

**ECONOMIC EFFICIENCY AND STRUCTURAL ANALYSES
OF ALTERNATIVE U.S. TAX POLICIES FOR
FOREIGN DIRECT INVESTMENT**

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INTRODUCTION

This pamphlet¹ continues the recent work of the staff of the Joint Committee on Taxation in reconsidering tax expenditure analysis, by applying our new framework for that field to the case of current law's "deferral" of the earnings of foreign corporations owned by U.S. persons.² In particular, this pamphlet describes the economic inefficiencies (and resultant behavioral distortions) reflected in current law's "deferral" treatment of foreign earnings, and considers two possible alternative tax regimes. This pamphlet was prepared in connection with a public hearing on international tax reform to be held by the Senate Committee on Finance on June 26, 2008.

As we describe in Section II, the taxation of domestic corporations on worldwide income, coupled with the deferral treatment of foreign earnings, raises several important and related economic efficiency concerns: (1) the differing treatment of domestic and foreign corporations creates an incentive for a multinational group to locate its parent company offshore, (2) deferral implies a conditionally different tax rate on foreign active business income than the rate that applies to domestic income, and this difference may affect the type and location of business investment when compared either to a wholly domestic enterprise, or to a wholly foreign one, and (3) U.S. firms may have an incentive under present law not to repatriate certain "active" foreign earnings to the United States.³ One possible solution to these efficiency concerns is to adopt a "territorial" tax regime; at the other extreme, another solution would be to adopt a "full inclusion" tax regime. Each solution in turn raises structural issues relating to its implementation. These solutions and the issues they present are discussed in Sections III and IV below.

In this pamphlet, we apply our new tax expenditure paradigm, with its emphasis on economic efficiency concerns, to the debate over what constitutes appropriate U.S. income tax policy for foreign direct investment by U.S. firms. Our revised approach to tax expenditure analysis seeks to improve the utility of the doctrine and reemphasize its neutrality. To do so, we divide the universe of such provisions into two main categories: tax expenditures in a narrow sense, which we label "Tax Subsidies," and a new category that we have termed "Tax-Induced Structural Distortions."

We define a "Tax Subsidy" as a specific tax provision that is deliberately inconsistent with an identifiable general rule of the present tax law (not a hypothetical "normal" tax). Some important provisions previously identified as tax expenditures cannot easily be described as

¹ This document may be cited as follows: Joint Committee on Taxation, *Economic Efficiency and Structural Analyses of Alternative U.S. Tax Policies for Foreign Direct Investment* (JCX-55-08), June 25, 2008. This document can also be found on our website at www.jct.gov.

² Our new framework is described in Joint Committee on Taxation, *A Reconsideration of Tax Expenditure Analysis* (JCX-37-08), May 12, 2008.

³ A taxpayer whose foreign tax credit position leaves it vulnerable to U.S. residual taxation may refrain from repatriating income back to the United States.

exceptions to a general rule of present law, because the general rule is not clear from the face of the Internal Revenue Code (the “Code”). These provisions therefore cannot fairly be described as “Tax Subsidies.” The “deferral” treatment under present law of the earnings of foreign corporations owned by U.S. persons is an important example of such a provision.⁴

Under our revised approach to tax expenditure analysis, we classify the deferral treatment of foreign earnings as a Tax-Induced Structural Distortion. These we define as structural elements of the Code (not deviations from any clearly identifiable general tax rule and thus not Tax Subsidies) that materially affect economic decisions in a manner that imposes substantial economic efficiency costs.

This pamphlet focuses on U.S. tax policies towards foreign direct investment by U.S. multinational corporations. A “direct investment” is one over which the owner has direct control, such as a wholly-owned subsidiary. The Department of Commerce, for example, defines an investment as “direct” when a single person owns or controls, directly or indirectly, at least 10 percent of the voting securities of a corporate enterprise or the equivalent interests in an unincorporated business. The remainder of this pamphlet describes the standards of present U.S. tax law in this regard, and how those standards might be revised in the alternative approaches described below.

The largest category of outbound investment by U.S. investors is not direct investment, but rather portfolio investment — that is, investment in securities of foreign governments or private enterprises that do not confer any position of control.⁵ At year-end 2006, for example, U.S. foreign direct investment constituted approximately one quarter of U.S. ownership of foreign assets, with foreign direct investment valued at \$2.89 trillion and portfolio investment valued at \$9.34 trillion (with direct investment measured at current cost).⁶ Nonetheless, foreign direct investment remains an extremely important component of the present profitability and future growth of many of the largest U.S.-domiciled public companies, and of many smaller or privately-held firms as well. U.S. tax policies towards foreign direct investment by U.S. firms therefore have a significant effect on the economy, and deserve periodic careful reconsideration. At the same time, however, those policies must be designed with a view to their coordination with U.S. tax policies towards cross-border portfolio investment, because as the data suggest, U.S.-based multinational firms compete for capital from U.S. investors with portfolio investment opportunities in foreign firms.

⁴ See J. Clifton Fleming, Jr. and Robert J. Peroni, *Reinvigorating Tax Expenditure Analysis and its International Dimension*, 27 Virginia Tax Review 101, 196-97 (2008).

⁵ See Joint Committee on Taxation, *Economic and U.S. Income Tax Issues Raised by Sovereign Wealth Fund Investment in the United States* (JCX-49-08), June 17, 2008, at 16-17.

⁶ *Id.* at 17.

I. PRESENT LAW: WORLDWIDE TAXATION AND DEFERRAL OF ACTIVE BUSINESS INCOME

The United States employs a “worldwide” tax system, under which U.S. resident individuals and domestic corporations generally are taxed on all income, whether derived in the United States or abroad.⁷ Income earned directly or through a pass-through entity such as a partnership is taxed on a current basis. However, active foreign business income earned by a domestic parent corporation indirectly through a foreign corporate subsidiary generally is not subject to U.S. tax until the income is distributed as a dividend to the domestic corporation. This favorable rule in turn is circumscribed by the anti-deferral rules of subpart F of the Code, which provide that a domestic parent corporation is subject to U.S. tax on a current basis with respect to certain categories of passive or highly mobile income earned by its foreign subsidiaries. In order to mitigate double taxation of foreign source income, the United States allows a domestic corporation to claim a credit for foreign income taxes paid by it and by its foreign subsidiaries, subject to certain limitations. In addition, U.S. tax law imposes an exit tax when a U.S. company decides to sidestep U.S. taxation by migrating its tax residence from the United States to a foreign jurisdiction through a “corporate inversion” transaction.

This section describes the principal features of present law and discusses the economic distortions resulting from the current regime.

A. Present Law — Principal Features

1. Anti-deferral regimes

Subpart F

Under the subpart F rules,⁸ 10 percent-or-greater U.S. shareholders (“United States Shareholders”) of a controlled foreign corporation (“CFC”) are subject to U.S. tax currently on their pro rata shares of certain income earned by the CFC, whether or not such income is distributed to the shareholders. A CFC is defined generally as a foreign corporation with respect to which United States Shareholders own more than 50 percent of the combined voting power or total value of the stock of the corporation.

Income subject to current inclusion under subpart F (before consideration of the temporary rules described below) includes, among other categories, insurance income and foreign base company income. Foreign base company income consists of foreign personal holding company income, income from certain transactions involving a related person (e.g.,

⁷ For convenience, the remainder of this pamphlet generally is phrased in terms of U.S. corporate, rather than individual, owners of foreign subsidiaries, as this is the most common fact pattern.

⁸ Secs. 951-964. Unless otherwise specified, all section references are to the Internal Revenue Code of 1986, as amended.

income derived from services performed for or on behalf of a related person outside the country in which the CFC is organized) and income attributable to certain oil and gas activities.⁹

Foreign personal holding company income generally comprises the following: (1) dividends, interest, royalties, rents, and annuities; (2) net gains from the sale or exchange of (a) property that gives rise to the preceding types of income, (b) property that does not give rise to income, and (c) interests in trusts, partnerships, and real estate mortgage investment conduits (“REMICs”); (3) net gains from commodities transactions; (4) net gains from certain foreign currency transactions; (5) income that is equivalent to interest; (6) income from notional principal contracts; (7) payments in lieu of dividends; and (8) amounts received under personal service contracts.

Temporary exceptions from foreign personal holding company income, foreign base company services income, and insurance income apply for subpart F purposes for certain income that is derived in the active conduct of a banking, financing, or similar business, as a securities dealer, or in the conduct of an insurance business (so-called “active financing income”).¹⁰ In addition, so-called “look-through rules” temporarily provide that dividends, interest, rents, and royalties received by one CFC from a related CFC are not treated as foreign personal holding company income to the extent attributable or properly allocable to non-subpart F income of the payor. For these purposes, a related CFC is a CFC that controls or is controlled by the other CFC, or a CFC that is controlled by the same person or persons that control the other CFC. Ownership of more than 50 percent of the CFC’s stock (by vote or value) constitutes control for these purposes.¹¹

⁹ Sec. 954.

¹⁰ Temporary exceptions from the subpart F provisions for certain active financing income applied only for taxable years beginning in 1998 (Taxpayer Relief Act of 1997, Pub. L. No. 105-34). Those exceptions were modified and extended for one year, applicable only for taxable years beginning in 1999 (Tax and Trade Relief Extension Act of 1998, Pub. L. No. 105-277). The Tax Relief Extension Act of 1999 (Pub. L. No. 106-170) clarified and extended the temporary exceptions for two years, applicable only for taxable years beginning after 1999 and before 2002. The Job Creation and Worker Assistance Act of 2002 (Pub. L. No. 107-147) modified and extended the temporary exceptions for five years, for taxable years beginning after 2001 and before 2007. The Tax Increase Prevention and Reconciliation Act of 2005 (Pub. L. No. 109-222) extended the temporary provisions for two years, for taxable years beginning after 2006 and before 2009. Section 239 of the “Renewable Energy and Job Creation Act of 2008,” H.R. 6049 (which passed in the House of Representatives on May 21, 2008), would temporarily extend this provision through January 1, 2010.

¹¹ The temporary look-through rules apply only for taxable years of foreign corporations beginning after December 31, 2005 and before January 1, 2009, and to the taxable years of United States Shareholders with or within which the specified tax years of such foreign corporations end. Sec. 954(c)(6)(B). Section 240 of the “Renewable Energy and Job Creation Act of 2008,” H.R. 6049 (which passed in the House of Representatives on May 21, 2008), would temporarily extend this provision through January 1, 2010.

In addition to current taxation of insurance income and foreign base company income, United States Shareholders are subject to taxation currently on income that is deemed to be distributed when a CFC increases its investment in U.S. property. For this purpose and subject to certain exceptions, U.S. property includes tangible property located in the United States, stock or debt of a related U.S. person and rights to use certain intangible property in the United States.

Passive foreign investment companies

U.S. shareholders (both individuals and corporations) are effectively taxed currently on earnings of passive foreign investment companies (“PFICs”), regardless of the amount of the PFIC’s stock that they own.¹² A PFIC is any foreign corporation: (1) 75 percent or more of the gross income of which is passive, and (2) at least 50 percent of the assets of which produce passive income or are held for the production of passive income.¹³ Passive income generally is the same as foreign personal holding company income, as defined for subpart F purposes.¹⁴

The PFIC rules provides for three different methods of taxation. The first is the “excess distribution” regime pursuant to which gains from the disposition of PFIC stock and distributions that exceed prior year averages are deemed to have been earned ratably over the U.S. taxpayer’s holding period and are subject to an interest charge to reflect the time value of the deferred tax payment. The excess distribution regime can be avoided if a U.S. shareholder elects to treat the PFIC as a qualified electing fund (a “QEF”). If a QEF election is made, the U.S. shareholder is taxed currently on its share of the QEF’s earnings. QEF elections may be made only if the PFIC provides sufficient data to its shareholders that the PFIC’s ordinary earnings and net capital gain can be determined each year. For investors in publicly traded foreign mutual funds, who may not be able to make QEF elections, there is also a mark-to-market election. In that case, the U.S. shareholder reflects its annual built-in gain or loss for the year in its taxable income.

2. Foreign tax credit

Subject to certain limitations, a domestic corporation is allowed to claim a credit for foreign income taxes it pays. A domestic corporation that owns at least 10 percent of the voting stock of a foreign corporation is allowed a “deemed-paid” credit for foreign income taxes paid by the foreign corporation that the domestic corporation is deemed to have paid when the related

¹² For purposes of the PFIC rules, references to a U.S. shareholder must be distinguished from references to a United States Shareholder (as defined above). A U.S. shareholder in the context of the PFIC rules is a U.S. person that holds any number of shares of PFIC stock. In the context of subpart F, a United States Shareholder is any U.S. person that owns at least 10 percent of the total combined voting power of all classes of stock of a CFC. Sec. 951(b).

¹³ Sec. 1297(a).

¹⁴ Sec. 1297(b).

income is distributed or included in the domestic corporation's income under the anti-deferral rules.¹⁵

The foreign tax credit generally is limited to a taxpayer's U.S. tax liability on its foreign-source taxable income (as determined under U.S. tax accounting principles). This limit is intended to ensure that the credit serves its purpose of mitigating double taxation of foreign-source income without offsetting U.S. tax on U.S.-source income.¹⁶ The limit is computed by multiplying a taxpayer's total U.S. tax liability for the year by the ratio of the taxpayer's foreign-source taxable income for the year to the taxpayer's total taxable income for the year. If the total amount of foreign income taxes paid and deemed paid for the year exceeds the taxpayer's foreign tax credit limitation for the year, the taxpayer may carry back the excess foreign taxes to the previous year or carry forward the excess taxes to one of the succeeding 10 years.¹⁷

The computation of the foreign tax credit limitation requires a taxpayer to determine the amount of its taxable income from foreign sources in each category by allocating and apportioning deductions between U.S.-source gross income, on the one hand, and foreign-source gross income in each limitation category (described below), on the other.¹⁸ In general, deductions are allocated and apportioned to the gross income to which the deductions factually relate.¹⁹ However, subject to certain exceptions, deductions for interest expense and research and experimental expenses are apportioned based on taxpayer ratios.²⁰ In the case of interest expense, this ratio is the ratio of the corporation's foreign or domestic (as applicable) assets to its worldwide assets. In the case of research and experimental expenses, the apportionment ratio is based on either sales or gross income. All members of an affiliated group of corporations generally are treated as a single corporation for purposes of determining the apportionment ratios.²¹

¹⁵ Secs. 901, 902, 960 and 1295(f).

¹⁶ Secs. 901 and 904.

¹⁷ Sec. 904(c).

¹⁸ Subject to applicable limitations, deductions allocated and apportioned to foreign source gross income are deductible on a current basis irrespective of whether the related foreign income is taken into account currently or is deferred. To the extent that foreign income is deferred indefinitely or permanently, this treatment could create a situation in which there is effectively a negative tax rate because expenses that are deducted are never matched up to the corresponding — but untaxed — income they produce.

¹⁹ Treas. Reg. sec. 1.861-8(b) and Temp. Treas. Reg. sec. 1.861-8T(c).

²⁰ Temp. Treas. Reg. sec. 1.861-9T and Treas. Reg. sec. 1.861-17.

²¹ Sec. 864(e)(1) and (6); Temp. Treas. Reg. sec. 1.861-14T(e)(2).

The term “affiliated group” is determined generally by reference to the rules for determining whether corporations are eligible to file consolidated returns.²² These rules exclude foreign corporations from an affiliated group.²³ The American Jobs Creation Act of 2004 (“AJCA”)²⁴ modified the interest expense allocation rules for tax years beginning after December 31, 2008.²⁵ The new rules permit a U.S. affiliated group to apportion the interest expense of the members of the U.S. affiliated group on a worldwide-group basis (i.e., as if all domestic and foreign affiliates are a single corporation). The new rules are generally expected to reduce the amount of the U.S. group’s interest expense that is allocated to foreign source income.

The foreign tax credit limitation is applied separately to “passive category income” and to “general category income.”²⁶ Passive category income includes passive income, such as portfolio interest and dividend income, and certain specified types of income. General category income includes all other income. Passive income is treated as general category income if it is earned by a qualifying financial services entity. Passive income is also treated as general category income if it is high-taxed (i.e., if the foreign tax rate is determined to exceed the highest rate of tax specified in Code section 1 or 11, as applicable). Dividends (and subpart F inclusions), interest, rents, and royalties received by a United States Shareholder from a CFC are assigned to a separate limitation category by reference to the category of income out of which the dividend or other payment was made.²⁷ Dividends received by a 10 percent corporate shareholder of a foreign corporation that is not a CFC are also categorized on a look-through basis.²⁸

²² Secs. 864(e)(5) and 1504.

²³ Sec. 1504(b)(3).

²⁴ Pub. L. No. 108-357.

²⁵ AJCA, sec. 401. Section 402 of the “Renewable Energy and Job Creation Act of 2008,” H.R. 6049 (which passed in the House of Representatives on May 21, 2008), would temporarily delay implementation of this provision until January 1, 2018.

²⁶ Sec. 904(d). AJCA generally reduced the number of income categories from nine to two, effective for tax years beginning in 2006. Prior to AJCA, the foreign tax credit limitation was applied separately to the following categories of income: (1) passive income, (2) high withholding tax interest, (3) financial services income, (4) shipping income, (5) certain dividends received from noncontrolled section 902 foreign corporations (also known as “10/50 companies”), (6) certain dividends from a domestic international sales corporation or former domestic international sales corporation, (7) taxable income attributable to certain foreign trade income, (8) certain distributions from a foreign sales corporation or former foreign sales corporation, and (9) any other income not described in items (1) through (8) (so-called “general basket” income). A number of other provisions of the Code create additional separate categories in specific circumstances. *See, e.g.*, secs. 865(h) and 901(j).

²⁷ Sec. 904(d)(3).

²⁸ Sec. 904(d)(4).

Application of the foreign tax credit limitation separately to passive category income (generally considered to be low-taxed income) and general category income is intended to limit cross-crediting (i.e., the use of foreign taxes imposed at high foreign tax rates to reduce the residual U.S. tax on low-taxed foreign source income). However, even with these constraints, the current system allows for a significant amount of cross-crediting. For example, excess foreign taxes, such as those arising in connection with the receipt of dividends from a high-taxed CFC, are often used to offset U.S. tax on royalties received for the use of intangible property in a low-tax country. According to one study, almost two-thirds of royalties were sheltered by excess foreign tax credits in 2000.²⁹

3. U.S. taxation of foreign corporations — corporate inversions

The U.S. tax treatment of a multinational corporate group depends significantly on whether the top-tier “parent” corporation of the group is domestic or foreign. For purposes of U.S. tax law, a corporation is treated as domestic if it is incorporated under the laws of the United States or of any State.³⁰ All other corporations (i.e., those incorporated under the laws of foreign countries) are treated as foreign.³¹ Thus, the place of incorporation determines whether a corporation is treated as domestic or foreign for purposes of U.S. tax law, irrespective of other factors that might be thought to bear on a corporation’s “nationality,” such as the location of the corporation’s management activities, employees, business assets, operations, revenue sources, the exchanges on which the corporation’s stock is traded, or the residence of the corporation’s shareholders.

The United States taxes only domestic corporations on a worldwide basis. Foreign corporations are taxed by the United States only on income that has sufficient nexus in the United States.

Until recently, a U.S. parent corporation could reincorporate in a foreign jurisdiction, potentially without any exit tax to compensate the U.S. for the loss of future tax revenue from the departing company. It was not always clear, however, whether such reincorporations generally had a significant non-tax purpose or effect, or whether the corporate group had a significant business presence in the new country of incorporation. These transactions were commonly referred to as “inversions.” Under prior law, inversion transactions could produce a variety of tax benefits, including the removal of a group’s foreign operations from U.S. tax jurisdiction and the potential for reduction of U.S. tax on U.S.-source income through subsequent “earnings

²⁹ Harry Grubert and Rosanne Altshuler, *Corporate Taxes in the World Economy: Reforming the Taxation of Cross-Border Income*, prepared for presentation at the James A. Baker III Institute for Public Policy Conference, “Is It Time for Fundamental Tax Reform?: The Known, Unknown, and Unknowable,” held in Houston, Texas on April 27-28, 2006 (draft dated December 12, 2006) (hereinafter, Grubert and Altshuler (2006)), at 11.

³⁰ Sec. 7701(a)(4).

³¹ Sec. 7701(a)(5).

stripping” transactions (e.g., large payments of interest or royalties from a U.S. subsidiary to the new foreign parent).

AJCA included provisions designed to curtail inversion transactions. Most significantly, section 801 of AJCA added section 7874 to the Code, which denies certain tax benefits of a typical inversion transaction by deeming the new top-tier foreign corporation to be a domestic corporation for all Federal tax purposes. This sanction generally applies to a transaction in which, pursuant to a plan or a series of related transactions: (1) a U.S. corporation becomes a subsidiary of a foreign-incorporated entity or otherwise transfers substantially all of its properties to such an entity in a transaction completed after March 4, 2003; (2) the former shareholders of the U.S. corporation hold (by reason of the stock they had held in the U.S. corporation) 80 percent or more (by vote or value) of the stock of the foreign-incorporated entity after the transaction; and (3) the foreign-incorporated entity, considered together with all companies connected to it by a chain of greater than 50 percent ownership (i.e., the “expanded affiliated group”), does not have substantial business activities in the entity’s country of incorporation, compared to the total worldwide business activities of the expanded affiliated group.³²

³² AJCA also provides for a lesser set of sanctions with respect to a transaction that would meet the definition of an inversion transaction described above, except that the 80 percent ownership threshold is not met. In such a case, if at least a 60 percent ownership threshold is met, then a second set of rules applies to the inversion. Under these rules, the inversion transaction is respected (i.e., the foreign corporation is treated as foreign), but any applicable corporate-level “toll charges” for establishing the inverted structure are not offset by tax attributes such as net operating losses or foreign tax credits. AJCA also subjects certain partnership transactions to the new inversion rules.

II. ECONOMIC DISTORTION RESULTING FROM DEFERRAL POLICIES

A. Overview

Many analysts have concluded that U.S. tax policy significantly influences cross-border investment decisions by U.S. persons. When tax policy influences economic decisions it creates economic inefficiencies. That is, the distortive effects of a tax policy (whether those effects are to encourage or discourage particular activities), beyond those distortions that are inherent to an income tax structure (e.g., consumption versus saving), lead taxpayers to allocate their resources in a manner that they would not do in a world without taxes, or in a world with a more neutral income tax.

Our tax expenditure analysis labels these sorts of economic inefficiencies as tax induced structural distortions. When applied to the international operations of U.S. firms, the signature features of present law that are the genesis of these tax induced structural distortions are: (1) the policy decision to tax U.S. persons on their worldwide income; and, (2) the policy decision to allow deferral of U.S. tax for income from active business operations abroad, if conducted in a foreign corporation. In turn, the practical expressions of these economic distortions include decisions over where to locate new investments, and decisions over whether to repatriate foreign deferred earnings.

Each country chooses its own tax base and the tax rates applicable to that base. If not all countries choose the same effective tax rate, and if not all countries choose a worldwide system of income taxation, a taxpayer seeking to maximize its after-tax returns on investment may choose its residence to increase the after-tax returns to its investments. In addition to the distortion of residency choice, the residency decision affects countries' tax bases, necessitating higher or lower taxes than would otherwise occur, with resulting distortions that such other taxes may create.

Under any income tax, the opportunity for deferral of recognition of income lowers a taxpayer's effective tax liability. As a result, any system involving deferral creates incentives for taxpayers to choose lower earning investments which benefit from deferral at the expense of higher earning investments on which income recognition cannot be deferred. The decision to defer income offshore may have the collateral effect of changing the domestic rate of growth of income.

In addition, deferral may create what may be called "second order" distortions of taxpayers' choices. Rules created to protect the policy of deferral for active income or the determination of taxpayers subject to the worldwide regime may result in economically inefficient business structures or investment decisions as taxpayers try to qualify their income as the result of an active business or qualify their investment as not resident in the United States.

B. Worldwide Taxation and Distortion of Residency Choice

1. Worldwide taxation and residency choice

As explained in Section I.A.3., above, the U.S. tax treatment of a multinational corporate group depends significantly on whether the top-tier “parent” corporation of the group is domestic or foreign. For purposes of U.S. tax law, a corporation is treated as domestic if it is incorporated under the laws of the United States or of any State. All other corporations (i.e., those incorporated under the laws of foreign countries) are treated as foreign. Only domestic corporations are subject to tax on a worldwide basis. Foreign corporations are taxed only on income that has sufficient nexus in the United States.

To understand the implications of this distinction consider two corporations: one a U.S. resident corporation and one a foreign resident corporation. Assume the corporate income tax rate everywhere outside the United States is 25 percent. Absent consideration of deferral, the income earned by the U.S. corporation from operations in the United States is taxed at the prevailing U.S. corporate tax rate, generally 35 percent, and the income earned by a U.S. corporation from operations outside the United States also is taxed at 35 percent. The income of the foreign corporation from operations in the United States is taxed at the prevailing U.S. corporate income tax rate, 35 percent, just as is such income earned by the U.S. corporation. On the other hand, the income earned by the foreign corporation from operations outside the United States is taxed at 25 percent.

All else equal, the foreign corporation has a higher after-tax cash flow than does the U.S. corporation.³³ Shareholders, regardless of the nation of residence of the shareholders, would view the shares of the foreign corporation as more valuable as the foreign corporation could pay higher dividends from its after-tax income. As a result, to maximize shareholder value, a corporation’s choice of residency may be determined by tax considerations in addition to considerations such as liability protection, shareholder rights, and other concerns.

As described earlier, U.S. firms in the recent past sought to take advantage of the differential treatment of U.S. and foreign domiciled top-tier companies through inversion transactions. AJCA included provisions designed to curtail inversion transactions.

AJCA did not, however, address the choice of residency available to *new* enterprises. As a result, even post-AJCA law contains powerful tax incentives for a new firm to opt out of U.S. residence for its top-tier entity.

The economic distortion created consists of two components. First, an enterprise that in the absence of the prevailing tax policy would have naturally chosen to incorporate in the United

³³ Joel Slemrod and Reuven Avi-Yonah, *How Should Trade Agreements Deal with Income Tax Issues?* 55 Tax Law Review 533 (2002). Slemrod and Avi-Yonah write, “[T]his system is no more efficient than in a domestic context taxing corporations with names beginning with the letters A through K at one rate, while taxing at a higher rate those with names beginning with L through Z (and not allowing name changes)” at 542.

States, chooses to incorporate elsewhere. This decision creates a “second order” distortion in that by incorporating outside the United States the U.S. tax base is reduced. The diminution of the U.S. tax base may result in higher taxes elsewhere in the economy. Increasing other taxes will increase the economic distortions inherent in those other taxes.³⁴

2. Does worldwide taxation distort ownership of cross-border investments?

Some analysts have characterized the distortion that can arise from a system of worldwide taxation in a world that includes other tax systems and differing tax rates, not by distortion of residency choice, but rather by the ownership of investments.³⁵ They argue that economic efficiency would be promoted if tax systems around the world do not distort the ownership pattern of investments, that is, an efficient system would promote “capital ownership neutrality.”

The underlying premise of this notion of neutrality is that the same units of physical capital (plant and equipment) will have different levels of productivity and profitability, depending upon who owns that capital and manages its operation. The differences in productivity from a given production facility may result from proprietary intangible assets of the owners.³⁶ If the productivity and profitability of physical assets depends upon the intangible assets of those who own and manage the assets, efficiency is improved if those who possess the proper intangible assets that will permit the greatest productivity from the physical assets own the physical assets. If the tax system dissuades the most productive owners from owning any particular physical assets, wherever located, then economic efficiency is diminished.

Capital ownership neutrality would be achieved if all countries were to tax foreign income, but permit a full foreign tax credit. Likewise, if all countries were to exempt foreign income from their tax base, capital ownership neutrality would be achieved. In each circumstance, ownership would be determined by productivity differences and not tax

³⁴ As a backstop to the erosion of the U.S. worldwide tax base that could occur under such “inverted start ups” and other inversion transactions, the Joint Committee on Taxation staff recommended altering residency tests within the policy of worldwide taxation. See, Joint Committee on Taxation, *Options to Improve Tax Compliance and Reform Tax Expenditures*, (JCS-2-05), January 27, 2005, hereinafter, *JCT Options Report*.

³⁵ Mihir A. Desai and James R. Hines, Jr., *Evaluating International Tax Reform*, 56 National Tax Journal 487 (September 2003). Also, Mihir Desai and James R. Hines, Jr., *Old Rules and New Realities: Corporate Tax Policy in a Global Setting*, 57 National Tax Journal 937 (December 2004).

³⁶ Some argue that much cross border investment by multinational businesses is motivated because these businesses possess intangible assets such as patents, trade names, and proprietary production skills. The purchase of an under-performing existing business’s physical plant allows the owner of these intangible assets the ability to quickly earn returns on these intangible assets and know-how in foreign markets. For example, see Richard E. Caves, *Multinational Enterprise and Economic Analysis*, (Cambridge, U.K.: Cambridge University Press), 1996.

differences.³⁷ In either circumstance, if any country's tax policy deviated from conformity, ownership neutrality could not be achieved. From this vantage point, the U.S. tax system, which is both complex and an outlier to the prevailing trend, is argued to be distortive, in a way that disadvantages US. corporate ownership of assets compared to some foreign corporate ownership.

³⁷ Desai and Hines, *Evaluating International Tax Reform*, *supra*. In the first case, involving taxation of foreign source income and a full tax credit, the tax systems of all countries would be consistent with the principle of capital export neutrality. In the second case, involving the exemption of foreign source income, the tax systems of all countries would be consistent with the principle of capital import neutrality. Each case would result in the multinational enterprise being subject to only the tax imposed by the residence country. In either case the rates of tax imposed by different countries could be different and ownership neutrality would be sustained. This could lead to distortions in the geographic location of physical investment, but not in the ownership of the physical investment. Desai and Hines write, "Whether the [efficiency] cost of having too many factories in the Bahamas is larger or smaller than the cost of discouraging value-enhancing corporate acquisitions is ultimately an empirical question, though the importance of ownership to FDI [foreign direct investment] suggest that its welfare impact may also be substantial."

C. Deferral and Distortion of Investment

1. The benefit of deferral

The principal advantage of deferral is the ability to retain earnings in the foreign corporation and invest them such that they are not subject to U.S. tax on an annual basis, i.e., invest them on a pre-tax basis. Suppose that a U.S. taxpayer in the 35 percent bracket earns \$100 of income today from a controlled foreign corporation and defers it for five years by re-investing the income in the controlled foreign corporation, such that the foreign corporation can invest the money and earn a 10 percent return per year.³⁸ The taxpayer would then have \$161.05 and pay tax of \$56.37, for an after-tax income of \$104.68. Suppose there is another U.S. taxpayer who has access to an equivalent investment opportunity, but cannot defer tax because this taxpayer's investment opportunity is located in the United States. This taxpayer receives \$100 in income today, pays tax of \$35, and has only \$65 to invest. The taxpayer invests that amount at an after-tax rate of 6.5 percent, i.e., a 10 percent pre-tax rate less 35 percent tax on the earnings each year. At the end of five years, this taxpayer will only have \$89.06. The \$15.62 ultimate difference in economic wealth between the taxpayer who could defer the income for five years (whose deferred income in turn compounded at 10 percent per year), compared to the otherwise identically-situated taxpayer who was required to pay tax on the income immediately (whose after-tax income compounded at 6.5 percent per year), can be analyzed as follows.

In the deferral case, the U.S. taxpayer can be understood at a conceptual level (by virtue of its ownership of a controlled foreign corporation under which deferred income grows at 10 percent per year) as if the taxpayer also received \$100 in cash income (but in this case not taxable income) immediately, and then set aside \$35 of that \$100 to fund its entire tax liability (which \$35 in turn also was invested at 10 percent). (Of course the taxpayer did not actually receive cash upfront, but the effect of the ownership of the controlled foreign corporation was to put the taxpayer in the same economic position as if it did receive that cash and immediately invested it at a 10 percent rate.) Each year the \$100 (and therefore the taxpayer's ultimate tax bill) would notionally grow at 10 percent, but so would the \$35 component of that amount set aside to fund the taxpayer's future tax bill. As a result, the \$35 notionally set aside by the taxpayer in the first period would be sufficient to pay its taxes at the end of the fifth year. This means that the taxpayer's total after-tax wealth at the end of the fifth year would equal \$65 (the portion of the \$100 notionally received at the start that was not needed to fund its tax liability) compounded at the full pre-tax rate of 10 percent, or \$104.68.

In other words, the incremental value of deferring income in this example is equivalent to the difference between investing \$65—the after-tax value of the initial income—at the pre-tax interest rate (10 percent), rather than the after-tax rate (6.5 percent), for the five-year life of the deferral. More generally, any deferral of income can be analyzed in the same way: the value of deferral is equivalent to the value of investing the after-tax amount of the income over the period

³⁸ To simplify, this example assumes there is no foreign tax on the earnings of the foreign corporation.

of the deferral at the pre-tax rate of return.³⁹ It is as if the corporate taxpayer that can defer its income must pay tax currently on the deferred amount, but then can invest the after-tax proceeds on a tax-exempt basis.

2. Deferral of U.S. residual income tax and the distortion of investment

Deferral leads U.S. taxpayers to inefficient investment decisions

The example above is analogous to the choice a U.S. taxpayer faces when considering making an investment in an active enterprise in the United States or in a country which has a local country income tax rate of zero. In such a case, the taxpayer would pay income tax annually on income earned from an investment located in the United States, at a 35-percent rate, as was the case with investment two in the preceding example. If the U.S. taxpayer were to make an investment in a country with a zero tax rate, and chose to liquidate the investment and repatriate the earnings after five years, paying residual U.S. income tax at that time, it would be the equivalent of the investment available to the taxpayer in the preceding example. The overseas investment would be the preferred choice.

The example has the same implication if one were to assume that the U.S. taxpayer started the analysis with \$100 of income earned in its overseas subsidiary. The taxpayer could consider an investment in the United States or reinvesting the proceeds overseas. To invest in the United States the taxpayer would have to repatriate the foreign earnings. After paying the residual U.S. income tax, the taxpayer would have \$65 to invest in the United States and the earnings on the investment would be subject to annual U.S. taxation. If the taxpayer reinvested the earnings in the foreign subsidiary, the initial investment would be \$100 and the earnings would grow free of annual taxation. If the rates of return on the two possible investments were the same, the overseas investment would be the preferred choice.

Moreover, the disparity in after-tax effects described above also implies there are overseas investments that earn less than 10 percent per annum that would dominate the 10 percent investment in the United States on an after-tax basis. Assume that a U.S. taxpayer has \$100 to invest. All else equal, compared to undertaking an investment in the United States that has an expected annual return of 10 percent, if the U.S. taxpayer located an investment in a country with an income tax rate of zero, and the investment has an expected annual return of 9.50 percent, this latter investment would produce a superior outcome for the U.S. taxpayer.⁴⁰

³⁹ The proposition assumes that tax rates remain constant.

⁴⁰ If invested in the United States and subject to annual taxation, the U.S.-sited investment earns a net return of 6.35 percent. Compounded for five years, this investment will be worth \$137. If invested abroad at 9.5 percent and not subject to foreign tax, the investment will compound at 9.5 percent and be worth \$157.42 at the end of five years. Upon repatriating the income, the U.S. taxpayer must pay a 35-percent tax on the \$57.42 of income, leaving the U.S. taxpayer with \$137.32.

When compared to a domestic investment that can be expected to return 10 percent per annum, the break even rate of return on an offshore investment on which the income can be deferred for five years is 9.44 percent.

Deferral distorts the investment choice by creating an incentive to choose a lower earning investment over a higher earning investment. When the lower earning investment is chosen, society as a whole loses the opportunity for greater total income. Economists would label such an outcome a social welfare loss from an inefficient allocation of investment.

The example is simplified by the choice of a zero tax rate in the foreign country. More generally, the greater the foreign effective marginal tax rate, the closer the rate of return on the offshore investment compared to the U.S. investment must be to yield a superior after-tax return. As the foreign tax rate approaches the U.S. tax rate the distortion approaches zero. However, the longer the residual U.S. income tax is deferred, the less the foreign investment has to earn relative to a U.S. based investment and the greater the distortion.⁴¹

Investment decisions are distorted in multiple dimensions

A U.S. based multinational enterprise must make investment decisions across several different dimensions: invest dollars earned in the U.S. in the United States or abroad; if investment is to occur abroad, in which country should the investment occur; from earnings that accrue abroad should the income be repatriated to the United States or should it be reinvested abroad? While many nontax factors drive these decisions, the tax analysis applicable to each is that outlined above. Certain investment options offer the possibility of deferral of U.S. income tax liability. Other investment options imply current U.S. income taxation.

In sum, the policy of deferral on foreign-source active income creates incentives to invest offshore and allow earnings to accumulate, even where the choice is between a lower-earning offshore investment compared to a higher-earning U.S. opportunity. The inefficient allocation of investment that results is not solely between dollars invested in the United States and dollars

⁴¹ As an illustration of these points, in the example above, if the deferral were for 10 years, and the foreign tax rate were zero throughout that period, an offshore investment with an expected annual return of as low as 8.92 percent would produce a superior outcome for the U.S. taxpayer. If the deferral were for 20 years, an offshore investment with an expected annual return of as low as 8.26 percent would produce a superior outcome for the U.S. taxpayer.

Considering a five-year deferral period, if the foreign host country imposed an income tax on the earnings of the U.S. taxpayer's investment at a 10 percent rate, an offshore investment with an expected annual return of as low as 9.59 percent would produce a superior outcome for the U.S. taxpayer. If the foreign host country imposed an income tax on the earnings of the U.S. taxpayer's investment at a 20 percent rate, an offshore investment with an expected annual return of as low as 9.75 percent would produce a superior outcome for the U.S. taxpayer.

An alternative way to think about the trade off between the deferral period, the foreign tax rate, and the break even rate of return on a deferred offshore investment is as follows. The longer the period of deferral, the lower the effective residual U.S. tax rate. In fact, permanent deferral would create an effective rate of residual tax equal to zero. Thus, as deferral increases, the effective total tax rate (U.S. residual tax plus foreign host country tax) that the U.S. taxpayer faces approaches the foreign host country tax rate. Consequently, as deferral increases, the break even return on a deferred offshore investment declines and approaches the rate of return on the foreign investment net of the foreign host country tax.

invested abroad, but also misallocation among investments abroad. Because the allocative distortion arises from the differential between a foreign tax rate and deferred payment of the U.S. residual tax, a U.S. taxpayer may choose to locate an investment in lower-tax country A rather than higher-tax country B, to take advantage of the fact that country A's lower tax rate allows the U.S. taxpayer to better exploit the benefit of deferral of U.S. residual income tax.

Lastly, in analyzing the possibility of repatriating foreign earnings to the United States, the taxpayer must first pay residual U.S. income tax on the repatriated earnings and then pay U.S. tax annually on future earnings. In comparison to continued deferral abroad, the U.S. taxpayer may forgo repatriation of earnings, even if, on a pre-tax basis, there were greater earnings potential from investment in the United States. This "lock-in" effect can lead to very large sums of money being held outside the United States, which in turn creates policy and political pressure to accommodate the repatriation of those funds. Section 965's one-year repatriation rule is an example of one response to these pressures.

3. The resulting tax-induced distortion is empirically important

Most empirical research substantiates the expected negative relationship between a foreign country's tax rate and U.S. outbound investment.⁴² The greater the responsiveness of

⁴² A growing body of empirical work examines the responsiveness of foreign investments made by U.S. taxpayers to foreign tax rates. One of the first such studies was Harry Grubert and John Mutti, *Taxes, Tariffs and Transfer Pricing in Multinational Corporate Decision-Making*, 73 *Review of Economics and Statistics* 285 (May, 1991). They examined the responsiveness of outbound direct investment in plant, property, and equipment by U.S. taxpayers to foreign country average tax rates in 33 host country locations. They found a significant negative statistical relationship. In a later study Grubert and Mutti found comparable results when examining the outbound investments in over 60 countries by over 500 U.S. taxpayers. (Harry Grubert and John Mutti, *Do Taxes Influence Where US Corporations Invest?* 53 *National Tax Journal* 825 (December, 2000). Using similar data, but different empirical specifications, Rosanne Altshuler, Harry Grubert, and T. Scott Newlon, *Has US Investment Abroad Become More Sensitive to Tax Rates?* in James R. Hines, Jr., (editor), *International Taxation and Multinational Activity*, (Chicago: University of Chicago Press), 2001, find similar results. Using different data encompassing all nonbank affiliates of nonbank U.S. corporations, James R. Hines, Jr. and Eric M. Rice, *Fiscal Paradise: Foreign Tax Havens and American Business*, 109 *Quarterly Journal of Economics* 149 (February 1994), find an even stronger negative statistical relationship between foreign tax rates and outbound investment by U.S. taxpayers.

The preceding studies used cross sectional analysis, that is, they examined the effect of taxes on location of investment by examining data on different taxpayers and investments in one year. Mihir A. Desai, C. Fritz Foley, and James R. Hines, Jr., *Foreign Direct Investment in a World of Multiple Taxes*, 88 *Journal of Public Economics* 2727 (December 2004), undertake a panel study. In this study they examine the outbound investments of U.S. taxpayers in the manufacturing sector, tracking the same taxpayers over the period 1984 to 1992. They report statistical relationships similar to those found in the cross sectional studies cited.

OECD, *Tax Effects of Foreign Direct Investment/ Recent Evidence and Policy Analysis*, (Paris: Organisation for Economic Cooperation and Development), 2008, reviews a large number of empirical studies on the responsiveness of foreign direct investment, both inbound and outbound, to taxes.

U.S. taxpayers to the benefit of deferral of tax on active foreign source income the greater the distortion to the economy. Indeed, data show that at the end of 2004, accumulated earnings and profits of the approximately 75,000 U.S. controlled CFCs, which filed IRS Form 5471, reported accumulated earnings and profits abroad of approximately \$1 trillion.⁴³ While many other variables influence the location of investments, these same data show that accumulated earnings and profits of U.S. controlled CFCs in Ireland, a relatively low tax country, exceeds the sum of the accumulated earnings and profits of U.S. controlled CFCs in the United Kingdom and Germany, both higher tax countries, with substantially larger populations and markets.

Recent data compiled relating to the one-time 85-percent dividend received deduction permitted in section 965 provides possible further evidence of magnitude of the potential distortion of investment decisions. The 85-percent dividend received deduction had the effect of reducing the highest U.S. marginal tax rate on repatriated earnings from 35 percent to 5.25 percent. The preliminary data show that approximately \$360 billion in dividends were repatriated on 2004 corporate income tax returns.⁴⁴ These repatriations exceed the annual average of prior year repatriations of foreign earnings by more than \$250 billion. While without further analysis it is inappropriate to conclude that taxes alone would have kept \$250 billion or more deferred offshore, the magnitude of repatriations is suggestive of the magnitude of the amount of investment dollars subject to potentially distorted economic choices.

4. Additional ramifications from the geographic misallocation of investment

Once a U.S. taxpayer makes an investment offshore whose income qualifies for deferral, the benefit of deferral creates incentives to report as much income as possible as qualifying income. Hence, deferral may create what may be called “second order” distortions of taxpayers’ choices. Rules created to protect the policy of deferral for active income or the determination of taxpayers subject to the worldwide regime may result in economically inefficient business structures or investment decisions as taxpayers try to qualify their income as the result of an active offshore business. For example, deferral places tremendous pressure on the determination of transfer prices under section 482, because the greater the amount of income that can be deferred offshore in a low-tax country, the greater the aggregate benefit of deferral to the taxpayer. An increase in the amount of income that can be attributed to a low-tax jurisdiction is equivalent to increasing the pre-tax return to the offshore investment, magnifying the distortion of investment choice.⁴⁵ Ignoring the expense that the taxpayer and the Service may engage in

⁴³ Unpublished data tabulated by the Statistics of Income Division, Internal Revenue Service from Form 5471 for controlled foreign corporations. The data were collated from Form 5471 filed with some 11,000 tax returns. The data compile the accumulated earnings and profits for approximately 75,000 U.S. controlled CFCs.

⁴⁴ Melissa Redmiles, *The One-Time Received Dividend Deduction*, Statistics of Income Bulletin, 27, Spring 2008.

⁴⁵ For an example of this point, see Harry Grubert and Joel Slemrod, *The Effect of Taxes on Investing and Income Shifting to Puerto Rico*, 80 Review of Economics and Statistics 365 (August 1998). Grubert and Slemrod examine the interaction of income shifting and the investment decision.

with respect to transfer pricing determinations, shifting income via aggressive transfer pricing after the decision to locate investment has been made creates no further direct loss of economic efficiency. However, the diminution of the U.S. tax base and U.S. tax receipts may result in higher taxes elsewhere in the economy. Increasing other taxes will increase the economic distortions inherent in those other taxes.

Taxpayers make investment decisions on the basis of many factors in addition to tax consequences. The other factors all influence the pre-tax return. As a consequence, U.S. taxpayers have undertaken many investments offshore in high tax countries. However, as described above, deferral can make it advantageous to choose a relatively lower earning investment in a low tax country rather than a higher earning investment in a high tax country. If a high tax country has a tax rate in excess of the U.S. tax rate, a taxpayer can plan offshore investments in both the high tax country and in a low tax country to enable cross crediting of the foreign taxes paid (subject to certain limitations imposed by the foreign tax credit basket rules). This can extend the benefit of deferral to investments in high tax host countries. In such a case the policy of deferral in conjunction with the foreign tax credit limitation creates second order distortions of the taxpayer's investment decisions.

5. U.S. foreign direct investment and domestic investment

Some argue that the benefit of deferral may significantly diminish the U.S. tax base by encouraging investment offshore at the expense of domestic investment. For example, instead of manufacturing products in the United States and selling the products domestically, as well as exporting products abroad, a firm might choose to locate production facilities abroad and import some products back to the United States and serve overseas markets from the foreign location.⁴⁶ This could have two effects. First, diminished investment in the United States could lead to diminished growth in labor productivity, wages, and aggregate national income. Second, the diminution of the U.S. tax base could result in higher taxes, and increased distortions, elsewhere in the economy.

Others argue that foreign direct investment undertaken by U.S. persons is not a substitute for U.S. domestic investment, but rather is a complement to U.S. domestic investment. They note that a foreign production facility can be a major source of demand for components from its U.S. affiliate and that the foreign production affiliate relies on U.S.-based research facilities and headquarters operations. If a foreign production facility fosters overall demand for the firm's products, then investment in the U.S.-based component facilities, research facilities, and headquarters operations will be required to sustain the increased worldwide demand.

Empirical studies have attempted to examine whether foreign direct investment is a substitute for or complement to domestic investment. More than a decade ago the President's Council of Economic Advisors concluded, "On a net basis, it is highly doubtful that U.S. direct

⁴⁶ This possibility is often referred to as a "run-away plant."

investment abroad reduces U.S. exports or displaces U.S. jobs.”⁴⁷ Generally, empirical studies find either no effect or a positive effect of overseas production in a host-country market on home-country exports to that market. One survey of the empirical literature reports that, on average, studies find one dollar of overseas production by U.S. affiliates generates \$0.16 of exports from the United States.⁴⁸ The evidence does, however, suggest that overseas production displaces certain types of domestic production, as the parent firm shifts to more capital intensive and skill intensive domestic production.⁴⁹

There is no definitive conclusion about the effect of outbound investment on U.S. employment. The same survey concludes, “[T]he evidence suggests that the effect of overseas production on the home-country labor market involves the composition of a firm’s home employment rather than the total amount. That change in composition is mainly a shift toward more managerial and technical employment”⁵⁰ However, most of the evidence on this subject examines individual industries rather than aggregate economic effects.

In the aggregate, it is clear that U.S. manufacturing employment has fallen among U.S.-owned manufacturing enterprises, but the decline has been largely offset by employment at foreign-owned manufacturing facilities located in the United States.⁵¹ What is not clear is whether U.S. manufacturing employment would have fallen more, less, or the same if the United States had employed a different tax regime for foreign direct investment, or whether multinational U.S. manufacturing enterprises would have been more or less successful in developing their non-U.S. operations in such circumstances.

⁴⁷ Council of Economic Advisers, *Economic Report of the President*, (Washington, D.C.: U.S. Government Printing Office), February 1991, at 259. The report also surveys some of the evidence on the economic effects of outbound investment.

⁴⁸ Robert E. Lipsey, *Outward Direct Investment and the U.S. Economy*, in Martin Feldstein, James R. Hines, Jr., and R. Glenn Hubbard (eds.), *The Effects of Taxation on Multinational Corporations*, (Chicago: University of Chicago Press), 1995. In later research, Lipsey reaches similar conclusions. Robert E. Lipsey, *Home and Host Country Effects of FDI*, in Robert E. Baldwin and L. Alan Winters (eds.), *Challenges to Globalization*, (Chicago: University of Chicago Press), 2004, at 333-379.

⁴⁹ Lipsey, *Home and Host Country Effects of FDI*, *supra*.

⁵⁰ Lipsey, *Outward Direct Investment and the U.S. Economy*, *supra*, at 31. One study does find some substitution of foreign labor for U.S. labor but characterizes the degree of employment substitution as low between domestic and foreign affiliates, finding greater labor substitution between employees in different developing countries. S. Lael Brainard and David A. Riker, *Are U.S. Multinationals Exporting U.S. Jobs?* in David Greenway and Douglas Nelson, eds., *Globalization and Labour Markets*, Elgar, 2001.

⁵¹ Lipsey, *Home and Host Country Effects of FDI*, *supra*.

III. TERRITORIAL SYSTEM

As described more fully in Section II, the deferral element of the United States' present system of worldwide taxation introduces significant economic inefficiencies — what we have labeled in the tax expenditure context a tax-induced structural distortion. Deferral implies a conditionally different tax rate on active foreign business income than the rate that applies to domestic income, and this difference appears to affect both the type and location of business investment. Moreover, while active foreign earnings are fully taxed on repatriation, the ability to postpone U.S. tax indefinitely by delaying repatriation can reduce the present value of that U.S. tax to the point that deferral is economically equivalent to exemption.

There are two possible — but polar opposite — solutions to the distortions created by present law's treatment of foreign direct investment. The first possible solution is to move towards a “territorial” system in which active foreign income is fully exempt from U.S. taxation. The second is to move towards a “full inclusion system” in which all foreign source income is currently taxed, without regard to the active or passive character of the income. A territorial approach would exempt from U.S. tax those active foreign earnings that are repatriated as dividends. A full inclusion approach would tax all foreign earnings currently, regardless of whether the earnings are repatriated.

Both of these alternatives would reduce the current disincentive to repatriate low-taxed foreign earnings, but would do so through vastly different mechanisms. Under either approach, the repatriation tax is eliminated, and there is no longer any U.S. tax motivation to keep low-taxed foreign income offshore. The effects of the two alternatives on the initial locational decision are not clearly equivalent, however, and the two options differ materially in other respects. Moreover, the two might have different implications for the international competitiveness of different U.S. industries.

This Section III focuses on a territorial system. Section III.A. describes the principal features of a dividend exemption approach, which is the most common form of territorial taxation. Section III.B. evaluates the purported benefits of, and considers the issues presented by, a territorial system. For comparison purposes, Section III.C. includes a description of the territorial regimes employed by other countries. Section IV analyzes a full inclusion approach.

A. Principal Features

There have been several proposals in recent years for a territorial regime in the United States, all of which have taken the form of a dividend exemption system.⁵² Although the details of the proposals differ, they all generally provide that income earned abroad by a domestic corporation from foreign subsidiaries would fall into one of two categories: (1) active foreign income earned by a foreign branch or repatriated as a dividend from a foreign subsidiary, which would generally be exempt from U.S. tax; and (2) all other income, including passive income and non-dividend payments received from foreign subsidiaries, which would be included in income by the domestic corporate shareholder on a current basis. The deferral regime and repatriation tax at the heart of the present system would be eliminated, and the foreign tax credit system would serve a more limited function than it does under present law.

For discussion purposes, the following section describes in detail the dividend exemption system outlined by the staff of the Joint Committee on Taxation as part of a 2005 report on options to improve tax compliance and reform tax expenditures (the “JCT Option”).⁵³ The JCT Option is similar to the dividend exemption system recommended by the U.S. President’s Advisory Panel on Federal Tax Reform as part of the Reform Panel’s recommendations for making the tax code “simpler, fairer and more conducive to economic growth”⁵⁴ (the “Reform Panel Proposal,” and together with the JCT Option, the “Exemption Proposals”).⁵⁵ Material differences between the two proposals are identified throughout the discussion.

⁵² See, e.g., JCT Options Report; President’s Advisory Panel on Federal Tax Reform, *Simple, Fair and Pro-Growth: Proposals to Fix America’s Tax System* (November 2005) (hereinafter, Reform Panel); U.S. Department of the Treasury, *Approaches to Improve the Competitiveness of the U.S. Business Tax System for the 21st Century*, December 20, 2007 (hereinafter, Treasury Department); Michael J. Graetz and Paul W. Oosterhuis, *Structuring an Exemption System for Foreign Income of U.S. Corporations*, 54 *National Tax Journal* 771, 781 (hereinafter, Graetz and Oosterhuis).

Although these proposals are commonly referred to as “dividend exemption” systems, they contemplate exemption of active income earned by domestic corporations through foreign branches as well.

⁵³ See JCT Options Report at 186-197. This report was prepared at the request of then Senate Finance Committee Chairman Charles Grassley and Ranking Member Max Baucus.

⁵⁴ Reform Panel, at xiii (Executive Summary).

⁵⁵ The Reform Panel Proposal recommends the territorial system as part of its Simplified Income Tax Proposal. Reform Panel at 134. The Simplified Income Tax Proposal responds to the President’s directive that the panel submit at least one option that uses the current income tax system as the starting point for reform. *Id.* at 107. The proposal is designed as a comprehensive plan and is intended to be viewed as an integrated package. *Id.* at xv (Executive Summary). This pamphlet does not address certain features of the Reform Panel Proposal that are integrally related to other changes proposed as part of the comprehensive plan, such as integration of corporate and shareholder-level taxes.

1. Exemption of active foreign income

Foreign subsidiaries

Under the Exemption Proposals, a domestic corporate shareholder that owns 10 percent or more of the stock of a CFC would exclude from income all dividends received from the CFC.⁵⁶ Foreign tax credits would not be allowed for foreign taxes attributable to the excluded dividend income (including both corporate-level income taxes and dividend withholding taxes). In addition, deductions for interest and other expenses of the domestic corporation would be disallowed to the extent allocable to such exempt CFC earnings.

With respect to a domestic corporation's sale of CFC stock, any resulting gain would be excluded from income to the extent of undistributed exempt earnings.⁵⁷ Any excess of gain over this amount would be taxable. Deductions for losses on the sale of CFC stock would be disallowed.

In addition, a domestic corporation would be allowed to elect CFC treatment with respect to a noncontrolled section 902 corporation.⁵⁸ This election would render the investment eligible for dividend exemption, but would also subject it to current taxation on its mobile income under subpart F. If the dividend exemption election were not made, an investment in a noncontrolled section 902 corporation would be treated like a portfolio stock investment. Thus, a U.S. corporation would be permitted to choose between treating the noncontrolled section 902 corporation as a portfolio investment or as a direct, CFC-type investment.⁵⁹

Foreign branches

Foreign branches would be treated like a CFC under rules that would treat foreign businesses conducted directly by a domestic corporation as CFCs for all U.S. Federal tax purposes. Thus, (1) income derived from a branch would be exempt to the same extent as it would be if earned by a CFC; (2) subpart F would apply; (3) branch losses would not flow directly onto a domestic corporation's U.S. income tax return; and (4) transactions between a domestic corporation and its foreign branch would be subject to the full range of rules applicable

⁵⁶ The Reform Panel Proposal provides more generally that dividend exemption would apply to "foreign affiliates," which it refers to as controlled foreign subsidiaries. Reform Panel at 134.

⁵⁷ The Reform Panel Proposal provides generally that "gains from the sale of assets that generate exempt income" would be exempt from U.S. tax. Reform Panel at 240. The extent to which gains would be exempt from tax is an issue that would need to be resolved under a territorial system. See Section III.C., *infra*, for a detailed discussion of this issue.

⁵⁸ A noncontrolled section 902 corporation — which is also referred to as a "10/50 company" — is a foreign corporation with respect to which the domestic corporation owns 10 percent or more of the stock, but which does not qualify as a CFC because ownership is less than 50 percent. Sec. 904(d)(2)(E).

⁵⁹ The Reform Panel Proposal states only that rules would be needed to address noncontrolled section 902 corporations. Reform Panel at 240.

to intercompany transactions.⁶⁰ All businesses conducted predominantly within the same country generally would be treated as a single CFC for this purpose. Rules would be needed to implement this approach in order to put foreign branches on an equal footing with CFCs so that the choice of business entity (branch versus corporation) does not produce disparate results.

2. Full U.S. taxation of other foreign income

Deductible payments (e.g., interest, royalties, service fees, income from intercompany sales) received by a domestic corporation from a CFC⁶¹ would be subject to full U.S. tax, because those payments do not bear foreign net income tax. Dividends from non-CFCs, or from CFCs with respect to which the domestic corporation is not at least a 10 percent shareholder, would be fully subject to U.S. tax.

Subpart F would be retained in its current form. Thus, notwithstanding the general rule of dividend exemption, a domestic corporation that owns 10 percent or more of the stock of a CFC would still face current income inclusion when the CFC earns certain types of passive or highly mobile income.⁶² The PFIC rules also would be retained in their current form.

Foreign source income received directly by a domestic corporation from unrelated persons, such as foreign source royalties and interest, would also be subject to full U.S. tax.

The foreign tax credit would be available for foreign taxes attributable to taxable income. For example, foreign withholding taxes imposed on a royalty received by a domestic corporation would be eligible for the credit. Similarly, a subpart F inclusion would carry with it a deemed-paid credit for foreign taxes imposed on the CFC with respect to the subpart F income. Because most high-taxed foreign business income would be exempt and thus removed from the foreign tax credit system, the separate categories for passive and general income would be repealed. As a result, the foreign tax credit limitation would be applied on an overall basis.

Because the foreign tax credit system would apply mostly to low-taxed foreign source income, it has been suggested that the potential for cross-crediting would be greatly reduced relative to present law, and that taxpayers generally would have excess foreign tax credit

⁶⁰ The Reform Panel Proposal explicitly notes that royalty income would need to be imputed to foreign branches. *Id.*

⁶¹ Unless specified otherwise, references to CFCs hereinafter in Section III of this pamphlet include foreign branches and any noncontrolled section 902 corporations with respect to which there is an election in effect.

⁶² A special rule would provide that no subpart F inclusions would be created as dividends move up a chain of CFCs, to the extent the dividend is attributable to a 10 percent or greater direct or indirect interest of a domestic corporation in the dividend-paying CFC. This rule would ensure that dividends could be repatriated from lower-tier CFCs without losing the benefit of dividend exemption, and it would also make it easier to redeploy CFC earnings in different foreign jurisdictions without triggering subpart F. This should maximize decision-making flexibility with respect to utilization of CFC earnings.

limitation.⁶³ Conceivably, this situation might provide an incentive for other countries to seek higher withholding tax rates on non-dividend income in treaty negotiations with the United States or, in the case of non-treaty partners, to raise those rates unilaterally.

3. Allocation and apportionment of expenses

Under a territorial system, a domestic corporation would need to allocate and apportion deductible expenses to determine the expenses that would be disallowed and to determine the foreign tax credit limitation. Under both the JCT Option and the Reform Panel Proposal, the principles of the current allocation and apportionment rules (including the worldwide affiliated group approach for interest expense) generally would be retained. However, the treatment of research and experimental expenses would be modified. Under the JCT Option, research and experimental expenses would be allocated and apportioned first between U.S.- and foreign-source income under rules similar to those of present law. The amount of research and experimental expenses allocated to foreign-source income then would be further allocated, first to taxable royalties and similar payments (e.g., cost sharing or royalty-like sale payments) to the extent thereof, then to CFC earnings to the extent thereof (with this amount divided on a pro rata basis between exempt CFC earnings and taxable CFC earnings), and then finally to other foreign-source income. Under the Reform Panel Proposal, domestic research and experimental expenses would not be allocated to exempt foreign income.⁶⁴ The Reform Panel Proposal is based on the premise that all royalty income and similar payments associated with the domestic research and experimental expenses would be subject to tax in the United States.⁶⁵

⁶³ Graetz and Oosterhuis at 777.

⁶⁴ Reform Panel at 241. *See also* Graetz and Oosterhuis at 781.

⁶⁵ See, however, the discussion, *infra*, in Section III.C. regarding transfer pricing issues under a territorial system.

B. Economic Analysis

1. Efficiency considerations

As explained in Section II.B., the differing treatment of multinational groups with domestic parent corporations and those with foreign parent corporations creates an incentive to locate parent companies offshore. Under the Exemption Proposals outlined above, most foreign active business income would no longer be subject to U.S. taxation, regardless of the residence of the parent corporation. Accordingly, the proposed territorial regime could be expected to reduce the distortions in corporate residence decisions that exist under present law. On the other hand, the continued taxation of passive income and highly mobile income under subpart F and foreign active business income earned by a domestic corporation other than through a foreign subsidiary or branch (including foreign active business income received by a domestic corporation in the form of deductible payments from a foreign subsidiary) could partially vitiate this effect.

A territorial system would also tend to eliminate one of the principal tax-induced structural distortions caused by deferral – the disincentive to repatriate foreign earnings – and facilitate repatriation decisions based on business needs, rather than on tax considerations. In practice, the extent to which this objective is achieved would depend upon the specifics of the regime implemented – for example, whether dividends from foreign subsidiaries were wholly or only partly exempt, the level of ownership required for eligibility, and the extent to which foreign earnings were required to have been subject to foreign tax to qualify for the exemption.⁶⁶ Nonetheless, it seems clear that a territorial approach would be significantly more neutral than present law with regard to the repatriation decision.

It is less clear, however, whether a territorial system would enhance economic neutrality with regard to other locational decisions. In fact, some critics have argued that moving from a system of deferral to a system of permanent exemption for active income earned overseas would cause U.S. investment to flow out of the United States, and would encourage U.S. companies to move their manufacturing and service operations (and thus jobs) abroad. Others have argued that a territorial system will directly affect decisions regarding the location of investments by raising the after-tax return required for a domestic investment.⁶⁷ Increasing the rate of return required for domestic investment arguably would be necessary to cover taxes due on U.S. source income that would not be imposed if that income were earned overseas. As a result, offshore investments may become even more attractive on an after-tax basis than they currently are, even if the foreign undertaking were less attractive on a pre-tax basis.

In addition, some argue that a territorial system would increase the incentives for U.S. taxpayers to develop their intangible assets offshore, because the resulting income could be

⁶⁶ Foreign withholding taxes on dividends, and possibly state income taxes, could also affect decisions to repatriate foreign earnings.

⁶⁷ Richard J. Joseph, *The Problem with Territoriality*, 40 *Tax Notes International* 1165, 1166 (December 26, 2005).

repatriated as exempt dividends rather than as taxable royalties.⁶⁸ This incentive could be mitigated through countervailing domestic research and development incentives. Nonetheless, such incentives may not have the desired effect: taxpayers may prefer the relative certainty of developing foreign owned intangibles in light of the recent legislative uncertainties involving periodic extension of the research credit available under section 41 and current Federal budget accounting rules.⁶⁹

Further, a territorial system could encourage taxpayers to design strategies to produce so-called “stateless income” (i.e., income that is taxed nowhere or taxed at extremely low rates in a country where the income is not earned).⁷⁰ Such strategies include the structure of financial capital within a U.S.-based multinational group (and the creation of deductible interest payments in high-tax jurisdictions), and the use of inter-affiliate payments, disregarded entities and hybrid instruments to strip income out of high-tax jurisdictions into low- or no-tax foreign jurisdictions.⁷¹

On the other hand, some economists who have studied the projected effects of an exemption system on locational decisions have found no definitive evidence that the underlying incentives would change significantly. In this regard, two recent studies have examined how the incentive to invest in low-tax locations abroad would be affected if the United States were to move to a dividend exemption system similar to the one described here.⁷² In both studies, the authors consider dividend exemption systems that impose comprehensive expense allocation rules similar to those of present law, such that some portion of the deductions for interest and overhead expenses incurred by the U.S. parent company and allocated to exempt foreign income are disallowed as deductions from U.S. taxable income. This assumption is critically important to the conclusions they reach.

⁶⁸ George Yin, *Reforming the Taxation of Foreign Direct Investment by U.S. Taxpayers*, 49 Tax Notes International 511, 514 (February 11, 2008) (hereinafter, Yin).

⁶⁹ This result is not without its own tension. In the long term, research and experimental expenses are optimized when intangibles are developed in a low-tax jurisdiction, such as Ireland. However, there is a short term financial statement effect that arises from deducting these expenses in a low-tax jurisdiction. This results from the reduced tax benefit of the expenses when the deduction is taken at the 12.5 percent rate of the Irish tax system, versus the 35 percent rate of the U.S. tax system.

⁷⁰ Edward D. Kleinbard, *Throw Territorial Taxation From the Train*, 48 Tax Notes International 63, 77, (April 2, 2007) (hereinafter, Kleinbard).

⁷¹ *Id.*

⁷² Harry Grubert and John Mutti, *Taxing International Business Income: Dividend Exemption versus the Current System*, Washington, D.C., American Enterprise Institute (2001) (hereinafter, Grubert and Mutti); Rosanne Altshuler and Harry Grubert, *Where Will They Go if We Go Territorial? Dividend Exemption and the Location Decisions of U.S. Multinational Corporations*, National Tax Journal, Vol. LIV, No. 4 (December 2001) (hereinafter, Altshuler and Grubert (2001)).

One study concludes that the effective tax rate on U.S. investment in low-tax locations would increase under a territorial system, relative to the system in place prior to the AJCA.⁷³ Although active foreign business income would avoid U.S. residual taxation, the loss of the ability to shield foreign royalties from U.S. tax through cross-crediting and to claim deductions for overhead and interest expense at home (or in other high-tax locations) results in a higher overall tax burden on earnings generated in low-tax locations.

The second study presents hypothetical effective tax rates for incremental investment by a U.S. taxpayer in a low-tax subsidiary abroad under the U.S. tax system in place prior to the AJCA and under dividend exemption with expense allocation rules.⁷⁴ This study also finds that the tax burden of investing in low-tax countries may increase under dividend exemption. In addition, the study uses two other approaches to investigate how location decisions may change under a dividend exemption system: a comparison of foreign direct investment patterns for the United States and for two countries which exempt dividends received from foreign affiliates resident in countries with which they have tax treaties (Germany and Canada) and an empirical analysis of the extent to which residual U.S. taxes on low-tax foreign earnings affect the location decisions of U.S. corporations. Neither approach yielded results that would suggest that location decisions would be significantly altered if the United States were to exempt dividends from residence country taxation.⁷⁵

Moreover, the analysis is complicated by the fact that a territorial system could result in substantially different tax burdens on different industries. These differences would result from the fact that distinct industries are characterized by their own sets of norms and operating conditions. For example, normative debt-to-equity ratios for financial companies will be vastly different from those of manufacturing companies. Similarly, the importance of separately identifiable intangible assets (as opposed to goodwill) for financial companies will be vastly different from their importance to pharmaceutical companies. Further, the ability to migrate

⁷³ Grubert and Mutti.

⁷⁴ Altshuler and Grubert (2001).

⁷⁵ Some economic research has focused on the effect of home country tax systems on foreign direct investment into the United States. The conclusions from this literature are mixed. Joel Slemrod uses time-series data to compare the responsiveness to U.S. corporate tax rates of foreign direct investment from exemption and “worldwide” countries. Joel Slemrod, *Tax Effects on Foreign Direct Investment: Evidence from a Cross-Country Comparison*, in *Taxation in the Global Economy*, edited by Assaf Razin and Joel Slemrod, University of Chicago Press, 1990. The study does not find any difference between the two groups of countries. James R. Hines, Jr. examines whether the sensitivity of manufacturing foreign direct investment to State income tax rates varies across exemption and “worldwide” countries. James R. Hines, Jr., *Altered States: Taxes and the Location of Foreign Direct Investment in America*, 86 *American Economic Review*, No. 5 (December, 1996). The study finds that foreign direct investment from exemption countries is more responsive to differences in State income tax rates. Although relevant, these papers do not examine the experience of U.S. corporations and how location incentives may change under the dividend exemption proposal described here or the current system.

intellectual property offshore, and the rate at which such migration is completed, for financial companies will be vastly different from that of high-tech companies. In each case, a financial company would be disadvantaged in a territorial system when compared to a manufacturing, pharmaceutical or high-tech business.

A further complication arises from the differential treatment of portfolio and direct investments under typical exemption systems. Dividends from foreign direct investments (i.e., investments in which a domestic corporation's share of the foreign business is at least 10 percent) are exempt under the JCT Option and most similar exemption systems, while portfolio dividends are taxable. As a result, the effects of an exemption system on a U.S. company's locational decisions may vary as between foreign direct investments and foreign portfolio investments.⁷⁶

On balance, therefore, it would appear that a territorial approach could improve economic efficiency with respect to the repatriation of foreign earnings but that further analysis is needed to assess whether efficiency would be improved with regard to locational decisions.

2. Competitiveness

The principal argument asserted by territorial proponents is that many U.S. trading partners currently have territorial systems and do not subject their resident corporations to tax on worldwide income. As a result, the current U.S. system of worldwide taxation arguably places U.S. firms at a competitive disadvantage.⁷⁷ Thus, it is argued, a U.S. movement towards territoriality would enhance the competitiveness of U.S. businesses in the global economy.⁷⁸

For a number of years, policymakers, business groups, and economists have argued that improving the international competitiveness of the economy of the United States should be a major policy goal. This focus on competitiveness is certainly related to some of the economic trends of the past two decades: (1) large U.S. trade deficits; (2) large inflows of foreign investment in the United States; and (3) low national saving rates. Cross-border mergers of recent years and cases of corporate inversions to re-incorporate outside the United States have heightened interest regarding the position of the United States in the global economy.

⁷⁶ Kleinbard at 76. Two commentators have suggested that portfolio dividends could be treated as wholly or partially exempt without creating undue potential for tax planning, provided the PFIC rules are retained. Graetz and Oosterhuis at 779.

⁷⁷ Terrence R. Chorvat, *Ending the Taxation of Business Income*, 42 *Arizona Law Review* 835 (2000); National Foreign Trade Council, *NFTC Territorial Tax Study Report*, at 5 (2002), http://www.nftc.org/default/tax/Territorial_percent20Report.doc (hereinafter, NFTC Report); Keith Engel, *Tax Neutrality to the Left, International Competitiveness to the Right, Stuck in the Middle with Subpart F*, 79 *Texas Law Review* 1525, at 1563-1564 (May, 2001); Reform Panel at 134; Treasury Department at 54.

⁷⁸ Reform Panel at 105, 134.

One definition of U.S. competitiveness is the ability of U.S.-based multinational businesses that locate production facilities overseas to compete in foreign markets. Overseas production facilities owned by U.S. interests may compete with firms owned by residents of the host country or with multinational firms based in other countries. This definition of competitiveness focuses on the after-tax returns to investment in production facilities abroad.

The “big picture” view of competitiveness can also be broken down and reflected as an industry-by-industry view. For example, the United States could dominate world markets in one industry and be seen as very “competitive,” while in another industry U.S. businesses could be losing global market share.

Under this definition, the competitiveness of a U.S. business would be enhanced through a territorial system only if the total tax burden imposed on U.S.-based multinational operations is reduced. However, in 2005 the staff of the Joint Committee on Taxation estimated that the JCT Option would raise \$55 billion in revenue over a ten-year period.⁷⁹ This revenue estimate in turn was driven primarily by the denial of deductions for expenses (e.g., interest expense) allocable to foreign tax-exempt income. Arguably, then, a territorial system along these lines would not enhance the aggregate competitiveness of U.S. companies.

When broken down among taxpayers and industry groups, the effects of a territorial system would depend on the details of the system actually implemented, the nature and mix of the taxpayer’s activities, and the corporate structure of the taxpayer’s legal entities. Thus, the effect on each taxpayer’s U.S. tax burden under a territorial system would vary among U.S. companies: some would be hurt, some would benefit and others would be relatively unaffected.

Indeed, at least one industry group has questioned whether a territorial system would improve U.S. business competitiveness absent a number of specific, additional taxpayer favorable changes. In 2002, the National Foreign Trade Council (“NFTC”) completed a comprehensive review of a territorial system based on the regimes of three major European countries. Rather than endorsing expected competitiveness gains, the NFTC noted that there would be both gains and losses and that to improve the competitiveness of any substantial group of U.S. companies, taxpayer favorable changes would need to be made to subpart F with respect to active business income, the allocation of expenses to foreign income, and the foreign tax credit.⁸⁰ According to the NFTC, “a traditional territorial exemption system would not only fail to improve competitiveness significantly, but would also result in increased complexity and long term instability of the U.S. tax system” in the absence of such changes.⁸¹

⁷⁹ The estimate reflects the fact that deductions allocable to foreign source income would no longer be deductible. It also reflects the fact that royalties would remain subject to U.S. tax, but without the benefit of the significant amount of cross-cross crediting that occurs under present law.

⁸⁰ NFTC Report at 3. The report was completed by the Territorial Study Group, which was comprised of 32 member companies, such as Caterpillar Inc., General Electric Company, Intel Corporation, Pfizer Inc and Procter & Gamble Company.

⁸¹ *Id.*

Some even question whether a competitiveness issue exists, noting that no empirical data supporting claims of competitiveness problems was provided by either the JCT or the Reform Panel.⁸² In fact, the U.S. was ranked No. 1 overall in the 2007-2008 Global Competitiveness Report (the “Competitiveness Report”) compiled by the World Economic Forum.⁸³

⁸² J. Clifton Fleming Jr. and Robert J. Peroni, *Exploring the Contours of Proposed U.S. Exemption (Territorial Tax System)*, 41 *Tax Notes International* 217, 219 (Jan. 16, 2006) (hereinafter, Fleming and Peroni), questioning whether the problem actually exists. Those authors cite “Nordic Countries and Asian Tigers Top the Rankings in the World Economic Forum’s 2005 Competitiveness Ranking” (see http://www.weforum.org/en/media/Latest_percent20Press_percent20Releases/PRESSRELEASES182): “The United States, as last year, is ranked second: the country demonstrates overall technological supremacy, with a very powerful culture of innovation. However, technological prowess is partly offset by a weaker performance in other areas measured by the index. The US has a relatively low rank of 20 for the contracts and law indicator, with particular concerns on the part of the business community about the government’s ability to maintain arm’s-length relationships with the private sector, and in the formulation of policies more generally. But the country’s greatest weakness concerns the health of its macroeconomic environment, where it ranks a low 47th overall. This echoes the increasingly vocal international concerns about the macroeconomic imbalances in the US economy, especially as regards the public finances.”

⁸³ http://www.weforum.org/en/initiatives/gcp/Global_percent20Competitiveness_percent20Report/index.htm. The Global Competitiveness Report is a comprehensive assessment of countries’ competitiveness, including insights into the policies, institutions, and factors driving productivity that, in turn, enable sustained economic growth and long-term prosperity. The Report is produced in collaboration with leading academics and a global network of research institutes. Besides data from leading international sources, these indicators include the results of the Executive Opinion Survey carried out by the World Economic Forum annually. The purpose of the Survey is to identify the perceptions of business leaders across the countries on topics related to national competitiveness.

C. Structural Issues Presented by Territoriality

1. Transfer pricing

Due to the variation in tax rates and tax systems among countries, a multinational enterprise, whether U.S.-based or foreign-based, may have an incentive to shift income, deductions, or tax credits among commonly controlled entities in order to arrive at a reduced overall tax burden. Within a controlled group, there are no market pressures that impose market pricing on transactions between related parties. The lack of an identifiable market price provides opportunities for companies to shift income among group members through controlled transactions at off-market prices.

To preserve the U.S. tax base, section 482 authorizes the Secretary of the Treasury to redetermine the income of an entity subject to U.S. taxation when necessary to clearly reflect income. The statute generally does not prescribe any specific reallocation rules. Rather, it establishes the general standards of preventing tax evasion and clearly reflecting income. Treasury regulations adopt the concept of an arm's length standard as the method for determining whether reallocations are appropriate. Thus, the regulations generally attempt to identify the respective amounts of taxable income of the related parties that would have resulted if the parties had been uncontrolled parties dealing at arm's length.

Empirical evidence indicating that U.S. multinationals continue to shift income to low-tax foreign jurisdictions has led many to question the effectiveness of the current transfer pricing rules. In 2004, Congress directed the Treasury Department to conduct a study of the effectiveness of the transfer pricing rules and compliance efforts related to cross-border transfers and other related-party transactions. Congress requested that the study focus particularly on transactions involving intangible assets, service contracts and leases that may be used improperly to shift income out of the United States.⁸⁴ The Treasury Department issued its report in November 2007.⁸⁵ The Transfer Pricing Report concluded that there is some potential for income shifting under the current regulations, and that this potential is perhaps most acute with respect to cost sharing arrangements involving intangibles,⁸⁶ but exists also with respect to the provision of intercompany services and financial transactions.⁸⁷

⁸⁴ AJCA sec. 806.

⁸⁵ Department of the Treasury, *Report to the Congress on Earnings Stripping, Transfer Pricing and U.S. Income Tax Treaties*, November 2007 (hereinafter, Transfer Pricing Report).

⁸⁶ The rules governing cost sharing arrangements are provided for by Treas. Reg. sec. 1.482-7. In a cost sharing arrangement, two parties come together and share resources and costs (typically through a combination of cash and existing intellectual property rights) in the development of a new marketable asset. The party contributing the intellectual property is often a U.S. company, and the party sharing in costs is typically organized in a low-tax jurisdiction, such as Ireland. In exchange, the U.S. company owns all U.S. marketing and production rights, and the other party owns all marketing and production rights for the rest of the world. Reflecting the split ownership of the newly developed asset, no royalties are paid between cost sharing participants when the product is ultimately marketed and sold to customers

The Transfer Pricing Report's conclusion that there is potential for income shifting is consistent with the empirical data examined in the report. In general, if a multinational group is engaging in non-arm's-length pricing to shift income to low-tax jurisdictions, one would expect to observe higher CFC profitability in low-tax jurisdictions and lower CFC profitability in high-tax jurisdictions, assuming other factors are equal.⁸⁸ As part of its study, the Treasury Department examined the relationship between CFC profitability (measured by the ratio of operating profits to sales) and the statutory tax rate of the CFC's jurisdiction.⁸⁹ Using information from tax filings for the years 1996, 2000 and 2002, the study found an inverse relationship between pre-tax profitability and tax rates.⁹⁰ In other words, the data generally showed that pre-tax operating margins are higher in low-tax countries and lower in high-tax countries.⁹¹ The Transfer Pricing Report acknowledges, however, that many factors affect profitability,⁹² and that while the results are consistent with income shifting, a more refined empirical analysis is necessary to isolate income shifting through non-arm's-length pricing.

The Treasury Department findings are consistent with those of empirical studies conducted by economists, beginning in the early 1990s and continuing through today, which include controls for various non-tax factors.⁹³ For example one study using aggregated country-specific data and adjusting for financial structure and capital employed, found evidence of

(although intercompany royalties may be payable to the U.S. company by the other cost sharing participants with respect to the use of the pre-existing intangible that the U.S. company contributes to the cost sharing arrangement).

⁸⁷ Transfer Pricing Report at 36.

⁸⁸ Transfer Pricing Report at 57.

⁸⁹ Transfer Pricing Report at 57. For purposes of the study, operating profits were defined as pre-tax earnings, excluding interest income and interest expense. *Id.* "The measure is based on 'earnings and profits' and is intended to approximate 'book' operating profits for tax purposes." *Id.* Financial CFCs and CFCs with losses were excluded. *Id.*, note 72.

⁹⁰ *Id.* at 58.

⁹¹ *Id.*

⁹² Transfer Pricing Report at 58-59.

⁹³ See *Id.* at 59-62. See also Harry Grubert, *Intangible Income, Intercompany Transactions, Income Shifting, and the Choice of Location*, Vol. LVI, No. 1, Part 2 National Tax Journal 221, 226 (March 2003) (hereinafter, Grubert (2003)) (citing several studies); Reuven S. Avi-Yonah and Kimberly A. Clausing, *A Proposal to Adopt Formulary Apportionment for Corporate Income Taxation: The Hamilton Project*, Public Law and Legal Theory Working Paper Series, Working Paper No. 85, p. 7 (June 2007) (hereinafter, Avi-Yonah and Clausing) ("It is apparent that U.S. multi-national firms book disproportionate amounts of profit in low-tax countries.").

sensitivity of profitability to local country effective tax rates.⁹⁴ A second study, using firm-level data based on public (non-tax) filings of publicly traded companies, found evidence of income shifting out of or into the United States correlated with tax-rate differentials between the United States and foreign jurisdictions, taking into account company characteristics such as research expenditures and advertising (as proxies for intangibles), interest expense and number of employees.⁹⁵ Recent work by Grubert and Altshuler, comparing Treasury data for manufacturing subsidiaries in 1996 and 2000, indicates that income shifting has increased.⁹⁶ While not conclusive evidence of income shifting through non-arm's-length pricing, these studies are consistent with what one would expect to find if companies are engaging in income shifting.

In 2003, Grubert published a study examining the sources of income shifting, focusing on the role of intangible assets.⁹⁷ The study used firm-level data from 1996 corporate tax filings (supplemented by data from public filings), and controlled for U.S. parent and CFC non-tax characteristics. Like previous studies, Grubert found an inverse relationship between local statutory rates and reported earnings.⁹⁸ More specifically, however, Grubert found that “about half of the observed difference in profitability between high and low tax countries seems to be accounted for by the shifting of income derived from industrial intangibles.”⁹⁹

The conclusions reached by the Treasury Department in the Transfer Pricing Report and the findings by Grubert regarding the role of intangibles in income shifting are not surprising. Transfer pricing issues involving high-value intangibles are particularly difficult due to the unique nature and high value of those assets.¹⁰⁰ Transactions involving these assets are not readily comparable to other third party transactions (even if third-party transaction information were publicly available).¹⁰¹ In fact, a more recent paper by Grubert and Altshuler concludes that the transfer of valuable intangible assets to low-tax subsidiaries without adequate compensation

⁹⁴ James R. Hines, Jr. and Eric Rice, *Fiscal Paradise: Foreign Tax Havens and American Business*, 109 *Quarterly Journal of Economics* 149 (February 1994).

⁹⁵ David Harris, Randall Morck, Joel Slemrod, and Bernard Yeung, *Income Shifting in U.S. Multinational Corporations*, in Alberto Giovannini, R. Glenn Hubbard, and Joel Slemrod, eds., *Studies in International Taxation*, Chicago: University of Chicago Press (1993).

⁹⁶ Grubert and Altshuler (2003) at 26-27.

⁹⁷ Grubert (2003).

⁹⁸ *Id.* at 229.

⁹⁹ *Id.* at 229. The other half of income shifting appears to be accounted for by financing strategies (i.e., the allocation of debt between high- and low-tax countries). *Id.* at 230-231. The study does not provide information concerning the countries from which income is being shifted. *Id.* at 229.

¹⁰⁰ Grubert (2003) at 226.

¹⁰¹ *Id.* at 226; Kleinbard at 71.

in the form of appropriately priced royalties is probably one of the most important income-shifting methods.¹⁰²

The difficult problem presented by intangibles is further illustrated by data involving Ireland, which taxes trading income at a 12.5 percent rate. Grubert and Altshuler report that information from Treasury 2002 tax files for certain CFCs in manufacturing indicates that the ratios of pre-tax profits to sales are almost three times higher in Ireland on average than the mean ratio of pre-tax profits to sales for all such CFCs.¹⁰³ According to Grubert and Altshuler, “these ‘excess’ profits presumably reflect the fact that very valuable intellectual property is located in Ireland and the royalties paid back to the United States, while significant, do not fully reflect its contribution.”¹⁰⁴

The difficulties in applying the transfer pricing rules, particularly with regard to intangibles, have led some to conclude that the rules are ineffective in ensuring arm’s length prices. One paper, for example, argues that the arm’s length standard inherently leaves substantial room for tax incentives to affect pricing because arm’s-length prices are often difficult to establish.¹⁰⁵ As another commentator points out, due to the lack of real world comparables in many cases, the “arm’s-length analysis can, at best, suggest an area — a range — in which a transaction between uncontrolled persons would have been likely to occur.”¹⁰⁶ Additional criticisms of the current system are that it is administratively unworkable in its complexity, not suited to the global nature of international business and is based on an artificial distinction between legal entities.¹⁰⁷

As noted in the Reform Panel Proposal, transfer pricing “is even more important in a territorial system than under current law.”¹⁰⁸ Under a territorial system, the tax stakes involved would be increased: current taxation versus permanent exemption, as contrasted with the present-law stakes of current taxation versus deferral. Thus, a territorial regime would place additional pressure on the transfer pricing rules by, for example, providing domestic corporations with an incentive to convert foreign royalty income (which would generally be subject to full residual U.S. tax under the JCT Option) into exempt dividends by understating royalties.

¹⁰² Grubert and Altshuler (2003) at 23.

¹⁰³ Grubert and Altshuler at 29.

¹⁰⁴ Grubert and Altshuler (2006) at 29. The paper states, parenthetically, that “[p]arallel regressions for royalties and profits indicate that only about one-third of the contribution of parent’s R&D to CFC profits on average is paid back as royalties.” *Id.*

¹⁰⁵ Avi-Yonah and Clausing at 4.

¹⁰⁶ H. David Rosenbloom, “Angels on a Pin: Arm’s Length in the World,” 38 *Tax Notes International* 523, 526 (May 9, 2005).

¹⁰⁷ *Id.* at 4-6.

¹⁰⁸ Reform Panel at 134.

Therefore, in considering the adoption of a territorial regime in the United States, a critical question is whether the transfer pricing rules could be modified to provide an effective barrier to income shifting through non-arm's length intercompany transactions. Some believe that cost sharing arrangements are particularly problematic and that currently-proposed Treasury regulations on such arrangements, when finalized, will mitigate the problem. Others believe that the issue is much broader, and that revising the rules for cost sharing arrangements will merely shift the pressure elsewhere (e.g., to royalties). To date, the JCT Staff is unaware of any comprehensive proposal to modify the arm's-length pricing rules in a manner that would ensure their effectiveness.

2. Allocation and apportionment of expenses

The allocation of expenses between exempt and non-exempt income is also critical to the implementation of a territorial regime. Under a dividend exemption system, there would be two categories of foreign source gross income: taxable and exempt. With respect to the first category, the allocation of expenses would serve essentially the same function that it serves today, i.e., to limit the availability of the foreign tax credit in order to ensure that such credits do not offset U.S. tax liability on domestic income. In contrast, the effect of allocating expenses to exempt foreign source income would be to disallow those expenses, because they would offset gross income that is not subject to tax.

Consider, for example, the headquarter expenses (such as stewardship and general and administrative costs) typically incurred by the domestic parent of a multinational group. Under present law, those expenses are fully deductible (to the extent ordinary and necessary) and, because they benefit both domestic and foreign operations, they are allocable in part to foreign source gross income.¹⁰⁹ To that extent, they reduce foreign source taxable income and, thus, the foreign tax credit limitation (i.e., the amount of U.S. tax imposed on foreign source taxable income).¹¹⁰ Under a dividend exemption system, the allocation of headquarter expenses to taxable foreign source income would have the same effect as under current law. Allocation of these expenses to exempt foreign source income, however, would reduce the U.S. tax deduction available to the taxpayer, but typically would not affect the taxpayer's foreign tax liability.

This result is consistent, however, with the general approach of the Code to disallow expenses associated with the earning of exempt income.¹¹¹ The effect of failing to allocate expenses against exempt foreign source income has thus been described as facilitating negative effective tax rates for overseas investments, by permitting taxpayers to earn income in low-tax foreign countries while claiming the related deductions in the United States.¹¹² More

¹⁰⁹ Temp. Treas. Reg. sec. 1.861-14T(e)(3) and (4).

¹¹⁰ In practice, however, this allocation affects only those taxpayers with substantial foreign tax credits, for whom a reduction in the limitation may preclude full or current use of those credits.

¹¹¹ *See, e.g.*, Code sec. 265.

¹¹² Grubert and Altshuler (2006) at 13.

specifically, if headquarter expenses were allocated solely between U.S. and taxable foreign source income, those expenses would disproportionately reduce taxable income in those categories by expenses that are not entirely related to the production of that income. In the case of U.S. source income, the overallocation would directly reduce U.S. tax liability. In the case of taxable foreign source income, the effect would be to reduce disproportionately the foreign tax credit limitation. The practical effect of this reduction would be limited, however, because the types of foreign source income that would remain taxable under a dividend exemption system are those that typically bear relatively little foreign tax.

For these reasons, the JCT Option and the Reform Panel Proposal generally would retain present law rules for expense allocation.¹¹³ That approach is also presumed to be necessary by most other U.S. commentators on the implementation of a territorial regime.¹¹⁴ Concerns have been expressed, however, that merely applying the allocation rules of present law, without modification, could have inappropriate or potentially punitive results. Thus, as noted earlier, both the JCT Option and the Reform Panel Proposal, and other commentators, have assumed that interest expense would need to be allocated using a worldwide affiliated group approach, such as that of Code section 864(f) (as amended by AJCA and currently scheduled to take effect in 2009). Alternatively, it has been suggested that interest expense could be allocated first to interest income (whether or not eligible for exemption), with the remaining interest expense allocated to each category of income pro rata based on worldwide assets.¹¹⁵ It has also been suggested that the allocation of stewardship expenses to exempt foreign source income be limited, on the grounds that these expenses otherwise would not be deductible in any jurisdiction.¹¹⁶

Both the JCT Option and the Reform Panel Proposal would also modify the treatment of research and experimental expenses, but in different ways. Most significantly, the Reform Panel Proposal would not allocate any research and experimental expenses to exempt income, on the theory that foreign source royalty income attributable to U.S. research and development activity would be taxable at the U.S. rate (by virtue of bearing relatively little foreign tax). However, as described above, there is substantial evidence that intercompany royalties may be understated

¹¹³ This approach is analogous to the treatment of expenses and foreign tax credits in conjunction with section 965 of the Code, which temporarily allowed an 85 percent dividends received deduction for certain foreign dividends. Under section 965, expenses directly allocable to the exempt portion of a qualified 965 dividend were disallowed, as were the associated foreign tax credits.

¹¹⁴ See, e.g., Graetz and Oosterhuis at 780-782; Task Force at 725-26; Grubert and Altshuler (2006) at 12-13; Grubert and Mutti (2001) at 9-10.

¹¹⁵ Graetz and Oosterhuis at 781.

¹¹⁶ Graetz and Oosterhuis at 782 (pointing out that stewardship expenses, by definition, cannot be properly charged out to foreign subsidiaries).

under present law.¹¹⁷ A territorial system would only increase the incentive to understate intercompany royalties, because companies generally would no longer be able to eliminate U.S. tax on foreign royalties through cross-crediting and, thus, would have an increased incentive to convert royalties into exempt dividends. If so, allocating research and experimental expenses solely to taxable income would reward such behavior.

3. “Subject to foreign tax” requirement

As discussed above, potential concerns with a territorial system include the manipulation of transfer prices and the use of transactions designed to strip income from high to low or no tax jurisdictions in order to maximize income that would be permanently tax-free or extremely low-taxed (so-called “stateless income”).¹¹⁸

It has been suggested that a “subject to tax” requirement may mitigate some of the pressure on the transfer pricing rules and possibly limit the number of transactions designed to produce stateless income.¹¹⁹ This approach, which is used by some foreign countries, could be implemented in a number of ways. One alternative would be to require that the foreign income be subject to some threshold level of foreign tax in order to qualify for exemption. Another approach would be to limit exemption to income derived from countries with which the United States has a comprehensive income tax treaty. It has been noted, however, that there might be pressure to allow taxpayers to defer U.S. tax on active foreign income that fails to satisfy the “subject to tax” requirement. Conceivably, this pressure could ultimately lead to a system that is at least as complex as today, because three income categories would result (exempt, deferred and currently includible).¹²⁰

4. Defining exempt and non-exempt income

Because active foreign income would be permanently exempt rather than deferred, policymakers would need to give careful consideration to what items of income would qualify for exemption; they would further need to develop extensive rules defining those different classes of income. For example, under the JCT Option, the rules of subpart F generally would apply to determine what income is available for exemption. With subpart F as the starting point,

¹¹⁷ One study suggests that royalties represent less than half of the contribution that U.S. parent R&D makes to the income of foreign subsidiaries. Grubert and Altshuler at 11 (citing Grubert and Mutti (2006)).

¹¹⁸ Yin at 517; Kleinbard at 77. This concept is also described by Professor Reuven Avi-Yonah, *Competition and Competitiveness: Review of the NFTC Subpart F Report*, 83 Tax Notes 583, 587 (April 26, 1999);

¹¹⁹ See, e.g., American Bar Association, *Report of the Task Force on International Tax Reform*, 59 Tax Lawyer 649, 722-723 (2006) (hereinafter, ABA Task Force). Neither of the Exemption Proposals condition exemption on foreign taxation.

¹²⁰ Graetz and Oosterhuis at 783.

consideration would need to be given as to whether those rules should be modified. One question would be whether to retain the rules that treat highly mobile income (such as related party sales and services income, and related party royalties not covered by the temporary look-through rules of section 954(c)(6)) as subpart F income or whether to exempt all active income, including highly mobile income. A second question might be whether to retain present law section 954(c)(6), which facilitates the creation of stateless income by permitting a high-tax CFC to make deductible payments to a low-tax CFC without generating subpart F income for the recipient.

The treatment of foreign-source, non-dividend payments received by a domestic corporation directly also warrants further consideration. Under the JCT Option and the Reform Panel Proposal, such payments would not qualify for exempt treatment. However, one suggestion is to exempt, in whole or in part, royalties and interest received by domestic corporations.¹²¹ This proposed exemption for royalties is based on the concern that moving to a territorial system without providing some relief for royalties could exacerbate current issues with respect to intangible migration, and lead to the transfer of research and development activity outside of the United States.¹²² However, others view the imposition of U.S. tax on royalties as a critical component of a territorial system.¹²³ To some, an exemption for royalties would be unacceptable, because it provides a U.S. tax exemption for income that may have arisen from deductible U.S. research and experimental expenses.¹²⁴ Moreover, the proposal would inevitably have the practical effect of permanently exempting stateless income from U.S. taxation.

The treatment of gain on the sale of CFC stock would also require additional thought. The treatment of such gain is complicated by the fact that CFC stock may give rise to both exempt and non-exempt income. Under the JCT Option, gain would be exempt to the extent it reflects exempt earnings accumulated, but not distributed. Some may argue that this approach unfairly ignores the fact that a significant portion of the gain may reflect the present value of the future income stream expected from appreciated assets that give rise to exempt income. Nonetheless, implementing a system that looks through to the underlying assets of a company, then allocates gain between the appreciation of exempt basket and taxable basket assets, would be highly complex and would introduce difficult valuation issues into the system.¹²⁵

5. Foreign partnerships

The Exemption Proposals do not identify any principles that would govern foreign partnerships, leaving this question open for determination. One approach would be to continue

¹²¹ Treasury Department at 62.

¹²² *Id.*

¹²³ Grubert and Altshuler (2006) at 4-5.

¹²⁴ *Id.*

¹²⁵ JCT Options Report at 191, n.425; Graetz and Oosterhuis at 776.

to treat foreign partnerships as flow-through entities for purposes of determining the treatment of the partners, including each partner's share of exempt and non-exempt income. An alternative approach, similar to that recommended for foreign branches, would be to treat a foreign partnership like a foreign corporation. Under this approach, an investment in a foreign partnership could be treated as an interest in a CFC, an interest in a noncontrolled section 902 corporation or as a portfolio investment.

6. Simplification

Proponents of a territorial system believe that the potential for taxation under the U.S. system, by reason of either repatriation or application of the highly complex U.S. anti-deferral rules, arguably forces U.S.-based multinationals to contend with a greater degree of complexity, and to engage in a greater degree of tax-distorted business planning, than many of their foreign-based counterparts resident in countries with exemption systems.

Adopting a dividend exemption system, it is argued, would promote simplification of the foreign tax credit regime. This is due to the fact that most foreign business income would be exempt from U.S. tax under the system; therefore, the foreign tax credit regime would be inapplicable to a significant portion of offshore earnings. Application of the foreign tax credit regime on a more limited basis would allow simplification of the rules, such as the elimination of separate limitation categories. In addition, it would reduce the inefficiencies and costs associated with foreign tax credit planning because taxpayers generally would be expected to have excess foreign tax credit limitation.

Further, a territorial regime eliminates the need for the constructive dividend rules under subpart F because the timing of dividends would no longer have U.S. tax significance.¹²⁶

On the other hand, critics are skeptical that, on a net basis, there will be any simplification. They argue that the continued need for subpart F, the foreign tax credit and the intercompany pricing rules means that significant complexity will remain, and that the transition from the present-law system to the proposed system will create significant complexities of its own.¹²⁷

Critics also point to the increased importance of expense allocation. As described above, under present law, the primary role of the expense allocation rules in the international context is in determining a taxpayer's foreign tax credit limitation. Therefore, those rules primarily affect only those taxpayers that may not be able to fully utilize their foreign tax credits because of the foreign tax credit limitation. Under a territorial system, the expense allocation rules would determine the amount of deductions allocable to exempt income and, thus, the amount of a

¹²⁶ Fleming and Peroni at 225; Graetz and Oosterhuis at 783.

¹²⁷ See, e.g., Graetz and Oosterhuis (illustrating that moving to a dividend exemption system could provide an opportunity for simplification, but that many of the sources of complexity encountered under present law would remain); Kleinbard at 69 (continuation of these present law rules, in conjunction with new territorial rules, equates to the simultaneous operation of two parallel tax regimes.)

taxpayer's deductible expenses. As a result, the allocation of expenses would become a real "cash in hand" issue, affecting all taxpayers with exempt foreign income. Accordingly, critics argue that the disallowance of expenses would create additional incentives for tax planning by multinationals to reduce the amount of expenses allocable to exempt foreign income,¹²⁸ and disputes over expense allocations could be expected to increase.¹²⁹ The result would be greater complexity and corresponding compliance and administration costs.

One alternative adopted by some countries is to treat expenses as fully deductible, but then to exempt only an arbitrary fixed percentage of active foreign business income.¹³⁰ However, it has been argued that such a rule would negate the structural improvements of the territorial system.¹³¹

In addition, critics argue that the rules that would be required to put branch operations on equal footing with CFC operations would add further complexity. For example, under the Exemption Proposals, the treatment of foreign branches as CFCs requires the extension of subpart F rules to branch operations. Such CFC treatment would therefore require "deemed" transactions between a domestic corporation and its foreign branch, which would necessitate application of the full range of inter-company transaction rules, including the section 482 transfer pricing rules.

Finally, a territorial system would heighten the importance to taxpayers of devising methods to convert taxable foreign income into exempt income because the reward is permanent exemption from taxation. For example, domestic corporations would have an incentive to convert taxable royalties into exempt dividends.¹³² Conversely, it would create pressures to convert high-taxed exempt income into taxable income so that excess foreign taxes (i.e., foreign taxes in excess of the U.S. tax rate) imposed on high-taxed income could be credited against U.S. tax on low-taxed income. Absent the conversion into taxable income, such taxes would not be creditable. Taxpayers would also have an incentive to seek out foreign jurisdictions that might be willing to reduce withholding taxes on exempt dividends in exchange for increasing withholding taxes on payments of taxable royalties or interest. These incentives may require new anti-abuse rules and resources to protect the U.S. tax base — again, adding complexity to the system.

¹²⁸ Treasury Department at 60.

¹²⁹ Grubert and Mutti at 5.

¹³⁰ Fleming and Peroni at 226.

¹³¹ Yin at 519.

¹³² Graetz and Oosterhuis at 782; *see also* Grubert and Altshuler (2006) at 33 (companies may underpay royalties by using inappropriate transfer prices or other devices).

7. Transition Issues

Several transition issues would arise in connection with a move to a territorial system.

Income tax treaties.—Implementing a territorial system would require the renegotiation of existing income tax treaties, which are currently premised on the assumption that the United States operates on a worldwide tax system. For example, existing treaties generally require the United States to allow foreign tax credits for foreign corporate income taxes and dividend withholding taxes, subject to applicable limitations. These treaties would have to be revised to reflect the conversion from a credit mechanism to an exemption mechanism. As the United States currently has an extensive network of bilateral income tax treaties in place,¹³³ both the United States and our trading partners would incur significant expense to complete this task. While renegotiations are in progress, taxpayers will be burdened with uncertainty. In addition, with a territorial system, U.S. arguments for information-sharing treaty provisions may be weakened.

Untaxed earnings.—One of the critical transition issues is the treatment of previously untaxed earnings generated before the effective date of the territorial system. Under the JCT Option, the exemption system would apply only with respect to CFC earnings generated after the effective date. With respect to previously untaxed earnings, the present-law system would continue to apply in all respects. Thus, the JCT Option would require ongoing maintenance of separate pre-and post-effective date earnings and foreign tax accounts. Dividends would be treated as coming first from exempt, post-effective-date earnings and then from pre-effective date untaxed earnings. Implementing an ordering rule that treats dividends as paid first out of post-effective date earnings (rather than using a pro rata approach) may alleviate some of the complexity of this approach, and has legislative precedent.¹³⁴

In contrast, the Reform Panel Proposal would exempt from tax all CFC earnings and profits paid out after the effective date of the new system. Accordingly, no such distributions would ever be subject to U.S. tax, irrespective of whether they were paid from pre-effective date untaxed earnings or post-effective date earnings.¹³⁵ The Reform Panel proposal offers compliance simplicity, as separate tracking of earnings pools would not be required. Ostensibly, the trade off is the revenue that would have been generated on the repatriation of previously untaxed earnings. This trade off may be an illusion, however, as the JCT Option leaves in place

¹³³ There are currently more than 50 income tax treaties in place.
<http://www.irs.gov/publications/p901/index.html>.

¹³⁴ Graetz and Oosterhuis at 784 (“A precedent for this alternative can be found in both the rules applicable to C corporations that elect S corporation status and in the enactment of the 1986 foreign tax credit limitation rules.”).

¹³⁵ Reform Panel at 240.

the elective deferral system for previously untaxed earnings, thereby decreasing the likelihood that such earnings would ever be repatriated, except in extenuating circumstances.¹³⁶

¹³⁶ The “permanent reinvestment” concept under U.S. Generally Accepted Accounting Principles (GAAP), which is articulated in APB 23, plays a significant role in a company’s repatriation decision. Without the ability to assert that foreign earnings are permanently reinvested, a company would be required to record currently the U.S. tax expense associated with its foreign earnings for financial reporting purposes. However, it is unclear what incentives would follow if the “permanent reinvestment” concept were eliminated (whether by Congressional override of GAAP rules or through implementation of the International Financial Reporting Standards in the United States). While companies would still incur the U.S. cash tax cost of repatriating accumulated foreign earnings, a spectrum of transition rules are possible which could lead to varying results for financial accounting purposes.

D. Examples from Other Countries

1. Overview of other countries

A substantial number of other countries, including many of the United States' major trading partners, have adopted a territorial approach to the taxation of resident corporations. Most have done so through dividend exemption systems that are broadly similar to those of the JCT Option and the Reform Panel Proposal, although there are important differences in implementation. The variations between the existing systems of other countries can be categorized on the basis of:

- The level of dividend exemption;
- Threshold ownership requirement;
- Whether exempt income must first be subject to tax somewhere; and,
- The applicable expense allocation rules.

The level of dividend exemption

The level of dividend exemption refers to whether dividends from foreign subsidiaries are entirely exempt, or partially exempt. Where a foreign source dividend is fully exempt, the tax system generally contains rules that disallow deductions for certain expenses associated with the production of that exempt foreign income, such as interest.¹³⁷ Where a dividend is only partially exempt, the taxable portion of the dividend serves as a proxy for expense disallowance rules. The former approach may result in a more precise matching of expenses with corresponding income, but at the expense of simplicity; the latter approach, while simpler, presents the risk that the resulting tax will not correlate precisely with the tax effect of the expenses for which it serves as a proxy.

Threshold ownership requirement

Dividend exemption typically applies only where the parent company's ownership in the foreign subsidiary exceeds a certain threshold. Some countries predicate the exemption on at least 5 percent ownership, while others require at least 10 percent. Other countries predicate the exemption on a certain percentage of ownership or an ownership percentage representing a certain economic level of the company's capital.¹³⁸ Some members of the European Union apply

¹³⁷ *But see* the U.K. proposal described below: as initially proposed, the U.K. does not expect to implement interest allocation rules. As a result, interest expense incurred by the U.K. parent in connection with the production of exempt foreign profits would not be disallowed, yet dividends would be entirely exempt.

¹³⁸ For example, such a rule may require either a 10 percent ownership in the voting stock of a company, or ownership of €2 million of its capital.

the EU parent-subsidiary directive,¹³⁹ which currently requires 15 percent minimum ownership.¹⁴⁰

Subject to tax

In a territorial system, stateless income will never be subject to tax. Similarly, income earned in a low-tax jurisdiction would be subject only to that low tax rate. To prevent this result, some countries impose a “subject to tax” requirement. These systems specify that, in order to qualify for dividend exemption, the foreign profits must have been previously subject to tax. Denial of the exemption is structured through a variety of mechanisms, such as denying the benefits for dividends:

- From a company resident in a tax haven country specified on a “black list;”
- From a “privileged tax regime” (which varies in definition);
- From a source country with which the recipient country has no comprehensive tax treaty;
- When the underlying earnings were not subject to a comparable tax in the source country; and,
- When the underlying earnings were not subject to any tax in the source country.

Expense Allocation

As noted above, both the JCT Option and the Reform Panel Proposal recommend complex rules that would disallow as deductions those expenses attributable to exempt foreign profits. This methodology would not be unique to the United States, as some other countries follow this approach. Other countries avoid the complexity associated with an expense allocation system, and tax a portion of the otherwise exempt dividend as its proxy. There are, however, countries that fully exempt foreign dividends from taxation but do not impose any expense allocation. As discussed in more detail below, this is a feature of the territorial system being proposed in the United Kingdom.

¹³⁹ The parent-subsidiary directive was designed to eliminate tax obstacles in the area of profit distributions between groups of companies in the EU by: (1) abolishing withholding taxes on payments of dividends between associated companies of different Member States; and (2) preventing double taxation of parent companies on the profits of their subsidiaries.
http://ec.europa.eu/taxation_customs/taxation/company_tax/parents-subsidiary_directive/index_en.htm#relax.

¹⁴⁰ This will be reduced to 10 percent effective January 1, 2009. *Id.* The directive establishes the highest acceptable threshold; therefore, EU countries not following the directive have a lower threshold. For example, the directive currently mandates dividend exemption where there is at least 15 percent ownership. EU members are able to offer exemption based on a lower ownership threshold — thereby providing dividend exemption where there is, say, five percent ownership — but they cannot impose a more restrictive threshold, such as 25 percent.

2. Current U.K. reform discussions

Like the United States, the United Kingdom taxes its resident corporations on all income earned in the United Kingdom, but generally taxes the earnings of foreign subsidiaries only when those earnings are repatriated. Double taxation is mitigated through a foreign tax credit system. However, rules governing foreign income currently take an “all or nothing” approach: all of the income of a foreign subsidiary that meets the U.K. definition of a controlled foreign corporation (a “U.K. CFC”) is currently taxed, whereas the income of other foreign subsidiaries is not. Thus, there is an incentive for a U.K. parent to avoid classification of its foreign subsidiary as a U.K. CFC.¹⁴¹

The U.K. “Budget 2007” included significant reforms for domestic U.K. corporations. In conjunction with this domestic tax reform, HM Treasury and HM Revenue and Customs (“HMRC”) issued a proposal to tax foreign profits under a territorial tax system in June, 2007. This proposal was set forth in a paper titled “Taxation of companies’ foreign profits: discussion document” (the “Discussion Document”).¹⁴² The Discussion Document describes the broad terms of a U.K. territorial tax proposal (the “U.K. Proposal”), and was based on consultations with business that started in 2006. With the goal of meeting the needs of both business and the government, the Discussion Document requested that the government’s dialogue with business continue. A revised proposal, taking into account the outcome of that dialogue, is expected to be issued in the form of a consultation document this summer. While new legislation was originally planned for the 2009 Finance Bill (which would be effective in April, 2009), press reports indicate that this may be delayed until the 2010 Finance Bill.

One stated objective of the reform is to improve the competitiveness and attractiveness of the United Kingdom as a location for U.K.-based multinational business, while preserving the U.K. tax base. In addition, the government announced that it was seeking a revenue neutral outcome.¹⁴³ The government also noted that the Discussion Document responds to recent intra-European Union developments in international tax law, flowing from recent tax decisions handed down by the European Court of Justice.

¹⁴¹ This differs from the U.S. system, where all foreign subsidiaries meeting the 50 percent U.S. direct or indirect ownership threshold are controlled foreign corporations, and there is no pejorative connotation.

¹⁴² HM Treasury is the U.K. ministry responsible for economics and finance, and sets U.K. tax policy. HMRC is the corresponding ministry responsible for all other U.K. tax matters, including collection and enforcement. Both ministries ultimately report to the Chancellor of the Exchequer, who is responsible for all economic and financial matters. A “discussion document” typically outlines the terms of a proposal in broad terms, and invites input. A discussion document is then followed by a “consultation document,” which outlines a proposal in far more specific terms; again, input is requested before the proposal moves forward towards becoming law.

¹⁴³ Discussion Document at 25.

The U.K. Proposal would apply only to large and medium size businesses, and the government invited input on defining what constitutes a small business. For shareholders with 10 percent or more ownership in a foreign (i.e., non-U.K.) company falling within the revised scope of its controlled company rules, dividends would be exempt from U.K. tax when repatriated.

Because implementation of the U.K. Proposal would be expected to encourage income shifting, the existing U.K. controlled company rules would be updated to target mobile income within the control of a U.K. parent company and to eliminate the “all or nothing” approach of the current rules. To respond to European Union concerns, these rules would apply equally to U.K. corporations and controlled foreign subsidiaries.¹⁴⁴ As described by the government, mobile income includes both passive income and specific categories of active income, such as that arising from intra-group activities.¹⁴⁵ The U.K. Proposal will categorize all offshore licensing activities as passive,¹⁴⁶ and therefore, subject to current U.K. taxation. This would be a significant departure from present law, under which royalty income earned by foreign subsidiaries can be exempt from current U.K. taxation if the foreign subsidiary has sufficient exempt activity income to avoid classification as a U.K. CFC.

The U.K. Proposal would make specific exceptions for active financing business activities and certain de minimis intra-group financing activities. The U.K. Proposal anticipates that capital gains would be exempt, but those capital gains derived from the disposal of assets that would normally give rise to passive income would be treated as passive. The proposal also would introduce “substance over form” concepts to avoid what amounts to passive income (including income derived from the ownership of intangibles) from being treated as exempt, active income. Similarly, control rules will look beyond the legal form of property ownership.

In developing the U.K. Proposal, the deductibility of interest incurred to fund the cost of foreign activities — which would, in the future, give rise to exempt income — was considered.

¹⁴⁴ Equal application of the mobile income rules to U.K. and non-U.K. companies is likely a meaningless gesture, intended as a “belt and suspenders” response to recent decisions handed down by the European Court of Justice. This is because mobile income earned by a U.K. company is already subject to current U.K. tax.

¹⁴⁵ Discussion Document at 20. Under the current U.K. CFC rules, intra-group or U.K. derived sales and service income (sales income derived from dealing in goods for delivery to or from the U.K. or to or from affiliates where the goods are not delivered into the company’s territory of residence and intra-group/U.K.-derived sale or service income from wholesale, distributive, financial or service businesses) is not treated as exempt when determining whether a foreign subsidiary is a U.K. CFC. *Id.* at 22.

¹⁴⁶ Commentators have perceived an inconsistency in the U.K. Proposal, in that income from a genuine active treasury business would be exempt from current taxation, but that income from genuine active intellectual property management activities and genuine active leasing activities are not exempt. *See, e.g.,* The Law Society, *Taxation of Foreign Profits of Companies: Comments of the Corporation Tax Sub-Committee and the International Tax Sub-Committee of the Law Society of England and Wales on the discussion document published by HM Treasury and Her Majesty’s Revenue and Customs on 20 June 2007* (September 2007).

The Discussion Document notes that territorial regimes employ a variety of rules to disallow such expense, but also notes that these systems involve difficulties in terms of complexity and compliance. Taking into account that the government currently receives little tax with respect to foreign profits, the Discussion Document concluded that adopting such a system in connection with a territorial system was not justified.¹⁴⁷

Instead, the U.K. Proposal adopts a very limited and targeted approach to interest by proposing: (1) restrictions on the deductibility of U.K. interest expense by reference to worldwide external financing costs; and (2) expansion of the existing “unallowable purpose” rules, which target loans that are not connected to commercial or business purposes. In this regard, securing a U.K. tax advantage for any person is considered tax avoidance, which is an “unallowable purpose.” With these rules, HM Treasury and HMRC plan to counteract the “unwelcome behavioral effects of a move to dividend exemption.”¹⁴⁸ This, combined with the revised controlled company rules, is intended to be a “more balanced approach”¹⁴⁹ that would retain most of the present system for interest expense deductions.¹⁵⁰

In response to business concerns,¹⁵¹ the Chancellor of the Exchequer recently convened a tax forum including executives from U.K.-based multinational companies to address the proposed tax reforms. Depending on the outcome of this tax forum, it is possible that the planned summer publication of the consultation document — the next installment in the tax reform process — could be delayed.

3. Recent Japanese proposal

On May 9, 2008, the Japanese Minister of Economy, Trade and Industry (“METI”), Akira Amari, announced that METI’s tax reform package for fiscal 2009 will include a territorial tax system that would exempt overseas income earned by Japanese companies from Japanese

¹⁴⁷ Discussion Document at 24.

¹⁴⁸ *Id.* at 5.

¹⁴⁹ *Id.* at 4.

¹⁵⁰ Since 2004, interest charges have been covered by the U.K. transfer pricing rules, which take a loan-by-loan approach in determining whether an arm’s length interest rate is being charged. Prior to that, there were published thin capitalization rules that established 1:1 as the debt-to-equity safe harbor, and 1:3 as the interest coverage safe harbor. Under the transfer pricing rules, anti-avoidance rules continue to apply to related party interest.

¹⁵¹ *See, e.g.,* Jean Eaglesham, “Chancellor bows to foreign profits concerns,” *The Financial Times*, June 3, 2008. (“The government decision to give a substantive voice on the tax proposals to the new forum follows threats of potential exodus of companies from the UK if the initial Treasury proposals were not substantially rewritten... Pharmaceutical, media and consumer product companies have been particularly hostile to [the anti-avoidance provisions in the initial Treasury proposals], which would impose worldwide tax on “passive” income from intangible assets such as intellectual property and brands.”)

tax. Minister Amari indicated that he is taking this action in order to encourage repatriation of overseas earnings as part of a new growth strategy. This strategy is intended to create an environment that will further strengthen the competitiveness of Japanese companies in overseas markets and stimulate innovation in Japan.

Like the United States, Japan currently imposes tax on earnings of foreign subsidiaries only when those earnings are repatriated, and double taxation is mitigated through a foreign tax credit system. Ministry officials estimate that foreign subsidiaries of Japanese companies are each retaining, on average, approximately \$2 million per year. As a result, as much as 12 trillion yen (approximately \$112 billion¹⁵²) in subsidiary earnings have accumulated offshore. Without implementation of a territorial system, these earnings would be subject to tax at rates as high as 40 percent.¹⁵³

Prompting the change is concern that Japanese parent companies may not have enough capital to invest adequately in Japan in next-generation research and development, as well as top-of-the-line production facilities. A survey conducted by METI showed that 21 of 46 companies questioned said they would spend repatriated money for modernizing domestic production and R&D facilities.¹⁵⁴ METI officials also expect that, following the change, repatriation decisions will also be influenced by exchange rates and parent funding requirements.

It is expected that the reform package will be submitted for consideration to the Ministry of Finance in August, 2008. Further details of the proposal are not yet available.

¹⁵² Based on foreign exchange rates in effect on June 24, 2008.

¹⁵³ Dave Stewart, *Trade Ministry Urges Exemption for Repatriated Earnings*, 50 *Tax Notes Int'l* 672 (May 26, 2008); Toshio Aritake, *Japan Plans to Offer Corporate Tax Exemption on Repatriated Foreign Income*, Daily Report for Executives (BNA) No. 93, at I-2 (May 14, 2008) (hereinafter, Aritake); Associated Press, "Industry ministry eyeing territorial tax system for Japan business," May 9, 2008, http://www.breitbart.com/article.php?id=D90HUN000&show_article=1.

¹⁵⁴ Aritake.

IV. FULL INCLUSION SYSTEM

In recent years, a number of academics and tax professionals,¹⁵⁵ as well as some Members of Congress,¹⁵⁶ have advocated the adoption of a full inclusion system in the United States. Although there is no prevailing view regarding the mechanism that should be used to implement a full inclusion system, there seems to be agreement that a full inclusion system would include two basic features: (1) U.S. shareholders of a foreign corporation (at least those satisfying a certain ownership threshold)¹⁵⁷ would be taxed currently on their shares of the foreign corporation's income, and (2) the foreign tax credit would be retained in some form to mitigate double taxation of foreign source income. The discussion below is divided into three parts. The first section describes the three basic mechanisms that could be used to implement a full inclusion system. The second section examines the potential benefits of a full inclusion system from an economic perspective. The third section discusses certain structural issues that would need to be addressed in implementing a full inclusion system.

A. Mechanisms for Implementing a Full Inclusion System

This section discusses the following three options for implementing a full inclusion system: (1) treat CFCs as pass-through entities, such that each U.S. shareholder is required to include in income currently its share of the CFC's items of income, gain, deduction and loss; (2) expand the consolidated group to include foreign subsidiaries; and (3) expand the subpart F regime.

1. Pass-through regime

Robert J. Peroni, J. Clifton Fleming, Jr. and Stephen E. Shay, in an article published several years ago, outlined the key features of a pass-through regime.¹⁵⁸ Their approach generally would apply the principles of the current rules for taxing partnerships contained in

¹⁵⁵ See, e.g., Reuven S. Avi-Yonah, *The Logic of Subpart F: A Comparative Perspective*, 79 Tax Notes 1775 (June 29, 1998); Robert J. Peroni, J. Clifton Fleming Jr. and Stephen E. Shay, *Getting Serious About Curtailing Deferral of U.S. Tax on Foreign Source Income*, 52 SMU L. Rev. 455, 497 (1999) (hereinafter, Peroni, Fleming and Shay); Robert A. Green, *The Future of Source-Based Taxation of the Income of Multinational Enterprises*, 79 Cornell Law Review 18 (November 1993); Kleinbard. See also ABA Task Force at 731-735 (describing and evaluating, but not endorsing, a full inclusion regime).

¹⁵⁶ In 1992, Representatives Dan Rostenkowski and Bill Gradison proposed a full inclusion regime in the Federal Income Tax Rationalization and Simplification Act of 1992, H.R. 5270, 102d Cong. (2d Sess. 1992). The first serious call for rolling back deferral came from President Kennedy in 1961. Message from the President of the United States Relative to Our Federal Income Tax System, April 20, 1961, reprinted as H.R. Doc. No. 87-140, at 6-7. As originally proposed, the subpart F rules would have applied to all CFC earnings.

¹⁵⁷ As discussed *infra*, a threshold question for a full inclusion regime would be whether to require that a certain ownership threshold must be met in order to trigger current taxation.

¹⁵⁸ Peroni, Fleming and Shay at 509-512.

subchapter K of the Code. Therefore, each U.S. shareholder would be subject to U.S. tax currently on its share of the foreign corporation's items of income, gain, deduction and loss, and the character of such items (for example, capital gain or ordinary income) would flow through to the U.S. shareholder.¹⁵⁹ Basis adjustments similar to those in section 705 of the Code would apply to prevent double taxation of the foreign corporation's earnings when they are distributed to the U.S. shareholder or when the U.S. shareholder sells its stock.¹⁶⁰ Consistent with the limits imposed by section 704(d) of the Code, net losses of the foreign corporation generally would flow through to a U.S. shareholder, but would be limited to the extent of the U.S. shareholder's basis in the corporation's stock and the U.S. shareholder's basis in any loans to the foreign corporation.¹⁶¹ Distributions would be tax-free to the extent of a U.S. shareholder's basis in its stock.¹⁶² Distributions in excess of the U.S. shareholder's basis would be treated as gain from the sale of the stock.¹⁶³

The foreign tax credit generally would be retained. However, because foreign income items would flow through directly to the U.S. shareholders under the pass through approach, a U.S. shareholder would be treated as paying directly its share of the foreign corporation's foreign taxes. Accordingly, the indirect credit rules of present law would be eliminated.

The authors suggest two possible alternatives for determining a U.S. shareholder's share of the foreign corporation's items. The first option, which appears to be the option favored by the authors, would be to apply the principles of subchapter K, including the complex "substantial economic effect" rules.¹⁶⁴ The second option would be to use a pro rata approach based on each shareholder's economic interest in the foreign corporation. The authors suggest that a U.S. shareholder's economic interest could be determined based on three factors: (1) voting rights, (2) rights to participate in current earnings and accumulated surplus, and (3) rights to the corporation's assets upon liquidation.¹⁶⁵ The authors acknowledge that in cases involving multiple class of stock with differing rights, determining a U.S. shareholder's economic interest could be difficult.¹⁶⁶ The authors also point out that such an approach could create distortions in terms of choice-of-entity since foreign partnerships would remain governed by the subchapter K rules.¹⁶⁷

¹⁵⁹ *Id.* at 509.

¹⁶⁰ *Id.* at 510.

¹⁶¹ *Id.*

¹⁶² *Id.* at 511.

¹⁶³ *Id.*

¹⁶⁴ *Id.* at 509.

¹⁶⁵ *Id.* at 509-510.

¹⁶⁶ *Id.* at 510.

¹⁶⁷ *Id.*

In recognition of the fact that U.S. shareholders with a small interest (less than 10 percent) could have difficulty in obtaining necessary financial information, the authors suggest special rules that could be applied with respect to those shareholders. In the case of publicly traded foreign corporations, the authors suggest that a U.S. shareholder could be provided with a mark-to-market election similar to that available under present law for U.S. shareholders of a PFIC.¹⁶⁸ In the case of nonpublicly traded foreign corporations, the authors suggest that U.S. shareholders could either: (1) use generally available financial information, with adjustments to reflect U.S. tax rules for material items that can be readily identified, or (2) apply a modified version of the excess distribution rules for U.S. shareholders of PFICs.¹⁶⁹ The authors also describe a narrower pass-through approach that could be applied in lieu of the approach outlined here.¹⁷⁰

2. Worldwide consolidation regime

Under a worldwide consolidation regime, a U.S. affiliated group would be required to consolidate with its foreign subsidiaries. The tax results for the consolidated entities generally would be similar to those under a pass-through approach. The U.S. group would include on its return the foreign corporation's items of income, gain, deduction and loss, the character of such items would be preserved, and the foreign tax credit would be retained.

However, there are some significant differences between the partnership approach described above and a consolidation approach. First, under the consolidation approach, losses of foreign subsidiaries would be included on the U.S. return without regard to any basis limitation. Second, the consolidation regime would apply only to U.S. corporate shareholders of foreign subsidiaries. Third, depending on the details of the regime, including the ownership level required to trigger consolidation, a consolidation regime may require retention of the indirect foreign tax credit rules, with their inherent complexity.

A critical question that would need to be resolved would be the ownership threshold required to trigger consolidation. Under the existing consolidated return rules, consolidation is available only with respect to 80 percent owned subsidiaries. One option would be to retain this ownership threshold. An alternative would be to reduce the threshold to all foreign subsidiaries that are controlled by the U.S. group (i.e., foreign subsidiaries in which members of the U.S. group own more than 50 percent of the stock). Yet a third option would be to reduce the ownership level to 10 percent.¹⁷¹ In general, a lower threshold would expand the scope of full inclusion at the cost of greater complexity. For example, if the ownership threshold is reduced to

¹⁶⁸ *Id.* at 511.

¹⁶⁹ *Id.* at 511-512. In general, those rules permit deferral, but impose an interest charge on so-called excess distributions to recapture the benefits of deferral.

¹⁷⁰ *Id.* at 16-519.

¹⁷¹ See Robert A. Green, *The Future of Source-Based Taxation of the Income of Multinational Enterprises*, 79 Cornell Law Review 18 (November 1993).

a controlling interest, it would make sense to limit the controlling U.S. shareholder's inclusion to its share of the foreign subsidiary's income, which could create complexities. In addition, if the ownership threshold were lowered to 10 percent, it could be difficult for a U.S. shareholder to obtain the financial information necessary to determine the amount of its annual inclusion.

A U.S. shareholder to which the consolidation rule did not apply (i.e., individuals and minority corporate shareholders) generally would not be subject to tax until such shareholder received an actual distribution. The PFIC rules could be retained for these shareholders.

3. Expansion of subpart F

Under the present subpart F rules, United States Shareholders of a CFC are subject to U.S. tax currently on their pro rata shares of certain passive and highly mobile income of the CFC, whether or not such income is distributed to the shareholders. Those rules treat the United States Shareholder as if the CFC had distributed to the United States Shareholder its pro rata portion of the CFC's subpart F income as a dividend. United States Shareholders that are corporations generally are permitted to claim indirect foreign tax credits for foreign taxes paid by the CFC that are associated with the earnings that are deemed to be distributed as a dividend.

A task force comprised of members of the tax section of the American Bar Association recently published a report on international tax reform, which included an analysis of an expanded subpart F regime.¹⁷² The key feature of the system they evaluated was that a U.S. shareholder would include as a deemed dividend its share of the current foreign earnings of the foreign corporation. Thus, the distinction under current law between subpart F and non-subpart F income would be eliminated, and all foreign income would be taxed currently. Losses of the CFC would not, however, flow through to U.S. shareholders.¹⁷³

U.S. corporate shareholders owning a 10 percent interest in the CFC would continue to claim indirect credits for their share of the foreign taxes paid by the CFC.¹⁷⁴ Because earnings would be deemed to be distributed annually, the amount of indirect credits associated with a deemed dividend would be based on current year earnings and taxes.¹⁷⁵ Therefore, taxpayers would no longer need to maintain multi-year pools of earnings and taxes for CFCs, as required under present law.

Earnings that were effectively connected income (i.e., attributable to a U.S. trade or business and, thus, subject to U.S. net income tax at the corporate level) would not be subject to

¹⁷² ABA Task Force at 735. The expanded subpart F concept was also introduced by Representatives Dan Rostenkowski and Bill Gradison as part of the Federal Income Tax Rationalization and Simplification Act of 1992, H.R. 5270, 102d Cong. (2nd Sess. 1992).

¹⁷³ ABA Task Force at 734.

¹⁷⁴ *Id.* at 733.

¹⁷⁵ *Id.*

the current U.S. shareholder-level taxation.¹⁷⁶ As under present law, upon a distribution of those earnings, U.S. shareholders would be entitled to the dividends received deduction.¹⁷⁷

Ordering rules would treat actual distributions as coming first out of previously-taxed earnings, and then from effectively connected earnings.¹⁷⁸ As under present law, distributions in excess of current earnings would reduce basis to the extent thereof, and then generate capital gain.¹⁷⁹ The task force states that the ordering rules would eliminate the need to track earnings and profits at the CFC level because previously taxed earnings would be measured at the shareholder-level and would not transfer to a new shareholder.¹⁸⁰

The task force suggests modifying the present law definition of a CFC. Under present law, a foreign corporation is treated as a CFC only if the United States Shareholders of the foreign corporation in the aggregate own stock representing more than 50 percent of the total voting power or total value of the stock. Under the proposal, a foreign corporation would be a CFC if all U.S. shareholders owned in the aggregate 25 percent or more of the foreign corporation's stock (by vote or value) and U.S. shareholders exceed non-U.S. shareholders from any other single country.¹⁸¹ The 25 percent U.S. ownership level is based on the belief that this level of ownership would, in most cases, be adequate to cause the foreign corporation to take into account U.S. tax considerations.¹⁸²

With regard to the amount of stock that a U.S. shareholder would need to own to trigger current inclusion, the task force believes that the 10 percent threshold under present law is appropriate.¹⁸³ However, the task force suggests that the issue of whether less than 10 percent shareholders of a CFC should be taxed currently should be explored.¹⁸⁴

U.S. shareholders of foreign corporations that did not qualify as CFCs generally would not be subject to tax until they received an actual distribution. However, the PFIC rules would be retained, with certain modifications. Accordingly, U.S. shareholders of foreign corporations with substantial passive income (50 percent under the proposal) would be subject to those rules.

¹⁷⁶ *Id.*

¹⁷⁷ *Id.*

¹⁷⁸ *Id.*

¹⁷⁹ *Id.*

¹⁸⁰ *Id.*

¹⁸¹ *Id.* at 732.

¹⁸² *Id.*

¹⁸³ *Id.*

¹⁸⁴ *Id.* at 732, note 195.

Less than 10 percent shareholders of a CFC would also be subject to the PFIC rules, assuming the expanded subpart F rules did not apply.

In summary, the proposal would require current taxation of 10 percent or greater shareholders of CFCs (as defined under the proposal) on their respective shares of the CFC's foreign income and would retain the indirect credit for 10 percent or greater corporate shareholders. Subject to application of the PFIC rules, less than 10 percent shareholders of a CFC and U.S. shareholders of non-CFCs would not be taxed until receipt of an actual dividend.¹⁸⁵

¹⁸⁵ The task force did not express a view on whether the indirect credit for 10 percent U.S. corporate shareholders of *non*-CFCs should be retained.

B. Economic Analysis

1. Efficiency considerations

Like a territorial system, a full inclusion regime should eliminate the disincentive to repatriate foreign earnings, at least in the case of those earnings to which it applied. In that respect, full inclusion, like a territorial system, would be significantly more neutral than present law with regard to repatriation decisions. In addition, as a structural matter, it would appear that a full inclusion regime should be more neutral with regard to investment location decisions than is present law, and possibly than a territorial system, because (in the absence of the foreign tax credit issues described below) there would be no tax advantage to locating direct investments in a low-tax jurisdiction.

As a practical matter, the effect of a full inclusion system on location decisions may depend, in part, on the degree of excess foreign tax credits. If all foreign earnings are taxed on a current basis, in the same manner as domestic earnings, then U.S. taxation should not affect locational decisions. Assuming no excess foreign tax credits, effective tax rates for investment in tangible and intangible assets would not vary across locations. Thus, adopting a full inclusion regime that minimized excess credits could be expected to reduce distortions in location decisions.¹⁸⁶ On the other hand, if the full inclusion system led to many companies generating excess foreign tax credits, then low-tax locations would remain attractive.¹⁸⁷

More broadly, however, full inclusion could affect corporate residency decisions to a greater extent than present law. Under a full inclusion system, any U.S. tax-resident corporation would be taxed on its worldwide income, including its share of the income of its foreign subsidiaries. As under present law, a foreign tax-resident company would not be subject to the U.S. tax regime, except to the extent it had a nexus with the United States.¹⁸⁸ Differing U.S. tax treatment, based solely on tax residence, creates an unambiguous dividing line that can be expected to influence behavior. Specifically, existing companies could be expected to analyze and compare the cost of inverting with the cost of maintaining U.S. tax residency, and the incentive for new companies to incorporate outside the U.S may be increased.

One possible response would be to implement new tax residency rules in conjunction with a full inclusion system. In its *2005 Options* pamphlet, the JCT Staff outlined residency rules that would shift from the current, form-based system (which ties residency solely to the location of incorporation) to a “facts and circumstances” based test.¹⁸⁹ Under the JCT proposal, the tax residence of a foreign-incorporated company’s residence would be determined based on

¹⁸⁶ See Grubert and Altshuler (2006) at 34.

¹⁸⁷ *Id.* at 35.

¹⁸⁸ The exception to this general rule relates to U.S. companies that have reincorporated in foreign jurisdictions, but which are subject to the anti-inversion provisions of section 7874.

¹⁸⁹ JCT Options Report at 180.

the location of its primary place of management and control. The primary place of management and control would be where the executive officers and senior management of the corporation exercise day-to-day responsibility for the strategic, financial and operational policy decision making for the company (including direct and indirect subsidiaries). In the proposal, it was intended that the management and control rules would only apply to publicly traded companies, thereby mitigating the effect on small business.

2. Competitiveness

The criteria for evaluating the competitiveness of U.S. businesses are discussed in detail in Section III.B. above. One view is that the competitiveness of a U.S. business would be enhanced only if the total tax burden imposed on U.S.-based multinational operations is reduced. The effect of a full inclusion system on total U.S. tax revenues depends, in part, on the operation of the foreign tax credit rules and the treatment of losses. Nonetheless, although there would inevitably be “winners” and “losers,” the total tax burden on U.S. multinationals in the aggregate could be expected to increase unless adoption of the system is accompanied by a reduction of the U.S. tax rate.¹⁹⁰ For this reason, proponents of full inclusion often recommend that a reduction in the U.S. tax rate accompany a full inclusion system.¹⁹¹ Assuming that full inclusion were adopted in conjunction with a reduction in tax rates and other reforms, the increased burden could be mitigated or eliminated.

A study by Grubert and Altshuler suggests that a U.S. tax rate of 28 percent could achieve what they term a “burden neutral” result in a full inclusion system if accompanied by certain design elements, including the elimination of expense allocation for U.S. parent overhead expenses.¹⁹² However, Grubert and Altshuler acknowledge that due to imperfect information, the estimates are subject to substantial uncertainty.

Adopting a full inclusion system would set the U.S. regime apart because very few countries use a full inclusion system, and no major U.S. trading partner has such a system.¹⁹³ However, a full inclusion system would be consistent with international norms generally because the foreign tax credit would continue to mitigate double taxation of foreign income. Whether the total tax burden on U.S. companies would be more or less than the tax burdens of companies based in other foreign jurisdictions is a difficult assessment that would depend in part on the design of the system and the manner in which those jurisdictions chose to react to the new U.S. approach.

¹⁹⁰ See Grubert and Altshuler (2006) at 35-36.

¹⁹¹ Grubert and Altshuler (2006) at 15; Kleinbard at 80; *see also* ABA Task Force at 735.

¹⁹² Grubert and Altshuler (2006) at 15, 35-36. Their calculation of the burden neutral rate was determined by leaving the taxation of domestic income unchanged. *Id.* at 36.

¹⁹³ *The Deferral of Income Earned Through U.S. Controlled Foreign Corporations: A Policy Study*, Office of Tax Policy, Department of the Treasury (December, 2000).

C. Structural Issues

1. Transfer pricing

A significant potential benefit of a full inclusion system is that the incentive to shift profits to a low-tax foreign jurisdiction would be eliminated or greatly reduced for many taxpayers. Accordingly, taxpayers to which full inclusion applied would no longer have an incentive to spend resources developing income-shifting strategies. Taxpayer compliance costs and IRS administration costs related to transfer pricing issues would be reduced significantly. IRS resources dedicated to auditing transfer pricing issues and to transfer pricing disputes could be redeployed, and the administration of section 482 might be simplified.

However, the incentive to engage in income-shifting would remain for taxpayers with excess foreign tax credits. Taxpayers with excess credits would have an incentive to earn low-taxed foreign income in order to “cross-credit” the excess credits against such income and thereby reduce their U.S. tax. Accordingly, some commentators believe it would be important under a full inclusion system to minimize the extent to which taxpayers find themselves in an excess credit position,¹⁹⁴ and have recommended mitigating this situation by eliminating the allocation of parent overhead expenses.¹⁹⁵ The opposite approach would be to limit the ability of taxpayers to cross-credit by strengthening the foreign tax credit limitation rules. In deciding whether to adopt one of these approaches, one consideration would be the effect of each approach on the competitiveness of U.S. based multinationals.¹⁹⁶

Transfer pricing disputes could still be expected to arise between taxing jurisdictions.¹⁹⁷ However, assuming a taxpayer could fully credit its foreign taxes, the taxpayer generally would be a disinterested party. Thus, depending on the details of the foreign tax credit limitation rules, a taxpayer generally could be expected to be a disinterested party, except in those cases involving a foreign jurisdiction with a materially greater tax rate.¹⁹⁸

The full inclusion system would not affect foreign taxpayers operating in the United States. Accordingly, those taxpayers would continue to have an incentive to engage in transfer pricing strategies.¹⁹⁹ However, the more limited scope of the transfer pricing issues in the

¹⁹⁴ See Grubert and Altshuler (2006) at 14-15, 34-35.

¹⁹⁵ *Id.* at 14. See the discussion *infra* regarding the foreign tax credit limitation.

¹⁹⁶ See the discussion *supra* on the competitiveness of U.S. businesses.

¹⁹⁷ Kleinbard at 79.

¹⁹⁸ *Id.*

¹⁹⁹ *Id.*

outbound context would permit the IRS to devote additional resources to policing inbound transfer pricing activity.²⁰⁰

2. Foreign tax credit issues

Under present law, the foreign tax credit is limited to a taxpayer's U.S. tax liability on its foreign-source taxable income. Although there is general agreement that a full inclusion system should retain this limitation, there is disagreement regarding how the limitation should be implemented.

Certain commentators believe that a full inclusion system should be accompanied by more stringent foreign tax credit limitation rules.²⁰¹ Specifically, they believe that the rules should be modified to restrict cross-crediting.²⁰²

On the other hand, as noted above, some proponents of a full inclusion system believe it is important to liberalize the foreign tax credit limitation rules in order to minimize the amount of excess foreign tax credits. Grubert and Altshuler, for example, recommend eliminating the allocation of overhead expenses (including interest expense) incurred by a U.S. parent corporation to foreign source income.²⁰³ While Grubert and Altshuler acknowledge that failure to allocate such expenses may "violate the rules of correct income measurement,"²⁰⁴ they believe that minimizing excess credits will promote the competitiveness of U.S. companies and is necessary to reduce the incentive to engage in income-shifting transactions.²⁰⁵ In addition, the elimination of U.S. parent expense allocation would result in simplification. Finally, to the extent taxpayers have excess foreign tax credits, foreign withholding taxes on dividends may act as a disincentive to repatriate foreign earnings, undermining one of the principal benefits of moving to a full inclusion system.²⁰⁶

²⁰⁰ *Id.*

²⁰¹ ABA Task Force at 734.

²⁰² *Id.*

²⁰³ Grubert and Altshuler (2006) at 14.

²⁰⁴ *Id.*

²⁰⁵ *Id.* See the discussion *supra* on transfer pricing. On the other hand, U.S. companies for which liberalization of the expense allocation rules results in additional foreign tax credit limitation could have an incentive to engage in transactions designed to produce additional foreign tax credits.

²⁰⁶ Using 2002 corporate tax files, Atshuler and Grubert calculated the amount of excess credits that could be expected to arise, assuming their estimated burden neutral tax rate of 28 percent rate and no allocation of parent overhead expenses. They determined that approximately 30 percent of foreign income would have excess credits (as compared to 50 percent in 2002). Additionally, they estimated that excess credits would be concentrated in the petroleum industry, and that only about 18 percent of foreign income earned by manufacturing companies would have excess credits. *Id.* at 36.

In evaluating the design of the foreign tax credit limitation rules, another consideration is that a taxpayer with excess foreign tax credit limitation (that is, a taxpayer that must pay U.S. income tax on its foreign earnings, because those earnings are subject to foreign tax at a less than 35 percent rate) often would be indifferent as to whether it paid current U.S. tax or paid current foreign tax and claimed a credit for the foreign tax against its U.S. tax. Thus, a U.S. taxpayer with excess foreign tax credit limitation might have little or no incentive to minimize its foreign tax. This raises a concern that the U.S. fisc might bear the cost of unnecessary foreign taxes. The foreign tax credit regulations attempt to address this concern by requiring a taxpayer to use its reasonable efforts to reduce its foreign tax liability (including by invoking the competent authority procedures).²⁰⁷ Because the regulations generally do not require a taxpayer to alter the form of its business or the form of any business transaction in order to minimize its foreign tax expense, the regulatory requirement (commonly referred to as the “compulsory payment rule”) is somewhat limited in its scope. Accordingly, under a full inclusion regime, certain taxpayers may reduce their efforts to design transactions and structures in a manner that minimizes their foreign tax burden.

The potential reactions of foreign governments complicate the issue. If a full inclusion system were designed such that U.S. taxpayers generally had excess foreign tax credit limitation, foreign governments could have an incentive to raise taxes on U.S. taxpayers, for example by increasing dividend withholding taxes.²⁰⁸ As long as a U.S. taxpayer could claim foreign tax credits for the additional taxes, an increase in the foreign tax rate would not harm the U.S. taxpayer and, thus, would not discourage U.S. investment in the foreign jurisdiction.²⁰⁹ Rather, the increase in the foreign tax rate would be borne by the U.S. fisc.

3. Treatment of foreign losses

Under present law, losses of a foreign subsidiary do not flow through to U.S. shareholders. However, in order to benefit currently from such losses, some taxpayers structure new investments, or restructure existing investments with accumulated losses, as branch operations of a U.S. corporation.

In designing a full inclusion regime, it would be necessary to determine whether to permit losses to flow through. Some argue that fairness and equity require that losses, as well as earnings, flow through to the U.S. shareholder. Allowing losses would also simplify entity choice issues, as it would remove the tax incentive to structure loss operations in branch or partnership form. On the other hand, domestic utilization of foreign losses would reduce tax revenues.

The three approaches described above differ in their treatment of losses. The consolidation approach would permit full flow-through of losses. The pass-through approach

²⁰⁷ Treas. Reg. sec. 1.901-2(e)(5).

²⁰⁸ Grubert and Altshuler (2006) at 35.

²⁰⁹ *Id.*

outlined above generally permits flow-through of losses, but would limit the amount of losses by a taxpayer's basis in its stock. The expanded subpart F approach, which would utilize the present-law deemed dividend rules, would not allow losses to flow through to U.S. shareholders. However, if it were determined that losses should flow through without limitation under a full inclusion system, the pass through and subpart F approaches outlined above could be modified to reach this result.

4. Application of full inclusion to minority shareholders

Adopting a full inclusion system would require a determination of the ownership threshold that triggers full inclusion. A "pure" full inclusion system would tax all U.S. shareholders of foreign corporations on a current basis irrespective of the amount of stock owned. This is the result achieved under the pass-through approach to full inclusion outlined above. However, the imposition of current taxation on minority shareholders creates complexity and disincentives for portfolio investment in foreign corporations. In addition, as the level of U.S. ownership declines below that of control, issues arise regarding the ability of the U.S. shareholders to obtain the information necessary to comply with a full inclusion system. Finally, current taxation of minority shareholders in a foreign corporation who do not have the ability to force a distribution from the foreign corporation could leave some shareholders in the position of owing U.S. tax without having the funds to pay the tax.

In part for these reasons, some commentators would limit current taxation to 10 percent shareholders. Others would limit current taxation to controlling shareholders.²¹⁰ In addition, in considering some of these difficulties, the ABA task force suggested limiting current taxation to those cases where U.S. shareholders in the aggregate own 25 percent or more of the foreign corporation and U.S. shareholders exceed non-U.S. shareholders from any other single country.

One alternative for minority shareholders would be to adopt rules similar to the present law rules for PFICs. Under such rules, the benefits of deferral would be eliminated through the use of an interest-charge system.²¹¹

Because the pass-through approach would treat U.S. shareholders as paying directly their share of a foreign corporation's foreign taxes, all U.S. corporate shareholders of a foreign corporation would be eligible to claim foreign tax credits for foreign income taxes paid by the foreign corporation. This would be an expansion of present law, which permits only 10 percent U.S. corporate shareholders of a foreign corporation to claim credits for foreign taxes paid by the foreign corporation.

5. Treatment of individuals

Another issue is whether full inclusion would apply to individuals as well as corporate shareholders. In making this determination, considerations may include the ownership threshold

²¹⁰ Kleinbard at 66.

²¹¹ *See, e.g.*, Peroni, Fleming and Shay at 512.

required to trigger full inclusion. If it were determined not to apply full inclusion to individuals, the PFIC rules could be retained to prevent abuse.

Under present law, individuals generally are not entitled to claim indirect credits for foreign corporations in which they own stock, even if the shareholder meets the requisite 10 percent ownership threshold required for corporate shareholders.²¹² This is consistent with the classical system of income taxation in the United States, which imposes income tax at both the corporate and individual levels. In contrast, an individual who is a partner in a foreign partnership is treated as if the individual paid the tax and is allowed to claim a direct credit for the tax.²¹³ Consistent with these principles, the pass-through approach would permit U.S. individuals to claim foreign tax credits for foreign taxes paid by foreign corporations while the consolidation and subpart F approaches outlined above would not. One consideration to take into account in determining whether an individual should be permitted to claim a credit under any full inclusion regime would be whether the individual is subject to the full inclusion rules, although as stated, U.S. individuals who are subject to subpart F under present law generally are not permitted to claim indirect foreign tax credits.

6. Simplification

A full inclusion system could be significantly simpler than present law. First, the detailed rules contained in subpart F for determining whether income constitutes subpart F income subject to current inclusion could be eliminated in their entirety.²¹⁴ Other provisions related to deferral and subpart F, such as sections 367, 956 and 1248, could also be eliminated or simplified. Second, the foreign tax credit rules could also be simplified. For example, depending on the design of the full inclusion system, the indirect credit rules in section 902 and 960 may be eliminated or simplified. Similarly, depending on the details of the full inclusion system, the expense allocation rules could be simplified. Third, depending on the foreign tax credit limitation rules and the extent to which taxpayers are in excess credit, a full inclusion system would reduce the incentive to engage in transactions (such as inter-affiliate payments) designed to strip income from high tax jurisdictions to low or no tax jurisdictions and, thus, could be expected to reduce the resources dedicated to such activities.

²¹² There is a limited exception for 10 percent U.S. shareholders of CFCs. Such shareholders may claim indirect credits if they elect to treat their CFC stock as if it were held through a domestic corporation. Sec. 962. Thus, the price for the indirect credit is the imposition of a U.S. corporate level tax.

²¹³ Sec. 901(b)(5).

²¹⁴ Peroni, Fleming, and Shay at 512.

7. Transition issues

Treatment of untaxed earnings

One of the principal transition issues that would be faced if full inclusion were adopted would be how to treat previously untaxed earnings attributable to periods prior to the effective date of the full inclusion regime. Options span from mandating a current, full inclusion of all untaxed earnings to permitting continued, elective deferral indefinitely.

The 1992 Rostenkowski - Gradison bill would have resolved this conflict by putting this choice to taxpayers. To do so, the bill predicated one of its beneficial features — the ability to elect inclusion of foreign subsidiaries in the domestic consolidated group for U.S. tax purposes²¹⁵ — on inclusion of all untaxed earnings in U.S. taxable income (albeit over a four-year period). As a practical matter, it was expected that few companies would have been willing to incur the cost necessary to obtain the benefits of this election.²¹⁶

Absent transition rules, implementing full inclusion based on adoption of a pass-through regime would result in current full inclusion of previously untaxed earnings.²¹⁷ This conclusion results from the existing rules that define the treatment of a change in status from corporate to partnership form. These rules view the corporation as first distributing its assets and liabilities to its shareholders in liquidation, followed by the contribution of those same assets and liabilities to the newly formed partnership.²¹⁸

²¹⁵ A material benefit of including a foreign subsidiary in the consolidated group was the elimination of intercompany transactions as realization events. For example, U.S. rules tax intercompany sales from a U.S. manufacturing affiliate to a related foreign distributor at the time of the sale. Within a consolidated group, this realization event would be deferred until the product left the group, based on a sale to an unrelated party. Paul W. Oosterhuis and Roseann M. Cutrone, *The Cost of Deferral's Repeal: If Done Properly, It Loses Billions*, 58 Tax Notes 765 (February 8, 1993) (hereinafter, Oosterhuis and Cutrone). In this respect, tax consolidation would match up with financial accounting consolidation, thereby mitigating the burden of book to tax reconciliations.

²¹⁶ Oosterhuis and Cutrone at 766.

²¹⁷ Peroni, Fleming, and Shay at 520.

²¹⁸ If the shareholder is a domestic company that owns at least 80 percent of the CFC, the liquidating distribution qualifies as a section 332 liquidation, provided that the 80 percent shareholder elects to include the CFC's "all earnings and profits" amount in its taxable income; otherwise, the transaction is treated as a disposal of the CFC at fair market value. In that case, section 1248 applies and the gain on the deemed disposition is recharacterized as a dividend to the extent of the earnings and profits of the CFC (*i.e.*, to the extent of its previously untaxed earnings). If the implicit gain on the deemed sale exceeds the CFC's untaxed earnings, then the excess will be treated as taxable gain on the shares. If the implicit gain on the deemed sale is less than CFC's untaxed earnings, then some untaxed earnings may escape U.S. taxation. Because all CFCs would be converted to partnership status, shielding the untaxed earnings of lower-tier CFCs (*i.e.*, second, third and lower-tier companies) would not be possible: there would be no first-tier corporate blockers left in place, and any untaxed earnings that move

Adopting full inclusion either through a consolidation regime or by expanding subpart F would not require transition rules to mitigate immediate inclusion of previously untaxed earnings. As a policy matter, however, it may be desirable to remove the repatriation disincentive with respect to previously untaxed earnings by requiring inclusion of those earnings, possibly over a period of years.

Treaties

Depending on the design of the system, including the operation of the foreign tax credit, adopting a full inclusion system may not require renegotiation of our income tax treaties. Current treaties reflect the existing foreign tax credit system, which would continue as the mechanism for mitigating international double taxation.

up in a non-taxable foreign-to-foreign liquidation would ultimately flow upstream in a foreign-to-domestic liquidation.