of accumulated profits is effectively taxed at the outset.” ANNUAL REPORT OF THE COUNCIL OF ECONOMIC ADVISERS 233–34 (2015).

avored expenditure, in this case investment in infrastructure (which should be funded with a continuing and not a one-off revenue source). In our view, the opportunistic politics of the issue does not justify the structural damage to the corporate income tax of a permanent lower rate on foreign business income. What is needed instead is the increased revenue from an interim minimum tax on foreign income that does not give up the residual U.S. tax claim for the difference between the effective U.S. and foreign tax rates.

*B. A Minimum Tax Limit on Deferral*

*1. An Interim Minimum Tax Versus Full Rate Inclusion*

Under the existing U.S. CFC rules, income subject to current inclusion is taxed at the full U.S. rate. Perhaps for this reason, the scope of the inclusion rules has been limited to specific categories. Because these categories of foreign base company income are based on outdated paradigms, existing CFC rules have ceased to have a material restraining effect on U.S. MNCs' ability to shift profits to low-tax countries. However, under the interim (or tentative) minimum tax that we propose as a second-best measure, income subject to a low foreign effective tax rate would be subject to a currently imposed U.S. tax, up to some minimum effective rate that is lower than the regular U.S. tax rate. One advantage of this approach is that it would mitigate a "cliff effect"<sup>99</sup> of a minimum tax that caused income to go from a small foreign effective rate to a full U.S. effective rate.

Although deferral is itself a compromise when compared to full exemption of foreign-source income, our proposed interim minimum tax also would be a compromise, in comparison to full current taxation, in that taxation at the difference between the full rate and the minimum rate would await imposition under traditional realization principles. This interim approach to a minimum tax would ameliorate expected behavioral responses to adopting a low-taxed income category of subpart F income, such as in the Obama Administration's 2015 budget proposal, that results in a final lower tax rate on foreign income than on domestic income.<sup>100</sup> The interim minimum tax we propose would not apply to passive income, which would continue to be subject to current taxation under subpart F at a full U.S. rate (possibly subject to a high-tax exception), but would apply to active foreign income earned at

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99. See generally Grubert & Altshuler, *Fixing the System*, *supra* note 49.

100. U.S. TREAS. DEP'T, FY 2016 GENERAL EXPLANATIONS, *supra* note 34, at 20–22. Representative Camp's minimum tax proposal also would be a final tax at a rate materially below the full corporate rate. See H.R. 1, 113th Cong., 2d Sess., § 4001 (2014).

low foreign effective rates of tax.<sup>101</sup> The interim minimum tax would target the active foreign income that today is the most substantial component of profit shifting. If a minimum tax rate were set at as low as 15 percent, based on the 2006 data reported by Harry Grubert and Rosanne Altshuler, it still would increase tax on over 50 percent of aggregate CFC income.<sup>102</sup> While a 15 percent rate would be only 40 percent of the current U.S. corporate tax rate of 35 percent, such an interim minimum tax nonetheless would be a material improvement over current law, so long as it is not a final tax. An interim (i.e., not final) minimum tax would strengthen the deferral regime of current U.S. tax law.

Any minimum tax should be determined on a per-country basis.<sup>103</sup> It would be accounted for by averaging the effective tax rates of each qualified business unit (QBU) in the same country.<sup>104</sup> In order to retain the current law integration of the CFC and foreign tax credit rules, under an interim minimum tax, the CFC would be treated as distributing the portion of its earnings that would yield a residual U.S. tax equal to the required U.S. minimum tax. This amount of earnings and taxes thereafter would be treated as previously taxed and would be available for distribution without a further U.S. tax.

Such an interim minimum tax approach could be readily adapted to the current infrastructure of CFC rules, including the indirect foreign tax

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101. Full taxation of passive income from reinvestment of deferred earnings does not eliminate all of the benefit of deferral because the original business earnings benefit from deferral even if the subsequent return on those earnings does not. *See* MYRON S. SCHOLLES, MARK A. WOLFSON, MERLE ERICKSON, EDWARD MAYDEW & TERRY SHEVLIN, *TAXES AND BUSINESS STRATEGY: A PLANNING APPROACH*, 306–7 (5th ed. 2015); Warren, *Basic Analytics*, *supra* note 85, at 323–24.

102. Grubert & Altshuler, *Fixing the System*, *supra* note 49, at 699 (Table 3).

103. Grubert's and Altshuler's simulations of their low-tax inclusion proposal suggest that the revenue gain from determining the effective tax rate on a country-by-country basis as opposed to an overall basis is relatively modest and conclude that the revenue from a country-by-country approach may not justify the additional complexity. Grubert & Altshuler, *Fixing the System*, *supra* note 49, at 697–701. Applying an overall low-tax test, however, would create incentives to combine businesses with differing effective rates and to engage in the kind of tax planning familiar today under the two-basket foreign tax credit limitation of current law. We have previously recommended use of a per-country approach in formulating the foreign tax credit limitation, *see* Robert J. Peroni, J. Clifton Fleming, Jr. & Stephen E. Shay, *Reform and Simplification of the U.S. Foreign Tax Credit Rules*, 101 TAX NOTES 103 (Oct. 6, 2003), and we would make the same recommendation in designing a minimum tax. The Obama Administration FY 2016 budget proposal adopts such a per-country approach.

104. Under current law, a qualified business unit already is required to maintain separate books and records and to track foreign taxes by income category.

credit, and would result in some simplification of current law. The minimum tax could also eliminate certain subpart F provisions, including the foreign base company sales and services income rules and the active finance exception. We illustrate the operation of the proposal within the structure of existing law (but with the Administration's target 28 percent corporate rate) in Example 1.

**Example 1:** Assume a foreign corporate rate of 10 percent, a U.S. corporate rate of 28 percent, and a 15 percent interim minimum tax on foreign income. Assume a CFC has \$1,000 of pre-tax earnings and pays \$100 of foreign corporate tax for a foreign effective rate of 10 percent. The CFC's earnings would need to be subject to an additional \$50 of current tax to meet the 15 percent minimum tax objective. Under an "interim minimum tax," the CFC would be deemed to distribute \$250 of earnings and profits.<sup>105</sup> A gross-up for the foreign tax, of \$27.78,<sup>106</sup> would yield taxable income of \$277.78, a tentative U.S. tax of \$77.78,<sup>107</sup> and, after a foreign tax credit of \$27.78, a residual U.S. minimum tax of \$50. As under current law, the \$250 dividend deemed distributed would become previously taxed income and would not be further taxed when actually distributed. When the remaining untaxed \$650.00 of earnings are distributed, they would carry a gross-up of \$72.22, resulting in total taxable income of \$722.22.<sup>108</sup> There would be a tentative U.S. tax of \$202.22 and, after a foreign tax credit of \$72.22, the U.S. shareholder would pay the residual U.S. tax of \$130.00.

Alternatively, if the CFC's entire \$900 in after-foreign-tax earnings had been distributed without deferral, they would have been grossed up under section 78 to \$1,000 (\$900 cash distribution plus \$100 foreign tax). The 28 percent U.S. tentative tax on \$1,000 would have been \$280, and after allowing the \$100 foreign tax credit, the U.S. residual tax would have been \$180. In Example 1, the total U.S. tax turns out to be precisely the same amount: \$50 U.S. minimum tax, plus \$130 deferred U.S. residual tax, for a total of \$180. Of course, deferral of \$130 of tax means that the Example 1 tax result is not financially equal to the undeferred tax result in the immediate distribution scenario. However, the immediate \$50 interim minimum tax in Example 1 yields a less distortive result than deferral of the CFC's entire U.S. residual tax, as would occur under the present U.S. system. Thus, the interim minimum

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105. In a simple case without a withholding tax, the distribution may be derived by dividing the additional tax required (TA) by the difference between the U.S. rate (TUS) and the foreign rate on a distribution (TFD), grossed up by one minus the foreign rate (1-TFD), or  $X = TA / ((TUS - TFD) / (1 - TFD))$ .

106. The § 78 gross-up is the foreign corporate tax (TFC) times the ratio of the dividend (D) to the relevant pool of earnings and profits (E&P), or  $TFC \times (D/E\&P)$ , or  $\$100 \times (\$250/\$900) = \$27.78$ .

107.  $\$277.78 \times 28\% = \$77.78$ .

108.  $\$650 / (1 - .10) = \$722.22$ .



tax proposal is a second-best improvement on present law that stops short of repealing deferral.

2. *A Final Minimum Tax: the Obama Administration Proposal*

In its budget for FY 2016, the Obama Administration has proposed a minimum tax of 19 percent on the foreign earnings of domestic C corporations and CFCs before accounting for payment of any foreign tax. However, the proposal also provides that the tax base would be reduced by an allowance for corporate equity (ACE) invested in active foreign assets. Thus, the effective minimum rate would usually be below 19 percent.<sup>109</sup> Indeed, it would be zero if the ACE were sufficiently large in relation to the CFC's income.

Moreover, the 19 percent nominal minimum tax rate is reduced by 85 percent of the foreign effective tax rate measured against a tax base determined under U.S. tax principles, including the ACE allowance. Thus, the minimum tax would apply if the foreign effective rate were below 22.35 percent.<sup>110</sup> The Obama Administration proposal would not impose a further tax on income subject to the minimum tax regime, not even the ACE amount. In addition, the Administration's proposal would not impose any tax on foreign income that escaped the minimum tax because it bore a foreign effective tax rate of 22.35 percent or more. Thus, it is a final tax.

Adopting such a minimum tax as a final tax is effectively adopting an exemption system with a subject-to-tax requirement<sup>111</sup> at the minimum tax effective rate (after an ACE allowance). To see how it would apply, we will start with the same facts as in Example 1 and further assume that the CFC holds active foreign business assets (at a cost of \$10,000), and that the ACE allowance rate is 2.25 percent.<sup>112</sup>

**Example 2:** Assume a foreign corporate rate of 10 percent, a U.S. corporate rate of 28 percent, active foreign business assets of \$10,000, and an ACE allowance of 2.25 percent. Assume the CFC has \$1,000 of pre-tax earnings and pays \$100 of foreign corporate tax. The Administration minimum tax would apply to the CFC's pre-tax foreign income of \$1,000, and an ACE deduction of \$225 would be allowed, so the minimum tax base would be

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109. See Reuven Avi-Yonah, *All or Nothing? The Obama Budget Proposals and BEPS*, 41 INT'L TAX J. 17, 18 (Mar.-Apr. 2015).

110.  $19\% / 85\% = 22.35\%$ .

111. For a discussion of a subject-to-tax requirement in an exemption system, see Fleming, Peroni & Shay, *Designing a U.S. Exemption System*, *supra* note 1, at 413-26.

112. The 10-year Treasury yield on Wednesday, June 17, 2015, reported on the Treasury website, was 2.32 percent.

\$775.<sup>113</sup> The minimum tax rate would be 10.5 percent, which is 19 percent minus 85 percent of the 10 percent foreign tax rate. This yields a minimum tax of \$81.38,<sup>114</sup> and a total U.S. and foreign tax of \$181.38.

The Administration “minimum tax” is a final tax. Thus, after bearing the burden of the effective 18.14 percent tax rate,<sup>115</sup> the CFC’s earnings could be repatriated to a domestic C corporation without further tax. The Administration proposal does not adjust the qualified dividend income (QDI) definition<sup>116</sup> to account for the reduced level of corporate tax, so an individual U.S. shareholder in a corporation that earns lower-tax foreign income would benefit from both the low U.S. minimum tax rate and the 20 percent maximum rate that applies to QDI. This issue is discussed below.

Importantly, the Administration proposal would equalize the treatment of foreign branches and foreign subsidiaries, but by doing so it would allow the same de facto exemption result for the branch. In addition, the Administration proposal would reduce (i.e., “haircut”) interest expense allocable to lower-taxed foreign income.<sup>117</sup> These are important aspects of the proposal that distinguish it favorably from the last (H.R. 1) version of former House Ways and Means Committee Chairman Camp’s proposal. However, the essential design feature of having a de facto exemption system once a

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113. Because the minimum tax rate is net of 85 percent of the foreign tax, the minimum tax base presumably starts from pre-foreign tax earnings.

114. The ACE allowance is a consumption tax feature because, according to conventional dogma, consumption taxes exempt the risk-free return to capital whereas an income tax does not. See David Elkins & Christopher H. Hanna, *Taxation of Supernormal Returns*, 62 TAX LAW 93 (2008) (“As is generally accepted, under certain assumptions an accrual income tax system taxes the risk-free rate of return on capital but does not tax the risk premium, while a cash-flow consumption tax system (or wage tax system) taxes neither the risk-free rate of return nor the risk premium.”); Daniel N. Shaviro, *Replacing the Income Tax with a Progressive Consumption Tax*, 103 TAX NOTES 91, 100-01 (Apr. 5, 2004) (“[The risk-free return] is exempted by a cash flow consumption tax unless we reject the long-conventional scaling-up argument, whereas an income tax reaches this return.”). Thus, the ACE allowance is a curious element to include in an income tax regime. If it were eliminated and a conventional income tax approach were taken, the minimum tax base in Example 2 would be \$1,000. When the \$81.38 tax is measured against this base, the effective rate of the Obama minimum tax in Example 2 is 8.1 percent, not 10.5 percent—a 23 percent reduction.

115. \$181.38/\$1,000.

116. I.R.C. § 1(h)(11)(B).

117. We have previously pointed out that it is not enough to limit this treatment to interest expense; it would be important to restrict the deduction for all expenses allocable to lower-taxed foreign income. See Shay, Fleming & Peroni, *Territoriality in Search of Principles*, *supra* note 1, at 200-07; see also Fleming, Peroni & Shay, *Designing a U.S. Exemption System*, *supra* note 1, at 448-52.

minimum tax rate is satisfied suffers from many of the same defects that we have pointed out in relation to the Camp discussion draft dividend exemption proposal.<sup>118</sup>

Because it would be a final tax that is substantially less than the generally applicable U.S. tax, the Administration's minimum tax would suffer from the problems associated with an exemption system, including most fundamentally a potentially negative effective U.S. tax rate on foreign business income earned in low-tax countries.<sup>119</sup> The risk of revenue loss would be particularly acute if the Administration's haircut on the interest deduction allocated to low-taxed income and the application of the minimum tax to foreign branches do not survive the legislative process, which seems likely in light of the modifications made to the original Camp exemption proposal. Material additional tax system design adjustments would be required to accompany a shift to such a partial exemption system. These points are illustrated in the next section.

### 3. *A Final Minimum Tax Results in Partial Exemption*

If in Example 2 the CFC's \$1,000 of foreign income had been immediately repatriated and subjected to U.S. tax, it would have borne a total tax of \$280 (\$100 of foreign tax plus a \$180 U.S. residual tax).<sup>120</sup> Thus, the total effective tax rate would have been 28 percent.<sup>121</sup>

In contrast, the CFC's \$1,000 of foreign income actually bore a total tax of only \$181.38 in Example 2 (\$100 of foreign tax plus the final U.S. minimum tax of \$81.38) for an overall effective tax rate of 18.14 percent.<sup>122</sup> This is economically indistinguishable from a result in which \$647.78 of the CFC's income was taxed at the full U.S. rate,<sup>123</sup> and the remaining \$352.22 was earned in the zero-tax Cayman Islands under a U.S. exemption system.<sup>124</sup> In other words, to the extent of 35 percent of the CFC's income, the

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118. For an extensive, but not exhaustive, discussion of such issues in the context of recent exemption proposals, see Shay, Fleming & Peroni, *Territoriality in Search of Principles*, *supra* note 1. For discussion of how to design an exemption system, see Fleming, Peroni & Shay, *Designing a U.S. Exemption System*, *supra* note 1.

119. See Grubert & Altshuler, *Fixing the System*, *supra* note 49, at 691–93 (explaining that simulations under certain assumptions show negative tax result for varying forms of final minimum tax in a low-tax country).

120. \$100 foreign tax + (\$280 tentative U.S. tax – \$100 foreign tax credit) = \$280 total foreign and U.S. tax.

121.  $\$280 \div \$1,000 = 28\%$ .

122.  $\$181.38 \div \$1,000 = 18.14\%$ . This is a 35 percent reduction from a tax at a 28 percent rate.

123.  $\$647.78 \times 28\% = \$181.38$ .

124.  $\$1,000 - \$647.78 = \$352.22$ .

Administration's minimum tax would function as an exemption system in Example 2 and would provide an exemption system's incentive to locate business activity in no-tax or low-tax foreign countries. This would be accompanied by an exemption system's pressure on the weaknesses in transfer pricing, income sourcing, and expense allocation rules.

But, of course, the present U.S. international income tax system defers the U.S. residual tax on the CFC's foreign income in Example 2 until repatriation. So would the partial exemption system resulting from the Administration's final minimum tax be any more generous to taxpayers, and any more distortive, than the deferral privilege under existing law? We now turn to that issue.

#### 4. *The Enhanced Tax Incentive of Partial Exemption over Deferral*

Under current law, the tax advantage from deferring distribution of a CFC's low-taxed foreign earnings arises from the fact that the income from reinvested foreign earnings is taxed at a lower rate than would apply in the United States, thereby generating a higher after-tax return. Thus, even if it is assumed that reinvested earnings would yield the same pre-tax return in both the United States and abroad, there is a tax advantage from deferral if the effective rate of foreign tax is lower than the U.S. rate.<sup>125</sup>

The advantage of deferral under these assumptions, however, always would be less than the advantage to taxpayers under an exemption system because there is a residual U.S. tax on repatriation under deferral but not under an exemption system.<sup>126</sup> If a minimum tax applied at the rate of 15 percent and the U.S. rate were 28 percent, so a residual U.S. tax equaled 13 percent, under usual assumptions the benefit of deferral (taken alone) would always be 13 percent less than the benefit of exemption. Thus, to the extent that the Obama Administration's final minimum tax mimics an exemption system, it would be more generous to taxpayers than deferral.

Designed as a final tax, and, therefore, as a partial exemption system, the Administration's minimum tax would continue to induce material revenue

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125. Under standard assumptions in the academic literature that the foreign and U.S. tax rates remain constant over the period of deferral (including a tax on the distribution), if the foreign and U.S. rates of return are the same, the advantage of deferral lies in reinvesting deferred earnings at the lower foreign tax rate, not in postponing the U.S. tax (because under these assumptions it is levied on earnings that have grown before U.S. tax at the assumed rate of return). See Warren, *Basic Analytics*, *supra* note 85, at 323–24.

126. As Professor Warren points out, the benefit of a lower foreign tax rate under deferral, no matter how long the period of deferral, always is less than the benefit of exemption. *Id.* at 323.

shifting, including by new taxpayers that today do not take advantage of deferral because of the investment in U.S. property rules of section 956 that would be relaxed under a minimum tax that is a final tax. In particular, the increased tax advantage of exemption would induce new or additional income shifting by at least two groups of taxpayers. First, many business taxpayers today cannot benefit from deferral because of the section 956 rules protecting against use of deferred earnings in the United States. Even if operations can be configured to purportedly earn foreign business income eligible for deferral, such as in the Microsoft Puerto Rico example,<sup>127</sup> many taxpayers do not have a real foreign business footprint and need to be able to use the foreign earnings in their U.S. businesses. These taxpayers, with predominantly domestic businesses, have not pursued a deferral structure because of the constraints of the rules restricting use of deferred foreign earnings in their U.S. businesses.<sup>128</sup> Under an exemption system, the Microsoft Puerto Rico structure (or its counterpart in other non-U.S. jurisdictions) would be feasible to implement by many additional taxpayers because the exempted earnings could be immediately repatriated tax-free. The second category of taxpayer that would be benefited by exemption for the same reason consists of existing MNC taxpayers that have shifted less income as a result of business constraints that require foreign earnings to be promptly repatriated in order to meet financial needs.<sup>129</sup>

For these reasons, if a minimum tax were a final tax, it should be set at a rate that is a relatively high percentage of the U.S. corporate tax rate in order to reduce the exemption effect. The Administration's proposed rate, after taking account of the ACE, is roughly only one-half to two-thirds of the U.S. rate depending on a range of assumptions. As a final tax, this rate would be low enough to provide a strong incentive to shift real investment and income to low-tax countries (absent numerous additional protections). Thus, to reduce this incentive, the tax rate of the Administration's proposed final minimum tax needs to be significantly increased.

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127. See *supra* text accompanying notes 53–54.

128. See I.R.C. § 956. The U.K. dividend exemption system has separate rules for non-large taxpayers intended to frustrate offshoring activity by small and medium enterprises. There are no such rules in any of the U.S. international tax reform proposals.

129. See Scott D. Dyreng & Kevin S. Markle, *The Effect of Financial Constraints on Tax-Motivated Income Shifting by U.S. Multinationals* (working paper) (May 14, 2015), [http://papers.ssrn.com/sol3/papers.cfm?abstract\\_id=2336997](http://papers.ssrn.com/sol3/papers.cfm?abstract_id=2336997) (last visited June 17, 2015). There are a number of issues regarding the assumptions used and data limitations in accounting data-based estimates of income shifting, and comparable issues arise for the economic model-based estimates. Nonetheless, in this case, the direction of the response seems clear.

If, instead, an interim minimum tax is imposed at a rate fairly close to the U.S. corporate rate, the shifting incentive would be materially reduced and because the amount of previously taxed earnings would be substantial, the lockout pressure on earnings repatriations would be greatly reduced. If, in addition, financial accounting rules that encourage offshore profits accumulations are reformed, any legitimate concerns regarding incentives for management to defer earnings repatriations should be materially reduced.

##### 5. *Problems with the ACE*

As we have previously noted,<sup>130</sup> the ACE is a consumption tax feature because it exempts the risk-free return to capital which, according to standard theory, is a key cash-flow consumption tax characteristic that distinguishes it from an income tax.<sup>131</sup> Thus, the Administration's proposed inclusion of the ACE in the U.S. international income tax regime is a curious move that invites us to ask "What is the purpose?"

If the purpose is to equalize the treatment of corporate debt and equity between foreign subsidiaries and their U.S. parents,<sup>132</sup> the ACE is an imperfect device for accomplishing this objective. Deductible interest payments by a low-foreign-taxed subsidiary to its U.S. parent corporation avoid the low foreign tax, but at the cost of an immediate U.S. tax, except to the extent that the U.S. tax is eliminated by cross-crediting.<sup>133</sup> In contrast, ACE amounts

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130. *See supra* note 114.

131. *See sources cited supra* note 114. If the U.S. corporate income tax is regarded as a substitute for a current *income tax* on shareholders, inclusion of a *consumption tax* element in a minimum corporate tax on CFCs is incongruous. If, on the other hand, the U.S. corporate income tax is considered an excise tax on corporations for earning rents or doing business in corporate form, it is incoherent to inject a consumption tax element into the levy on CFCs but not into the levy on domestic corporations.

132. The usual rationale for an ACE is to reduce the disparate income tax treatment of equity in relation to debt. One objective is to encourage entrepreneurial investment. It is mysterious to us why the United States should provide this tax expenditure for foreign investment in addition to a reduced tax rate (or, as we observe, partial exemption) for foreign business income. Professor Kleinbard has proposed a business tax regime that includes a deduction for a cost of capital allowance that is, in part, intended to make the debt-equity distinction irrelevant. In stark contrast to the Obama Administration's ACE, his proposal is, however, a component of a comprehensive and coherent regime. *See* Edward D. Kleinbard, *The Business Enterprise Income Tax: A Prospectus*, 106 TAX NOTES 97, 101-03 (Jan. 4, 2005).

133. Cross-crediting occurs when foreign tax credits in excess of U.S. tax on high-taxed foreign-source income are used to reduce the U.S. residual tax on foreign-source income that bears a foreign tax less than the U.S. tax. *See generally*

would be part of the subsidiary's foreign tax base but would not be subject to either the U.S. minimum tax or a U.S. repatriation tax,<sup>134</sup> regardless of the availability or not of cross-crediting. Moreover, even if one were inclined to overlook these differences, the question remains why we should eliminate the debt-equity distinction between U.S. parent corporations and foreign subsidiaries but not other corporate taxpayers.

If the ACE is intended as competitiveness assistance for U.S. MNCs,<sup>135</sup> it is vulnerable to several objections. Most broadly, the case for diverting government resources from health, education, national security, infrastructure, and other pressing needs, to aid the relatively small population of U.S. MNCs<sup>136</sup> has not been made.<sup>137</sup> More narrowly, the ACE favors capital-intensive businesses over others and provides competitiveness assistance to the foreign operations of U.S. MNCs, even if they are substantially protected from competition by intellectual property law or their principal competitors are other U.S. MNCs. Thus, defending the ACE as a competitiveness device is an uphill slog.

Perhaps the ACE is a purely political ploy to please the tax reform constituency by proclaiming a minimum tax with a 19 percent headline rate while simultaneously mitigating opposition from the MNC constituency<sup>138</sup> with an effective minimum tax rate that can be considerably less than 19 percent because of the ACE's narrowing effect on the tax base. If this is so,

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GUSTAFSON, PERONI & PUGH, *supra* note 64, at 407–12 (discussing the tax benefits and tax policy implications of cross-crediting).

134. U.S. TREAS. DEP'T, FY 2016 GENERAL EXPLANATIONS, *supra* note 34, at 21 (“U.S. tax would be imposed . . . not at all (if the income . . . was exempt pursuant to the ACE allowance).”).

135. Improving the global competitiveness of U.S. corporations is the only reason given by the Administration for the ACE. See ANNUAL REPORT OF THE COUNCIL OF ECONOMIC ADVISERS, *supra* note 98, at 218 (2015).

136. Approximately 2,040,000 federal C corporation returns were filed for 2004. See STAFF OF J. COMM. ON TAX'N, SELECTED ISSUES RELATING TO CHOICE OF BUSINESS ENTITY 5 (2012). However, only 5,502 (0.27 percent) of those returns indicated receipt of foreign income because only that number of returns involved a foreign tax credit claim. See Scott Luttrell, *Corporate Foreign Tax Credit, 2004*, SUMMER 2008 IRS STATISTICS OF INCOME BULLETIN 111 (2008). More importantly, about 80 percent of the foreign income earned that year by U.S. MNCs was earned by fewer than 900 corporations. See Grubert, *Foreign Taxes*, *supra* note 51, at 247, 251.

137. See Fleming, Peroni & Shay, *Perspectives*, *supra* note 1, at 1085–87.

138. See Philip D. Morrison, *Administration Proposes to Repeal Deferral, Haircut the foreign Tax Credit and Interest Expense Deductions, Override Treaties and Abandon Arm's Length Transfer Pricing for Intangibles*, 44 BLOOMBERG BNA TAX MGT. INT'L J. 247, 249 (2015) (“[I]f enacted, these proposals would constitute a sea change . . . [M]ost observers in the private sector must hope this does not happen.”).

then it is important to note that the behavioral distortion, administrability, and complexity costs of this political legerdemain are not insignificant.

The ACE allowance would exempt income up to the allowance amount without regard to whether the income is subject to any foreign tax. In other words, a U.S. MNC could earn up to the ACE amount in Bermuda or Puerto Rico, pay no foreign tax, and neither the minimum tax nor a repatriation tax would apply to this amount.<sup>139</sup> The ACE allowance would not be allowed for investment in the United States. In addition, the allowance would be available only to a U.S. corporate shareholder in a CFC, not to shareholders in a domestic corporation or a foreign corporation that is not a CFC. These features obviously provide a distortive incentive for foreign investment rather than domestic investment and for foreign investment in CFCs.

The Administration has not fully specified details of the ACE; however, they are believed to employ a 10-year Treasury rate as the ACE return. A U.S.-dollar “risk-free” rate raises several design issues.

An initial issue is whether the risk-free rate should include a return for equity risk premium. We note that the Mirrlees Report would not include an equity return,<sup>140</sup> but the ACE system adopted in Italy does.<sup>141</sup> The answer to what is the “right” allowance rate presumably differs according to the purpose for the ACE. If the purpose is to equalize treatment of debt and equity, limiting the ACE to a debt return would make sense. If the purpose of the ACE is to incentivize investment in equity, as apparently is the case in Italy, then the rate should take account of the cost of equity capital. If the Administration’s articulated objective is to further U.S. MNC competitiveness, one would expect there to be pressure to use a rate with an equity risk return. This could have important revenue consequences.

A second issue is whether a U.S. dollar rate is appropriate for determining the risk-free return. If foreign business income is earned through a foreign corporation or other QBU using another currency as its functional

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139. See U.S. TREAS. DEP’T, FY 2016 GENERAL EXPLANATIONS, *supra* note 34, at 21.

140. JAMES MIRRLEES, STUART ADAM, TIMOTHY BESLEY, RICHARD BLUNDELL, STEPHEN BOND, ROBERT CHOTE, MALCOLM GAMMIE, PAUL JOHNSON, GARETH MYLES & JAMES POTERBA, *TAX BY DESIGN: THE MIRRLEES REVIEW* 421–25 (2011).

141. See Ernesto Zangari, *Addressing the Debt Bias: A Comparison between the Belgian and the Italian ACE Systems* 34 (Working Paper No. 44, European Commission Taxation Papers) (“[T]he normal ACE rate is based on the average returns on Treasury bonds, and it can be increased of up to three percentage points as a compensation for greater risk.”), available at [http://ec.europa.eu/taxation\\_customs/resources/documents/taxation/gen\\_info/economic\\_analysis/tax\\_papers/taxation\\_paper\\_44.pdf](http://ec.europa.eu/taxation_customs/resources/documents/taxation/gen_info/economic_analysis/tax_papers/taxation_paper_44.pdf) (last visited June 17, 2015).



currency,<sup>142</sup> the rate to achieve competitive neutrality would seem to be the foreign currency rate, not the U.S. dollar rate. The U.S. MNC's foreign business is paying for inputs and earning revenues predominantly in foreign currency as is its competitors. If the local currency environment is inflationary when the U.S. dollar interest rate is low, local returns will reflect the inflationary amounts and a low U.S. dollar rate would not place the U.S. affiliate on the same plane after-tax as a local competitor. By the same token, the U.S. dollar rate would be too generous for a functional currency that has a lower interest rate. This analysis also implies that the ACE rate should be set on a QBU-by-QBU basis.

Another set of issues raised by the ACE are the ways it will be gamed and the anti-abuse design rules that will be necessary to prevent such gaming. Under the ACE, a taxpayer will have an incentive to establish a foreign operation and earn at least up to an ACE return in a tax haven or tax holiday location. The ACE will be applicable on a country-by-country basis under the Administration proposal, so there would be an incentive to artificially increase the ACE allowance in low-tax countries. The Administration proposal anticipates this to some extent by including anti-hybrid rules, but it will be very difficult to monitor income shifting in the amounts that could maximize an ACE allowance.

Reinvested earnings would increase the ACE allowance if invested in active assets. The obvious assets for use in a tax haven would be intangible assets used in the business. Presumably, retained earnings could be used to purchase such intangibles.<sup>143</sup>

An ACE base generally would not include investments in affiliates. This has proven very difficult to manage in Belgium, where MNCs have artificially inflated the ACE base through reorganization planning, and will require careful rule design. Such anti-abuse rule design will necessarily complicate the proposal, but is necessary to maintain integrity of the ACE base.

In establishing a new CFC, there would continue to be an advantage to capitalize the CFC from the United States using a hybrid instrument treated as equity for U.S. purposes and debt that generates an interest deduction for local purposes (such as the preferred equity certificate in Luxembourg). This would reduce local tax and achieve ACE benefits on the U.S. side, as well as favorable treatment on disposition.

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142. For rules for determining a taxpayer's functional currency see section § 985.

143. This is not done for U.S. intangibles today outside of cost sharing because the basis in most intangibles would be taken into account under the section 956 investment in U.S. property rules and trigger a deemed dividend. This restraint would be eliminated under the Administration's proposal.

A transition issue is whether the ACE should be allowed for existing investment, which was the approach followed in Belgium, but which would provide a substantial and unjustified windfall for existing U.S. MNCs. It is more sensible to allow the ACE only for new investment as has been the approach taken by Italy. The revenue consequences of which transitional approach is taken could be material. If the ACE is little more than a pay-off to U.S. MNCs to accept other tax reform changes, then the windfall approach, which was used in Belgium to (over) compensate MNCs for the loss of the coordination center regime, may make some sense.

We have substantial doubts that the many design questions, as well as possible incentive effects that determine the efficacy of the ACE, have been thought through as fully as they should be. In any event, we think it is extremely poor policy to use an ACE as means of subsidizing foreign investment in CFCs.

## **V. ADDITIONAL STRUCTURAL CHANGES NECESSARY TO PROTECT THE U.S. TAX BASE**

### *A. Additional Reforms to Balance Residence and Source Taxation*

In order to redress the balance of tax considerations in determining whether to conduct business through a U.S. or non-U.S. MNC, or whether to attempt to change residence, additional structural reforms need to be adopted. We identify four: (1) broadening the definition of a resident corporation to provide that a foreign corporation would be U.S. tax resident if it satisfies a U.S. shareholder ownership test; (2) modifying U.S. taxation of a U.S. portfolio shareholder in a non-U.S. MNC to deny the advantage of a lower foreign corporate effective tax rate; (3) neutralizing the advantage of a non-U.S. MNC in stripping the U.S. corporate tax base with deductible payments by strengthening the U.S. earnings stripping rules; and (4) reforming the investment in U.S. property rules to prevent abuse of deferral under the interim minimum tax. These are important international reforms that are necessary under current law, as well as after reforming taxation of foreign active business income. This list is not exhaustive, but these reforms are closely aligned with increasing U.S. taxation of CFCs.

### *B. Corporate Tax Residence and “Expatriation”*

One policy concern regarding strengthening CFC rules is that it would increase the incentive for a start-up corporation to organize as a foreign corporation and for mature U.S. MNCs to change the tax residence of the parent company to become a foreign parent MNC. While commentators have noted that corporate residence is another “weak margin” that appears easy to change, actual experience suggests that the “home bias” for incorporation

location is surprisingly strong. Outside of a few industries that have a substantial foreign business footprint or regulatory advantage (e.g., offshore oil field services and property and casualty reinsurance), U.S. incorporation is a strong default for U.S. start-ups, including those that might have a significant potential foreign market. This is confounding to many, but is explained by a series of factors, including nontax considerations such as investor preferences and resource constraints. Importantly, tax benefits of non-U.S. parent structures are limited until a U.S. corporation generates material cash flow and taxable income, at which point a foreign-parented group may use earnings stripping strategies to realize tax benefits.<sup>144</sup> Early in the life of an entrepreneurial enterprise, the direct and indirect costs of managing the complex U.S. tax issues that arise for a start-up foreign corporation in order to avoid negative U.S. tax consequences are unattractive to many venture investors.<sup>145</sup>

With respect to mature U.S. MNCs, notwithstanding the adoption of anti-inversion legislation in 2004, there has been continued use of opportunistic expatriation by more mature companies in merger and acquisition transactions and other circumstances in which the foreign corporation will not be reclassified as a domestic corporation.<sup>146</sup> Although recent Treasury actions have slowed the trend, if taxation of foreign income is reformed in a way that increases the U.S. effective tax rate on foreign income, there will be greater pressures on corporate residence issues. It is essential that the issue be considered as part of general international tax reform and not solely in relation to expatriating entities.<sup>147</sup>

As we have discussed in earlier work, we believe that the United States should consider broadening its definition of a resident corporation to provide that foreign corporations are U.S. tax residents if they satisfy either a shareholder residency test or the presently controlling place of incorporation test.<sup>148</sup> We acknowledge that currently there are limitations on identifying ultimate owners, but the identity of shareholders or their tax residence already

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144. See generally Fleming, Peroni & Shay, *Cross-Border Earnings Stripping*, *supra* note 12.

145. For a review of factors influencing initial corporate residence decisions, see Susan C. Morse, *Startup Ltd.: Tax Planning and Initial Incorporation Location* 14 FLA. TAX REV. 319 (2013).

146. See I.R.C. § 7874(b); Notice 2014-52, 2014-42 I.R.B. 712; see also U.S. TREAS. DEP'T, FY 2016 GENERAL EXPLANATIONS, *supra* note 34, at 37-38.

147. See Omri Marian, *The Function of Corporate Tax-Residence in Territorial Systems*, 18 CHAP. L. REV. 157 (2014) (suggesting tying residence to location of business assets and activity); Omri Marian, *Meaningful Corporate Tax Residence*, 140 TAX NOTES 471 (July 29, 2013).

148. See Fleming, Peroni & Shay, *Formulary Apportionment*, *supra* note 1, at 21-25.

is used under the Code, and it is technologically feasible to increase the ability of corporations to learn shareholder identity information through reporting or other means.<sup>149</sup> Importantly, linking corporate residence to greater than 50 percent control by U.S. tax residents would align corporate residence with the one of the primary reasons that the United States seeks to impose a corporate tax—namely, to tax resident shareholders.

C. *Other Measures to Combat Avoidance and Protect the U.S. Tax Base*

Separate and distinct from proposals to modify the definition of corporate residence, two other reforms should be undertaken in relation to reforming taxation of foreign business income: strengthening earnings stripping rules and improving the taxation of U.S. portfolio shareholders in a foreign corporation.

1. *Earnings Stripping Reform*

The first and most direct proposal is to strengthen source taxation generally through improved earnings stripping rules. We have extensively discussed earnings stripping in a separate article and will not repeat that discussion here.<sup>150</sup>

2. *Portfolio Shareholders in a Foreign Corporation*

A second important proposal would be to move toward eliminating the preference for making portfolio investments in the shares of foreign corporations. Following the paradigm of treating a foreign corporation the same as a U.S. corporation, even though a foreign corporation does not pay a U.S. corporate tax on its foreign income, U.S. tax rules accord U.S. individual and tax-exempt shareholders substantially the same tax reliefs for holding stock in a foreign corporation (including a foreign corporation that has engaged in an inversion transaction) as in a U.S. corporation or MNC.<sup>151</sup> This is the case irrespective of whether the foreign corporation has paid a foreign corporate tax commensurate with a U.S. corporate tax.<sup>152</sup> A U.S. individual or tax-exempt shareholder will pay less aggregate tax on earnings distributed with respect to or on the sale of portfolio stock in a low-taxed foreign corporation than in a domestic corporation carrying on the same business. If this taxation is not equalized, there will be continued U.S. tax reasons for U.S.

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149. *See id.* at 22–25.

150. *See* Fleming, Peroni & Shay, *Cross-Border Earnings Stripping*, *supra* note 12.

151. *See, e.g.*, I.R.C. §§ 1(h)(11)(c)(1)(II), 501, 512(b).

152. *See id.*

portfolio investors to favor holding foreign MNC stock over U.S. MNC stock and for U.S. MNCs to expatriate.

One alternative would be to determine the portfolio shareholder-level U.S. tax on foreign earnings distributed from a foreign corporation in two parts. The first part would be a shareholder tax equal to the tax that would be paid on the foreign earnings if they were subject to domestic corporate tax, including allowing foreign corporate-level taxes as a credit. This equalizing tax would be imposed on tax-exempt as well as taxable shareholders just as would occur with respect to an equity investment in a domestic corporation. It is strange indeed to advantage investment by U.S. tax-exempt investors in foreign corporations over investment in U.S. corporations, but that is the case today in relation to foreign corporations subject to low effective rates of tax.

The distributed earnings (reduced by the preceding shareholder tax as though it were a corporate-level tax) then would be subject to the normal U.S. tax rules for that dividend income, including exemption in the case of a tax-exempt shareholder.<sup>153</sup> The same mechanism could be applied to gains on the sale of foreign stock to the extent of untaxed deferred earnings.<sup>154</sup> This would mitigate the advantage to a U.S. portfolio shareholder of earning foreign income through a foreign corporation not subject to U.S. corporate-level tax.<sup>155</sup>

At a minimum, as we have discussed in a prior article, foreign dividends should not qualify for the lower tax rate allowed for qualified dividend income to the extent that the foreign corporate-level effective tax rate

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153. The taxing structure described is used in current law section 962, which permits an individual U.S. shareholder in a CFC to elect to take a credit for a foreign corporate tax against the U.S. tax on a subpart F inclusion, but conditions the election on (1) the shareholder being subject to a notional U.S. corporate-level tax against which the foreign corporate tax is credited, and (2) the shareholder being subject to normal U.S. tax when the earnings are actually distributed (though reduced by any additional tax paid under (1)). The section 962 election is rarely used under current law. A U.S. portfolio shareholder owning less than 10 percent by voting power of the foreign corporation could be allowed to rely on the foreign corporation's published financial statements to make reasonable estimates of retained earnings and foreign taxes. In the absence of such information, gain would be attributed to earnings.

154. A similar deemed corporate-level tax is used as a limitation on the tax of an individual U.S. shareholder on dividend treatment of stock sale gain under section 1248. *See* I.R.C. § 1248(b).

155. Earning foreign income through a foreign corporation would have a time value of money advantage in that the equalizing tax would not be applied until a dividend was paid, whereas domestic corporations incur the U.S. corporate income tax as soon as foreign income is received or accrued at the corporate level. The foreign corporation advantage, however, would be materially reduced.

is lower than the U.S. corporate tax rate.<sup>156</sup> In addition, the preferential capital gains rate for stock sale gain attributable to the foreign corporation's low-taxed foreign earnings should be denied.<sup>157</sup> These modifications of shareholder taxation would bear on the corporate residence decision, particularly by domestic corporations that have a substantial U.S. shareholder base and may consider expatriation, not just in terms of the corporate-level tax, but also the taxation of ongoing shareholders.

If source taxation is strengthened and the taxation of U.S. portfolio investors in a foreign corporation is rationalized, as described above, the marginal effect of strengthening CFC rules on corporate residence decisions should be reasonably balanced. The risk of increased corporate expatriations should be held in check.

#### D. Fixing Investment in U.S. Property Rules

As a second-best approach, we recommend retaining deferral for earnings not deemed distributed under our proposed interim minimum tax. This would require retaining the section 956 investment in U.S. property rules, which have been the target of repeated tax planning and tax avoidance.<sup>158</sup> In order to forestall the continued whack-a-mole approach to planning around these limitations on the benefit from deferral, we recommend a simple adjustment that would frustrate most current avoidance of these rules.

As one of us has observed in another article:

The policy rationale for limiting the use of untaxed foreign subsidiary earnings in an affiliate's U.S. business is

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156. See Shay, Fleming & Peroni, *Territoriality in Search of Principles*, *supra* note 1, at 181–85; see also A.B.A. Tax Sec. Task Force on International Tax Reform, *Report of the Task Force on International Tax Reform*, 59 TAX LAW. 649, 698–699 (2006) (calling for reconsideration of the scope of qualified dividend income treatment for a dividend from a foreign corporation); see also Michael J. Graetz & Rachael Doud, *Technological Innovation, International Competition, and the Challenges of International Income Taxation*, 113 COLUM. L. REV. 347, 433 (2013) (stating that imposing a requirement that the lower tax rate in section 1(h)(11) apply only if U.S. corporate taxes are paid “might substantially relieve income-shifting incentives for U.S. MNEs”).

157. In addition, with respect to corporate managers of expatriated companies, if foreign taxes are imposed at lower rates than U.S. taxes, section 457A-type restrictions on compensation deferrals could be extended to all cases where the deferred amounts are not subject to a corporate tax equivalent to the U.S. corporate tax.

158. See, e.g., Levin & Coburn, *Memorandum on Microsoft and HP*, *supra* note 54, at 24–27 (describing HP's attempt to end run the I.R.C. § 956 rules).

that a U.S. MNE should not be allowed to use pretax dollars to invest in a U.S. business, just as a purely domestic business would have to pay U.S. tax on its earnings before it could reinvest them in its U.S. business. In other words, the U.S. MNE is allowed the tax benefit of deferral so it can compete with other MNEs outside the United States, but it cannot import that tax benefit to the United States to achieve an advantage over other U.S. businesses.<sup>159</sup>

Today, most repatriation planning revolves around isolating pools of low-taxed earnings in some CFCs and making loans or basis recovery distributions to the U.S. group from CFCs that do not have earnings. Adopting a foreign consolidated group approach to these rules would frustrate schemes used to circumvent the rules limiting use of pre-tax earnings in the U.S. business of the U.S. MNC.<sup>160</sup> We would recommend applying section 956 on the basis of all CFCs in the U.S. shareholder's worldwide affiliated group and treating their earnings as a single pool for purposes of testing whether a CFC's holding of U.S. property gives rise to a deemed dividend.

## VII. CONCLUSION

The preferred approach to strengthening the CFC rules is to adopt an interim minimum tax equal to a material percentage of the U.S. corporate rate. The minimum tax amount would be determined on a country-by-country basis, taking into account each QBU with positive earnings and the foreign income tax paid. The impact would be to impose an "additional tax amount" that would cause the effective rate of tax on earnings from each country to be not less than the minimum tax rate. The CFC would be deemed to distribute the amount of earnings that, when included in the income of its U.S. shareholder, would result in U.S. tax equal (in the aggregate) to the additional tax amount. The earnings deemed distributed would thereafter constitute previously taxed earnings. Sections 959 and 961 would apply to prevent a second taxation of these earnings.

This minimum tax reform should be accompanied by the enactment of provisions that would reduce the incentive for a U.S. parent corporation to shift

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159. Shay, *Truthiness of Lockout*, *supra* note 61, at 1394.

160. The Internal Revenue Service (IRS) has quite broad authority under existing anti-abuse regulations to counter circumvention of the section 956 rules, *see* Temp. Reg. § 1.956-1T(b)(4); however, this authority has not been employed in contexts that have become public. This is consistent with a general caution on the part of the IRS examination division to aggressively assert discretionary authority. In a similar vein, many practitioners are unaware of a single case in which the IRS has sought to make a retrospective adjustment using its authority under the transfer pricing regulations' periodic adjustment rules. *See* Reg. § 1.482-4(f)(2).

its tax residence abroad. The reduced incentives to shift income to a low-taxed CFC and the increased amount of previously taxed earnings by reason of imposition of the minimum tax would mitigate the incentive to hold excess earnings offshore and thereby ameliorate the lockout problem. Although implementation of an interim minimum tax proposal as described in this Article would be second best to ending deferral (our preferred reform), it would be a material improvement over current law.